STUDIES AND REPORTS SERIES

Spain and the euro: risks and opportunities

Joaquim Muns (editor)

Susan M. Collins
Manuel Conthe
Juergen B. Donges
José Luis Feito
José Luis Oller-Ariño
Alfredo Pastor

Research Department

"la Caixa"
CAJA DE AHORROS Y PENSIONES DE BARCELONA

The euro is currently a subject of great interest and importance and will be even more so during the coming months and years. It is an even more significant challenge than the 1959 Stabilization Plan itself or the inclusion of Spain in the European Economic Community in 1986, events which, along with the oil crisis, have been most influential on the Spanish economy during the last forty years.

In order to make a more in-depth study of the risks and opportunities involved in Spain's inclusion in the euro project, professor Joaquim Muns, Senior Professor of International Economic Organisation at the University of Barcelona, accepted the task of editing this manuscript, comprising a series of articles by different authors, in which Professor Muns himself contributes an article which charts the progress of Economic and Monetary Union from the Werner Plan to the Stability Pact approved during the recent Dublin summit.

Susan M. Collins, Senior Fellow in Economic Studies at The Brookings Institution and Professor of Economics at Georgetown University, contributes a traditionally sceptical American view of the pursuit of monetary union between so many and such a variety of countries. Manuel Conthe, ex-Secretary of State for Economic Affairs and Member of the Board of Spanish Representatives to the European Community, analyses the advantages and risks of joining a single currency, recognising that the former are more numerous. Juergen B. Donges, Senior Professor of Economics at the University of Cologne and a Member of Chancellor Kohl's Council of Economic Experts, offers a quite sceptical view of the plans for a single currency, emphasising the difficulties which have arisen during fulfilment of the criteria for convergence. José Luis Feito, Ambassador in Chief of Spain's Permanent Delegation to the OECD, refutes the principal objections voiced against Spain's participation in the EMU. José Luis Oller-Ariño, Managing Director of MEFF, carries out a critical analysis of the conventional wisdom regarding monetary union and advocates an acceleration of structural reforms, so as not to aggravate the level of unemployment, and finally, Alfredo Pastor, ex-Secretary of State for Economic Affairs and professor of Economics at IESE, argues that, for Spain's inclusion to be a success, it would need, in addition to the required ability to adapt, to have a higher level of social cohesion and to develop an appropriate collective plan.

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FOREWORD

The euro has become a major topic which is bound to grow in importance in the course of coming months and years. It involves a more far-reaching challenge than even the 1959 Spanish Stabilization Plan or Spain's entry in the European Community in 1986, two events indeed which, along with the oil crisis, have had the greatest impact on the Spanish economy in the last forty years. What is at stake is not just the fact that on such or such date we will start using euros instead of pesetas, francs and deutschemarks but, more importantly, the new currency's urgent call for an economic policy of fiscal consolidation and structural reforms to ensure the necessary monetary stability.

In September of last year, within this same Studies and Reports Series, we published an informative survey of the single currency by Joan Elias, a European Integration professor at the University of Barcelona and member of "la Caixa" Research Department. It traced the long road toward European construction since the 1950s, while attempting – by compiling, organizing and making accessible the most up-to-date information available at the moment – to answer the most commonly raised questions about the single currency scheme. Further to the acclaim won by this paper, of which we have already published a revised and updated version, there were a number of other outstanding issues to consider, above all the consequences of monetary union, the significance of regional impacts, the feasibility of alternative adaptation mechanisms, lower interest rates, etc., all of which require further analysis of the subject.

With these matters in mind, we invited Dr. Joaquim Muns, professor of International Economic Organization, and tenured holder of the Jean Monnet European Integration chair at the University of Barcelona, to undertake the editorship and coordination of this monograph, made up of a number of articles by different experts. His own contribution charts the progress of the Economic and Monetary Union from the Werner Plan to the Stability Pact endorsed by the recent Dublin summit and looks into the main pros and cons of Spain's possible presence in the first group of countries to adopt the single currency.

Senior Fellow in Economics at Georgetown University, Dr. Susan M. Collins, voices some common American reservations about the pursuit of a monetary union by so many widely differing countries. Manuel Conthe, former Secretary of State for Economic Affairs and adviser to Spain's Delegation to the European Community, weighs up the advantages and risks of joining a single currency system, to conclude that the advantages tip the scales in their favour. Dr. Juergen B. Donges, professor of Economics at the University of Cologne and member of Chancellor Kohl's Council of Economic Experts, takes a rather dim view of the single currency project, pointing out the difficulties which have arisen over the race to meet the convergence demands. José L. Feito, Head Ambassador of Spain's Permanent Delegation to OECD rejects the main objections to Spain joining the EMU. Dr. José L. Oller-Ariño, Managing Director of MEFF, runs a critical eye over the conventional wisdom of monetary union and plumps for faster structural reforms to prevent the current unemployment situation from getting worse, and finally, Dr. Alfredo Pastor, former Secretary of State for Economic Affairs and IESE professor, warns that successful membership entails, apart from the necessary adaptability, a higher degree of social cohesion and the adoption of an appropriate project involving the broad community.

This book is the outcome of securing a number of contributions from a variety of sources. His hoped that the respective studies, arguments and views expressed herein will give the reader a helpful deeper insight into the advent of the euro and its foreseeable implications.

Josep M. Carrau
Director, Research Department

Barcelona, July 1997

I. From the Werner Plan to the euro, or the history of the long march toward European Monetary Union

Joaquim Muns

Dr. Joaquim Muns, director and editor of this work, is Senior Professor of International Economic Organization and holder of the Jean Monnet Professorship of European Integration at the University of Barcelona. He has also been a Member of the Board of the Bank of Spain since 1994. A specialist in international organizations and the international monetary system, Dr. Muns has been executive director of the International Monetary Fund (1978-80), the World Bank (1980-82) and a Member of the European Parliament (1987-89).

1. Background to European Monetary Union (EMU): the Werner Plan

At the European Summit in The Hague in 1969, the heads of state and government of the European Community (EC) agreed that they should prepare a plan for the creation, in stages, of the economic and monetary union of the EC. The impetus for this important initiative was provided by the success achieved in European integration throughout the 1960s, the favourable state of the international economy and the signs of weakness shown by the Bretton Woods system.

In October 1970, the Werner Report was presented. It had been drawn up by a working group chaired by Luxembourg's President and Minister for the Treasury. In 1971, on the basis of this report, a resolution was adopted regarding the completion of economic and monetary union in stages, a process which was to reach its conclusion in 1980, that is to say, the whole procedure for the completion of this plan would have to be developed within a period of ten years.

The international monetary problems of 1971-73 (which gave rise to the general flotation of the principal currencies) and the energy crisis of 1973-74 prevented this project from advancing according to the proposed plan. One of the effects of the crisis was that it exacerbated the divergence between the economic policies of the EC member countries in such a way that the events of the first half of the 1970s had a clearly centrifugal effect as regards any proposal for European integration in general and economic and monetary union in particular.

The next fundamental step in the direction of European economic and monetary union was taken by the European Council on December 5, 1978, at which the European Monetary System (EMS) was established, its aim being the «creation of an area of monetary stability in Europe». This resolution was followed by a decision taken by the Council of Ministers and the EMS began to operate in March 1979 in the legal form of an agreement between the participating central banks, which avoided the need for a new treaty or amendments to the Treaty of Rome.(1)

In spite of the fact that all the proposed objectives have not been achieved, and in spite of the crisis of 1992-93, there is a broad consensus that the EMS has been an experiment which has produced consolidation and had considerable success in various fundamental aspects. In particular, it has kept the participating currencies within an area of greater relative stability, which in turn has had beneficial effects on inter-community trade and, in general, on the economic activity of the participating countries.

(1) This is precisely the formula which, according to the statement from the Dublin Summit in December 1996, is being considered for the monetary relationship between the countries forming the EMU in January 1999 and those which remain outside it. For more details on this problem, including the so-called «ins» and «outs», see Section 4.

Furthermore, discipline in exchange rates has forced the convergence of rates of inflation which in turn have had to fall, swept along by the strong influence exerted on the system by German economic policy.

Equally important, or even more so, has been the habit of co-operation between the participating countries in order to establish compatible economic policies with the mechanism for fixed parities incorporated in the EMS. Without this initial learning period, it would today be unrealistic to consider the possibility of the kind of co-operation required in putting the process for economic and monetary union in Europe into practice. As a result, in spite of its problems and limitations, the EMS was a very useful instrument in reinforcing the process of integration in the European Community.

All of these advantages offered by the EMS were especially manifest up to 1987. From this moment on, the system stagnated and differences in productivity and inflation between the various economies did not translate into adjustments in exchange rates. The system ended in a profound crisis for the EMS in August 1993, to which we will refer in detail in Section 3.[2]

2. The Single Act and European financial integration

In 1985, the Commission proposed the creation of a European economic area without borders, which finally involved taking the Treaty of Rome to its ultimate conclusion. This objective was included in the Single European Act which came into force on July 1, 1987. This was the legal instrument which provided the European Community with all the legal competence necessary for the realization, on December 31, 1992, of a European market without internal borders, including the free movement of capital.

(2) For views on the EMS of a different scope and attitude, see De Grauwe (1994), Dyson (1994), Elias (1996), IMF (1990), Louis (1990), Panic (1992), Portes (1993), Steinherr (1994), Ypersele and Keoane (1988). For an interesting comparison of the Werner Plan and the Delors Plan, see García-Durán Huet (1993).

The impact of the latter on a system of fixed though adjustable exchange rates as imposed by the EMS is very important as it makes it practically impossible to pursue national economic policies, especially monetary policies, without their being closely co-ordinated with the policies of other member countries. In fact, within the framework of conditions imposed by the free movement of capital, there were three options for combining monetary and fiscal policies with the removal of barriers to the movement of capital under an exchange rate regime such as the one defined by the EMS.

The first was to maintain the status quo. In this case one could expect either a substantial increase in the amount of intervention by the monetary authorities in order to maintain stability of exchange rates or, more probably, substantial adjustments in interest rates. The second alternative was to broaden the fluctuation bands for the EMS currencies, which would weaken the disciplining effect that the system must and did have and give rise to use of the exchange rate as an instrument of monetary policy, contrary to what was actually desired. It was considered that either of these alternatives would have a significant disruptive effect on the operation of the EMS.

This leads to the need for a third alternative, consisting of the strengthening of the EMS mechanism and the co-ordination of economic policies, especially monetary policy. This alternative presents itself as the only form of achieving two objectives simultaneously: a) the reduction to an acceptable minimum of disruption caused by the movement of capital; and b) the compatibility of different national policies within an agreed global framework accepted by all the parties involved. In the context of total mobility of capital with a fixed exchange rate system, the room for manoeuvre enjoyed by a country belonging to the EMS is similar to that enjoyed by a small economy on a world scale. This small economy effectively loses its capacity to develop its own monetary policy, except where such policy fully complies with the parameters established by the market, especially as regards interest rates.

Something similar happened with the countries participating in the EMS from the moment that the total freedom of movement of capital began to operate. Economic co-operation is, therefore, not only a necessity for each of the countries involved, but also the most rational means for them to maximize their combined welfare. It was precisely this lack of co-operation in a financial atmosphere characterized by the freedom of movement of capital which was principally responsible for the EMS crisis in August 1993.

Technically, the co-ordination of economic policy, to which European financial integration must lead, can be carried out without the need to formally establish economic and monetary union. This being the case, and bearing in mind the law of taking the line of least resistance by which many human actions are guided, we can ask ourselves, having arrived at this point, why should we complicate the situation even before we have fully achieved the aims of the 1992 single market, with a new and ambitious project to achieve European economic and monetary union such as that contained in the Delors Report.

The answer is clearly political. Germany and France feel that they must take advantage of the current impetus to project the European Community towards the objective of political union for which economic and monetary union represents a necessary stepping-stone. But of course, there are also weighty economic reasons which sustain this ambitious plan though it is true to say that there is no technical reason which demands it.

The Delors Report deals superficially with the subject, indicating that economic and monetary union «is, in many ways, *a natural consequence* (the emphasis is our own) of the undertaking to create an internal market without borders», which must ensure «a significant increase in the welfare of the Community». There is no doubt that this basic premise is correct, although one could question as to what degree, because this depends on the ability of economic agents to react to the greater certainty, above all in exchange rates, presented by the new situation. As a result, although it is sustained by good economic reasons, the principal justification for taking the step from a financially integrated Europe to economic and monetary union is, in my opinion, political. I believe that the functionalist (also called idealist) philosophy, which has been the basis of European integration since the beginning, supports and gives meaning to this interpretation. J.L. Oller, in his contribution to this book discusses the political nature of the plan for European Monetary Union at length. Pastor, in his chapter, also emphasizes the political aspect of European integration and considers that the different pace of progress towards political union as compared to that of monetary union may be a destabilizing factor in the EU.

3. The Delors Report

At the Hannover Summit in June 1988, the heads of state and of government began to study a new plan to achieve economic and monetary union.(3) The commission charged with this task, led by the president of the European Commission, Jacques Delors, included all the governors of the central European banks and a group of independent experts. The report this commission drew up, known as the Delors Report, was made public in April 1989 and formed the initial basis for the long process which led to the proposals at Maastricht.(4)

The Delors Report considers that a monetary union is characterized by the fulfilment of three conditions:

– the certainty of full and irreversible convertibility of currencies;

(3) The Delors Report refers to Economic and Monetary Union, while this essay refers to European Monetary Union (EMU). These similar terms should not be confused because they involve two concepts which, although closely linked, have a different scope. According to the Delors Report, an economic union is made up of four elements; a) a single market of persons, goods, services and capital; b) the policy of competition and other measures intended to reinforce the mechanisms of the market; c) common policies aimed at structural change and regional development; and d) co-ordination of macroeconomic policies including compulsory rules regarding budgetary policy. For its part, a monetary union is characterized by the three elements mentioned in the following paragraph.
(4) See Committee for the Study of Economic and Monetary Union (1989). It is interesting to record that one of the independent experts, Miguel Boyer, currently sides with those who consider that the Maastricht Treaty, which is derived from the Delors Report, is harmful.

– complete liberalization of capital transactions and full integration of banking and financial markets; and

– elimination of fluctuation margins in exchange rates and establishment of irrevocable parities between currencies.

Within the European Community, the first two conditions should have been fulfilled by the Single Act, while the third is the one which involves the decisive qualitative change from the European single market to monetary union.

The first institutional reaction to the Delors Report came at the Madrid Summit in June 1989. The heads of state and of government came to an agreement on the following points:

– to accept the Delors Report;

– to begin the first stage of economic and monetary union on 1 July 1990, as proposed by the Delors Report; and

– to carry out preparatory work for the convening of an inter-governmental conference intended to define the following phases.

The second half of 1989 was notable for the events unfolding in Eastern Europe, especially in Germany. This fact, along with the differences between the United Kingdom and the majority of the other member countries of the Community, as well as the concentration of Germany's attention on its problems in the East, meant that the question of economic and monetary union lost the priority it had enjoyed.

Nevertheless, the plan for economic and monetary union continued to develop. Perhaps the most significant event of this period was the statement made by Jacques Delors at the beginning of December to the effect that each country would maintain control over its budgetary policy.(5) In

(5) *Financial Times*, December 2, 1989.

doing so, he took a step backwards from the proposals in his report as regards this question, these having been considered to be unnecessarily centralist. This also prepared the ground for a favourable reaction at the forthcoming Strasbourg Summit.

1990 opened with the idea, supported above all by France, Italy and the European Community Commission, that the best response to the new situation in Europe would be to accelerate the process of community integration. This philosophy and the French desire to neutralize the new Germany within a strong EC led to President Mitterrand and Chancellor Kohl proposing, in April 1990, the plan for political union of the EC which would progress parallel to the process of economic and monetary union.

From 1991 onwards, the problems in Germany and the inevitable greater realism which surfaced as negotiations progressed led to various decisions being taken during the course of 1991 which counteracted both the initial euphoria and the original proposals.

Among these, the following stand out:

a) The establishment of the European Central Bank (ECB) was postponed until the beginning of the third and final phase, instead of taking place during the second as had been previously agreed and recommended by the Delors Report.

b) At the beginning of the second stage, a European Monetary Institute would be created instead, its mission being to co-ordinate the monetary policy of all the EMS countries.

c) Entry to the third stage would be preceded by a «test» for convergence which all the countries aspiring to the union would have to pass with flying colours. This point deserves further and deeper discussion.

In fact, throughout the negotiations leading to Maastricht, there were two opposing points of view regarding the conditions for passing on to the third and final stage. On the one hand, Germany, the United Kingdom and the Netherlands maintained the position that convergence of the principal macro-dimensions should precede the entry of a country in the third phase. On the other hand, the EC Commission and the southern countries of the Community were of the opinion that this convergence should be the result of the introduction of economic and monetary union. That is to say, the two groups of countries saw the process in radically different ways.

The first position finally won the day. In fact, the consensus reached before the Maastricht Summit was as follows. In 1996, the EC Commission and the European Monetary Institute would inform the finance ministers regarding the state of convergence in relation to the following macro-dimensions: inflation, fiscal situation, interest rates and stability within the EMS, together with other elements which might be taken into consideration. The ministers, bearing these recommendations and the «political» aspect in mind, would nominate the countries which were, in their opinion, ready for entry to economic and monetary union in the final stage. In view of this, the Council of heads of state and of government would decide whether it was advisable to begin the third stage. For this to happen, it would be necessary to have a minimum number of aspiring states which qualified. No agreement was reached in this regard.

The United Kingdom insisted throughout 1991 that, although it might fulfil the conditions necessary to enter the final stage of economic and monetary union when the time came, it would not accept being forced to join. In order to deal with the general problem of the compulsory or voluntary nature of economic and monetary union, as illustrated by Britain’s position, the following consensus was reached in 1991: a) no single country could oppose the formation of an economic and monetary union by those countries which fulfilled the necessary conditions; b) no country which fulfilled the conditions for joining the third stage of economic and monetary union could be excluded; and c) no country could be obliged to form part of the third phase of economic and monetary union, even if it fulfilled the conditions.

As one can see, the plan for economic and monetary union which was agreed in stages during 1991 included increasing amounts of flexibility in order to accommodate the fears, reticence and aspirations of the different countries. This greater flexibility did not, however, go so far as to accept an economic and monetary union running at two speeds. This would have held connotations of failure for those countries which could not join the group which was better prepared. As a result, it was decided to consider that, when entry to the third and final phase was agreed upon, all countries would theoretically be included. Those which were in practice unable to join would be considered subject to a regime of «exception» for economic and monetary union, similar to Article XIV of the Articles of Agreement of the IMF.[6] As we shall see in the following section, the Maastricht Agreements broadly reflect all of these compromises reached during 1990 and 1991.

4. From Maastricht 1991 to Madrid 1995: a tortuous path

On December 9 and 10, 1991 there was a meeting of the European Council in Maastricht (Holland). This discussed and approved the text of the European Union Treaty which included economic, social and political questions. From the writer's point of view, the most important fact is that the European Union Treaty incorporates, in its references to European Monetary Union (EMU), all of the agreements which had been worked out during the period from 1989 to 1991. Three of these in particular stand out: a) the option that any country which wished to remain outside the EMU could do so (an option which was taken up by Great Britain and

(6) Although the terminology of a «two-speed Europe» was used extensively throughout 1990-91 (and even later), it became clear that it was politically unacceptable. From this came the solution of the possibility of «exception» which is an elegant and more technical way of saying the same thing.

Denmark), but they could not oppose (veto) the right of the remaining countries to continue with the project; b) access to the EMU would involve the need to meet several economic criteria, known as the convergence criteria; and c) monetary policy would become the exclusive territory of the European Central Bank which would be created during the third stage (instead of the second as proposed by the Delors Report), while policy regarding exchange rates would be the jurisdiction of the Council. Fiscal policy would be the responsibility of the individual States.

Approved in December 1991, the European Union Treaty was signed on 7 February 1992. Ratification by the respective parliaments was planned to take place throughout this same year, meaning that the Treaty would come into force on 1 January 1993. However, the ratification process was longer and more complicated than expected and it was not finally accomplished until November 1993.

The years 1992 and 1993 were complicated not only by the difficulties in ratifying the European Union Treaty but also by other circumstances which occurred at the same time: the problems in the EMS, the decision to widen the European Union (EU) and the beginning of a period of economic stagnation which aggravated the alarming level of unemployment already existing in Europe.

As regards the ratification process, the pitfalls which led to it becoming an extremely difficult task (to the extent that hope was at some points almost lost completely) were many and varied. The critical point was reached on June 2, 1992 when the Danes rejected the Treaty in a referendum. Given that the Treaty was to be ratified by all member countries without exception, the famous Danish «No» was a severe reversal for the hopes of progress towards the European Union Treaty. Although the political consequences of this rejection were able to be corrected through a new referendum, the June 2 result detonated the serious crisis in the EMS which lasted for the best part of 1992-93.

At the Edinburgh Summit in December 1992, the Danish «No» vote was overcome by granting the country the capacity not to form part of both the EMU and the military structure of the EU, nor would it be part of the plan for European citizenship. With these concessions, the Danes held a second referendum in May 1993, which this time produced a favourable result. Meanwhile, in September 1992, the French, who had also been called to a referendum on the subject of the Treaty on European Union, approved it by a very small majority.

The ratification process was extremely laborious in the United Kingdom, where prime minister John Major had to confront an alliance of the opposition Labour party with the «Euro-sceptical» wing of his own party, encouraged by, amongst others, Margaret Thatcher. Following intense debate in the House of Commons, Major was able to obtain the majority which allowed him to ratify the Treaty on European Union. Ironically, Germany became the last country to ratify the Treaty in September 1993. The reason for this was that the constitutional character of the Treaty had been submitted for the consideration of the German Constitutional Court with the claim that the removal of the mark and its replacement by another currency might go against the fundamental laws of the country. The Court agreed to a degree with the plaintiffs in making judgment that the disappearance of the mark would eventually have to be approved by the German Parliament.

Without doubt the most serious problem to affect the EU during 1992-93 was the serious upsets suffered by the EMS. I have already mentioned the negative result of the first Danish referendum as the event which set off the problem but the causes are, in reality, much deeper. On the one hand, the central exchange rates within the system had not been modified since 1987, so that the adjustments (up to eleven were made) which from 1979 to 1987 had served to compensate for the different pace of price increases were not made from 1988 onwards.

Against this background of stagnation of the adjustment mechanisms, German reunification occurred, producing a very significant budgetary impact, as well as accelerating the country's domestic demand. The Bundesbank, sticking to its monetary orthodoxy, substantially increased interest rates to 8.75% on 16 July 1992, which contributed to the strengthening of the German mark against the remaining EMS currencies. In order to maintain the fluctuation bands allowed by the exchange rate mechanism of the EMS, the other countries, which were in a clearly downward phase in the cycle, also had to raise their interest rates, instead of lowering them as the economic situation which they were suffering at the time would have dictated.

While the markets trusted in the possibility that the Treaty on European Union would be approved and that EMU would become a reality, they did not act against the lack of economic logic which permeated the EMS. But when the Danes rejected the European Union Treaty in June 1992, the markets revised their predictions and began a strong attack against the pound sterling, the lira, the peseta and the French franc. After heavy losses of reserves, the first two of these currencies were forced to abandon the exchange rate mechanism of the EMS in September of that year, at the same time as the peseta was devalued by 5% in relation to its central exchange rate. The French franc was able to resist the assault thanks to the almost unlimited support it received from the Bundesbank.

In reality, these first attacks threw into sharp relief the disagreement between the member countries as regards protecting the exchange rate mechanism of the EMS. This encouraged the markets which moved to attack other currencies such as the Irish pound and the Danish crown, while continuing their siege of the peseta and the French franc. In February 1993, the Irish pound was devalued by 10%. For its part, the peseta was devalued twice: 6% in November 1992 and 8% in May 1993. On both occasions, the Portuguese escudo followed the peseta's fortunes, being devalued by 6% and 6.5% respectively.

All these operations provided enormous profits for the markets. In summer 1993, the latter launched an important attack on the French franc. The resistance of the French against devaluation, mainly for prestige reasons, and that of the Germans against revaluation, for reasons of competitiveness, led to a cul-de-sac situation. The solution had to come from an urgent meeting of Finance ministers and governors of the central banks during the last weekend in August 1993. Faced with a lack of agreement over moving the central levels of the key currencies (the French franc and the mark),(7) there was no option but to allow the introduction of wider fluctuation bands of ±15% for the currencies in the exchange rate mechanism of the EMS. The agreement came into force on September 2, 1993.

It is clear that maintenance of the EMS exchange rate mechanism was achieved at great cost.(8) It had been an important element for the European Communities and later was the keystone on which EMU was to be built. It is not strange therefore that disappointment spread and a phase of «Euro-pessimism» began, which in effect lasted until the spring of 1995, when the Commission began the serious design of the first blueprints for achieving the single currency. The inability of the EU economies to come out of recession and the consequent problems of increasing unemployment, with the notable exception of the United Kingdom, contributed to this feeling of pessimism.

The unemployment question was the subject of special treatment. It was, and unfortunately continues to be, Europe's biggest problem. It was feared that this would weaken the different economies and the popular support for the EMU. Under the direction of the president of the Commission, Jacques Delors, a white paper was drawn up by the Commission in 1993

(7) For a detailed account of the Franco-German disagreement, see the *Financial Times*, December 23, 1993, page 4.
(8) It was the perception of this cost which led six of the world's most renowned economists (Blanchard, Dornbusch, Fisher, Modigliani, Samuelson and Solow) to write a letter to the *Financial Times*, published on July 29, 1993 with the eloquent title «Why the EMS deserves a rapid burial».

which was presented at the Brussels Summit held in December of that year. The document's recommendations were received with scepticism and its plan for large infrastructures at a European level, directed at fomenting the creation of employment, was never put into practice. At the end of 1993, Jacques Delors himself assessed the first stage of EMU and characterized it as «a failure».(9)

In 1994 the economic situation improved and this began to infuse the various governments with more hope as regards EMU. Faced with the proximity of the first assessment (1996) and the low level of fulfilment of the convergence criteria among EU member countries, Germany and France launched the idea of an EMU based on a hard core of which both countries would form part. That is to say, they looked for a political solution to a problem which at that time seemed insoluble from the economic perspective. This concept of a «two-speed» Europe, or that of «variable geometry» advocated by the British as a variation on the former idea, had to be abandoned in the face of the violent opposition it met within the EU.(10)

These sterile discussions were carried out in an atmosphere of growing scepticism among the European public. A poll carried out in December 1994 indicated the lowest level of support for the EMU plan both in Britain and, more surprisingly, in Germany. Nevertheless, 1994 was not a completely wasted year as it saw the finalization of negotiations for the entry of Austria, Finland and Sweden as new members from January 1, 1995. It is worth mentioning that another extremely positive factor in 1994 was the creation, on January 1 of that year, of the European Monetary Institute, which began to radiate a constructive momentum and an air of rigour against the background of the then prevailing atmosphere of scepticism. The seriousness of its work was important in order for the different governments to feel that they had the support of an efficient body which was less politicized than the EU Commission.

(9) *Financial Times*, December 9, 1993.
(10) See Note 6 regarding this point.

Once the troubles in the EMS had been overcome and the different options proposed during 1994 had been set aside, there was no alternative but to either abandon plans for EMU or finally propose a scheme for its introduction. As if the increase to 15 members had given it a new lease of life, the EU opted for the latter. In April 1995, the Commission presented its «Green paper on the methods of transition to the single currency». In November of the same year, the European Monetary Institute published its view of the same issue in its report «The process of change to the single currency», which coincided to a great extent with the Commission's document.

These strategies were the basis for the decision taken by the European Council in Madrid in December 1995. This confirmed the strong desire to move the process for EMU forward and resulted in a name for the new currency, the euro, along with a timetable for its introduction, the details of which can be seen in the table below.

Without doubt, the Madrid Summit marked the turning point from pessimism to optimism regarding the future of EMU. Although some voices can still be heard in favour of delaying the dates, confidence in the plan has prevailed and the markets, the decisive brokers in all of these matters, have come out in favour of EMU and the euro during the course of 1996. But clearing away the unknown elements in a process does not mean eliminating the problems which may arise. For this reason, 1996 has been the year in which the merits and difficulties of EMU have been debated, along with the advantages and disadvantages for Spain of associating itself with this project. These are the two subjects I will deal with in the remainder of this essay.

Timetable for the third phase of EMU

PREPARATORY PERIOD

Starting date:	Already begun.
Objectives:	Adoption of a plan and timetable for the introduction of the single currency (Madrid 1995). Decision regarding the name of the single currency (Madrid 1995). Definition of the regulatory, organizational and logistical framework for the third phase (Dublin 1996 in some areas). Preparation of legislation and operational regulations of the European Central Bank and the European Central Bank System. Supervision of convergence plans for the different economies and fulfilment of convergence criteria. Definition of the relationship between participants and non-participants (Dublin 1996).

FIRST PERIOD

Starting date:	As soon as possible in 1998.
Objectives:	Decision regarding participating member States. Adoption of the legislative measures necessary to initiate the third phase. Beginning of minting of euros (Notes and coins). Preparation of measures relating to the conduct of monetary policy with the single currency. Preparations by economic sectors, especially the financial sector.
Institutions:	Creation of the Central European Bank. Creation of the European Central Bank System. Closing down of the European Monetary Institute.

SECOND PERIOD	
Starting date:	January 1, 1999.
Objectives:	Irreversible fixing of exchange rates. The euro becomes a currency *per se* and the ecu-basket ceases to exist. Legislation relating to the euro comes into force. Monetary policy conducted only in euros. Use of the euro as unit of accounting by the central banks. Issue of national public debt in euros. Pact for Stability and Growth comes into force.
THIRD PERIOD	
Starting date:	January 1, 2002 at the latest.
Objectives:	Euro notes and coins enter into circulation and national currencies withdrawn. National notes and coins cease to be legal tender. All monetary assets converted into euros.
End of process:	June 30, 2002 at the latest, although it is foreseeable that the exchange of local currency for euros will last longer.

5. Major topics of European Monetary Union

There is no doubt that EMU is a great challenge for the European Union and it involves the achievement of a series of goals which, in some form or another, become advantages in relation to the current situation. The problem is the nature of these advantages which are often generic and almost always diffuse, making them difficult to measure in any way other than arbitrarily.(11)

Nevertheless, it is possible to say that the EMU, with its central bank and single currency, and with its centralized monetary policy which is also the sole policy for the whole of the Union, represents, as I indicated in the second section of this work, the formula which most clearly and permanently ensures economic co-operation in the context of total freedom of movement of capital. Furthermore, the existence of a single currency implies the possibility of creating a truly single financial market, instead of its fragmentation into as many national markets as there are member countries, in spite of the freedom of circulation of capital referred to above.

The literature on this subject has referred to the great advantages that may exist in having a strong euro, especially for those countries which currently have a weak currency. The euro's exchange rates should not involve exchange rate premiums such as those resulting from the exchange uncertainties currently existing among the group's different currencies. The result of all this, according to this view, would be lower interest rates leading to greater investment and thus, a greater capacity for growth. In addition, business, another important source of growth for the EU, would be stimulated by the removal of uncertainty as regards the major European currencies.

This argument, accurate from a general point of view, is subject to certain qualifications. Firstly, the euro will exist alongside other important

(11) An in-depth analysis of the advantages of EMU can be found in the Commission's study, *One Market, One Money*. A more balanced view of the subject can be found in Viñals (1994b).

currencies: the dollar and the yen. As a result, it may continue to incur, as a single currency, a significant risk premium if the markets believe or perceive it to be a weak currency. This point, to which I referred earlier, is of the utmost importance for the future of EMU and it depends more on how the euro is conceived than on its existence per se.

As regards the subject of a greater future level of growth generated by EMU and its possible positive impact on employment, the general perception of the majority of authors is that, although the existence of EMU and the euro may be positive factors, the problems of lack of sustained growth and general unemployment in Europe are not given to simple solutions. They are the result of serious structural problems which EMU cannot solve on its own. On the contrary, as we will see at a later point in this section, it may end up becoming their victim.(12)

The literature dealing with EMU has also made favourable mention of the argument regarding the reduction of the cost of financial transactions resulting from the existence of one sole currency instead of many. That is to say, the economy would not only enjoy lower interest rates as I have stated earlier (although with the qualification indicated) but it would also incur lower transaction costs (or none at all) in cases where these had resulted from the conversion of one currency into another. The literature has favoured the example, as anecdotal as it is absurd, of a person going on a trip through 10 countries in the EU who loses more than half his money purely in exchange commissions.(13)

This argument also deserves various qualifications because it is clearly static and simplistic. Firstly, less cost to the general public would also mean less income for the banks and other institutions dedicated to currency exchange and other related operations. If these lower costs are absorbed through greater productivity or cost cutting in other items, the

(12) As regards the specific question of the impact of EMU on employment, see Viñals and Gimeno (1996). Their conclusions follow the view indicated in this text.
(13) This example is found in the Commission document (1990a), page 66.

net result for those affected could be positive. But if the companies in question regain their lost income by increasing the cost of all or some income items, the final result could be much less advantageous. In any case, it is to be hoped that the greater competition caused by EMU in the financial sector will make it difficult for these losses in income to be translated into an increase in costs in other areas.

The second important qualification to be made is that, against this savings (on the basis that there will eventually be net savings), one must place the costs resulting from the change to a single currency, which in most cases will be incurred at the onset. The problem is that a global and rigorous evaluation of these costs has not been made at EU level, among other reasons because of the enormous difficulty in calculating the extent of the costs involved. However, from the estimates which are available from the different sectors, it is clear that the initial costs of conversion are high, especially for the banking sector, and for this very reason it is highly probable that in the first years of EMU, the combined costs associated with conversion will exceed the advantage of the savings in transaction costs.

These qualifications do not in any way mean that EMU cannot and should not bring important advantages. The basic principle is that, as in all types of integration, these advantages surface more in the medium to long term, when the so-called dynamic effect takes place, rather than in the short term. In the short term the costs resulting from the impact of the change could be very high. On the other hand, as has been firmly established in the literature on the subject, the operation of the dynamic effect in a positive sense depends more on the attitude of the economic agents than on any aprioristic assessment. As a result, although there may be benefits in EMU, these must be gained on a day-to-day basis, to put it simply. They will not occur automatically and, furthermore, one must bear in mind the initial costs which are inevitable and of considerable magnitude.

Against the medium and long-term advantages of EMU, one must consider the problems to be overcome during the course of progress towards this objective. For the observer, it is clear that, for the time being, it is much more important to overcome the obstacles which lie in the way of eventual success, than to spend time calculating future advantages. In reality, we should not be surprised by this lack of symmetry between the problems and advantages of EMU, because, as the process moves forward and until its conclusion, it will be necessary to overcome endless difficulties which, for the moment, are the matter attracting attention. Although, as we have seen, a timetable for the introduction of the euro has been drawn up, which would imply the existence of the political will to continue along the planned course, one would be naive to ignore the problems which it will be necessary to overcome for EMU to become an effective reality on January 1, 1999. In the remainder of this section, we will discuss the most obvious problems and difficulties regarding the achievement of EMU and its being able to function and be viable once established.

Along the way, two obstacles, among many others, are vital to the success of the project: the way in which the convergence criteria are applied and the relationship which is established between the countries making up the EMU in the first wave and those which, of their own choice or as a result of their not fulfilling the criteria required, remain on the outside.

As regards the matter of the convergence criteria, what we might call their «philosophical» development has been extremely interesting and complex. When they were agreed upon in 1991 and later incorporated in the Treaty on European Union, the presumption made by the Germans, who were the champions of the criteria, was that these would be a group of measures which ensured the financial strength of the EMU. For its part, Germany regarded them from a position of comfortable fulfilment and, as such, with a strong moral right to demand that other countries fulfil them. Of course, it is true that some voices were heard claiming that the definition of the so-called convergence criteria only included financial variables, to the exclusion of others of great importance and from the domain of the real economy such as productivity, unemployment, etc. But these objections were rejected because what was sought was that the countries joining the EMU would not create monetary and financial instability, rather than any intention for them to be competitive. The German point of view regarding this and other aspects of EMU is to a great extent reflected in Professor Donges's essay included in this book. In this sense, more emphasis is given to the aspect of an area of «monetary stability», sought by the Germans for the EU, than to that of growth.

With the passage of time and the progressive weakening of the economic situation in the majority of EU countries, expectations of fulfilling the convergence criteria have worsened, even for Germany itself which no longer fulfils the public deficit criterion. Faced with this new situation and now that the first proposed date (January 1, 1997) has been dismissed, for the precise reason that it was clear that there would not be a majority of countries fulfilling the Treaty on European Union criteria, the greater or lesser degree of strictness with which these criteria should be interpreted in the selection process to be carried out in 1998 has come to the forefront.

The facts seem to tilt the balance in favour of a «flexible» interpretation of the convergence criteria. On the one hand, this is permitted by the Treaty on European Union itself. Secondly, Germany and France may have difficulties in fulfilling the criteria relating to fiscal deficit and public debt. Thirdly, the countries excluded *in pectore*, such as Italy and Spain, are making considerable efforts to fulfil the Maastricht criteria which it would be politically and economically inadvisable to discourage. Finally, let us not forget that the selection of countries by the council will be made by a qualified majority, which would tend to lead to agreements being reached to make the criteria more flexible rather than the reverse.

Naturally, this apparent tendency towards a flexible interpretation carries the serious danger that it will result in a weak euro. For this reason, the German government proposed a Stability Pact at the end of 1995 in order to guarantee budgetary discipline beyond the selection date, in view of the conviction that a deficit of 3% is excessive as a medium-term guide and can only be accepted as a maximum level during periods of recession. The purpose of this Pact is to demonstrate a degree of strictness to the markets, in the event that countries with a history of rather dubious discipline might join the EMU thanks to heroic efforts made at the last moment.

An agreement in principle was reached regarding the Stability Pact at the Dublin Summit in December 1996. This was not easy, as Germany was demanding automatic rules in order to define exceptional situations, while the other countries, with the exception of the Netherlands which supported the German position, preferred a more flexible interpretation. It would therefore seem that Germany has, through the Stability Pact, succeeded in recovering at least some of the rigour which appeared to be disappearing due to the way in which the convergence criteria will certainly end up being applied.(14)

The second important obstacle to which I referred earlier is that of the relationship between the countries which are to be selected and those which remain on the outside of the EMU. These are known as the «ins» and the «outs» in the current EMU terminology. The extent of this problem will ultimately depend on the number and importance of the countries which remain excluded, but some people consider that the United Kingdom and Italy are certain candidates for this position. The countries forming the core

(14) The principles of the Pact for Stability and Growth (this last word was added as a concession to France which asked for its inclusion in the title in order to sweeten its effect) are transactions which considerably ease the strictness which Germany had demanded, without actually removing it. A public deficit of more than 3% of GDP will only be permitted when GDP has shown a fall of greater than 2% in the course of one year. If the fall is between 2% and 0.75%, the application of sanctions will be discretional. Finally, in the event of a fall of less than 0.75%, the application of the relevant fine will be automatic. The supposed precision of these criteria and the mixture of automatic and discretional measures may be difficult to administer in practice.

of the euro are concerned that if a relationship is not established between their currencies and the currencies of the «outs», the latter may take advantage of the situation and make competitive devaluations. As a result, it is suggested that the euro and these other currencies remain linked by an EMS II, the nature of which was outlined by the European Council meeting at Dublin in December 1996. Fundamentally, it was decided that a new exchange rate mechanism would be established (ERM2), based on the central exchange rates of the currencies remaining outside EMU in relation to the euro. Although it did not specify the levels, the press communiqué stated that «the normal fluctuation band will be relatively wide, as it is currently» that is to say, probably a band of ±15%. As regards other matters, a system of co-operation and supervision was put forward, the details of which are still to be established and may still lead to difficult negotiations, as some of the countries on the side of the «outs», such as the United Kingdom and Denmark, are rejecting the decisive role of the European Central Bank in the new exchange rate mechanism (ERM2).

The problems involved in arriving at EMU have many other facets – legal, institutional, etc. In all of these fields, work is being accelerated to make sure that insurmountable obstacles do not arise at any point. But in addition to what we might call problems in the transit toward EMU, several authors have raised various fundamental questions regarding its viability, that is to say, the possibility of the EMU's proper operation once it is introduced. Of these I feel there are two problems which stand out from all the others: the fact that the EU does not constitute an optimum currency area and the difficulty of reconciling a single and centralized monetary policy with a budgetary policy carried out at the domestic level by each of the member countries, that is to say, decentralized. I shall refer to these problems in the following paragraphs.

Many authors, especially from North America, have placed great emphasis on the fact that the EU does not have the necessary capacity to stand up to so-called asymmetric shocks which occur within a monetary union, that is to say, shocks which affect one or various countries but not the remainder. According to these authors, in order to overcome these unfavourable situations without using the exchange rates as a compensating element for the loss of competitiveness, it would be necessary for one or both of the following circumstances to occur – the emigration of labour from the depressed areas to the prosperous ones and an increase in financial transfers from the central or federal government to the depressed areas. These are the phenomena which typically occur in the United States when some individual states or areas are in crisis.

In Europe, these compensating movements of labour cannot be expected for cultural reasons, and those relating to funds cannot be expected because of the reduced size of the total EU budget. The only solution would therefore be to have labour legislation which is sufficiently flexible to allow for adjustment through a fall in real earnings. As this possibility does not exist either, the authors making these observations conclude that the only mechanism which remains in practice is that of an increase in unemployment in the depressed areas. This leads to their pessimism regarding the capacity of the people to accept this situation and their scepticism regarding the viability of EMU in the medium and long term. The final conclusion would be that it is premature for the countries of the EU to abandon the exchange rate mechanism.[15] In this book, in a very considered fashion, professor Collins agrees with the scepticism shown in North American academic circles regarding the viability of EMU. The question which one should ask is why the majority of European academics are in favour of EMU when they and their North American counterparts have been educated using the same texts and ultimately share the same economic principles.

These criticisms, which I understand to be very serious, can be countered by two arguments. Firstly, the low probability of asymmetric

(15) There is no doubt that the majority of the most renowned North American economists have objections to the EMU which range from the serious to the absolute. Some characteristic examples can be found in Feldstein (1992), Krugman (1993) and Dornbusch (1996). The majority of MIT Nobel laureates (see note 8) also have a negative view of the EMS and EMU.

shocks in an area as integrated and homogeneous, not to mention relatively small, as the EU. Secondly, there is the fact that the different governments will continue to have the capacity for budgetary compensation at a national level. It can also be claimed that to remain outside of the EMU would also be no solution to the problem, because a devaluation in conditions of fixed salaries would not ensure the recovery of competitiveness. Furthermore, *ad hoc* remedies can be expected within the EU, as has been demonstrated by the bovine spongiform encephalopathy or «mad cow» problem in the United Kingdom which was solved by the award of special funds. A subject on which those who defend maintaining the competence over exchange rates agree with those who do not consider it necessary is that it is unavoidable to have more flexible labour legislation in Europe. This is not only to deal with the problem of asymmetric shocks but, in general, to make significant progress regarding Europe's greatest problem which is that of unemployment.

The question of the compatibility of a single monetary policy for the whole of the EU with separate budgetary policies is quite serious. In the Delors Report, this question was resolved with an appeal to member countries for a policy which would result in the «definition of the overall stance of fiscal policy over the medium term, including the size and financing of the aggregate budgetary balance». Faced with resistance from countries against losing control over the only policy they had left, that relating to budgets, the Commission began to retreat on this subject in 1989, as we saw in the second section of this essay. In place of the «combined aggregate», a process relating to excessive deficits was incorporated in the European Union Treaty, in such a way that individual supervision replaced the idea of a combined aggregate budget for the whole of the EU.

With the Stability Pact, the Germans wanted to reinforce budgetary supervision in the event that the rules contained in the Maastricht Treaty were not sufficient. In reality, an efficient monetary policy for the maintenance of price stability, such as the European Central Bank will have to observe, is only compatible with a budget deficit in the EC which does not exceed the aggregate limit defined by the level of demand required by the stance of monetary policy. Having abandoned the aim of setting global figures, the only effective policy is that of a rigorous supervision of the budgetary policy of the different member countries within the Stability Pact. Another possible alternative for some experts is that of eventually transferring greater budgetary resources to the EU,[16] but this possibility seems remote at the moment.

As a whole, all of these obstacles, although serious, do not seem insurmountable. Nevertheless, a great effort of political will is required in order to overcome them and two courses of action which currently seem difficult will probably become inevitable – the reinforcement of the co-ordination of macroeconomic policies with an acceptance of greater supervision by the central bodies of the EU and a higher budget volume for the EU, the level of which currently runs at little more than 1% of its combined GDP. This is a proportion which is clearly insufficient to be able to take any effective action in the field of stabilizing policies which, whether we like it or not, may be unavoidable in order to maintain the viability of the EMU.

6. Spain and European Monetary Union

The debate on the effects of EMU for the Spanish economy has, in reality, been neither intense nor profound, except in academic circles. Amongst the latter, the proximity of the dates for the selection of the countries which will form the first group, and the fact that Spain has indicated its desire to be among the founding members of the EMU, have given rise to a debate in which the majority of authors are clearly in favour of the option that Spain form part of the EMU. In this respect, they consider

(16) For example, Masson (1996).

that the advantages vastly outweigh the disadvantages and they dismiss most of the latter. As a result, the academic debate is not so much between those who are in favour and those who are against Spain joining the EMU. It is rather an enthusiastic and self-satisfied exercise, with very few exceptions, in support of one theory – the one which comes out in favour.

This unanimity should not come as a surprise. In Spain, everything which relates to European integration has connotations which go much further than an in-depth economic debate. These involve the country's historic moving into line with Europe, which only a generation ago seemed inaccessible both politically and economically. As a result, the inclusion of Spain in all aspects of European integration, including EMU, is seen as a great historical opportunity to abandon an era of backwardness and obscurantism. Clearly, to oppose Spain's entry in the EMU (as once happened with the Common Market) is to be reactionary in many eyes. This important factor clearly influences any debate which may arise on this subject.

A similar observation can be made from the political point of view. Spain is the only country in the European Union in which entry to the EU was agreed upon unanimously by all of the political parties, without a single vote against. A similar thing is currently happening as regards EMU, except that Izquierda Unida (the Communist Party) has indicated its rejection of the Maastricht Agreements. This is one dissident voice within an extremely broad framework of political agreement in favour of Spain's being a founding member of the EMU.

As regards public opinion, one can detect a certain detachment from this subject. There has not been a systematic campaign of information to help the average citizen progress from the «anecdotal» phase of the peseta being changed for some unknown currency called the euro. The sacrifices associated with the fulfilment of the convergence criteria are awakening unfavourable reactions within some union groups which, nevertheless, are not in any way reaching the levels of vehemence found in other countries, such as France. We could say that, for the moment, the average person is a spectator who understands little and has few opinions on the subject.

Within this general framework which is not very inducive to lively discussion, we will review the principal arguments for and against Spain's entry in the EMU. To a certain extent, we will have to touch on some of the points discussed in the previous section. This is inevitable to the extent that the pros and cons of EMU exist not as abstract ideas but in relation to the countries which they affect. For this reason we will have, in some cases, to re-examine an argument which has been discussed earlier, but from the point of view of a specific country, in this case Spain.

Beginning with the advantages of joining the EMU, we find three main areas of argument – the political, economic and institutional. The first area places the emphasis, as mentioned in other parts of this essay, on the fact that EMU and the Maastricht Treaty itself are no more than a step on the ladder leading to political union. According to this viewpoint, to break away from the EMU would be to abandon the process towards the final objective which has permeated through right from the beginning of European integration. According to this argument, it would be very wrong for Spain to adopt an attitude like that of Britain which is only interested in the economic aspects of European integration. Spain will only really take a step forward into the future if it accepts all the implications involved in efforts to integrate Europe. From the point of view of our troubled political past and the inability of this country to regenerate itself, in spite of the laudable efforts made in recent years, there is no doubt that the political argument in favour of EMU carries very significant weight.

The economic arguments, in a way, reiterate the advantages referred to in the previous section. Emphasis is laid on the reduction of transaction costs, lower rates of interest and the reduced level of uncertainty regarding exchange rates as the positive elements which the Spanish economy would enjoy on joining the EMU. Emphasis is also given to the fact, again favourable, that Spain would be fully integrated in a broad financial market, with great potential from the point of view of opportunity, both for its financial institutions and the public in general. The fact that Spain could have a strong currency like the German mark is also considered to be an important achievement.

These arguments, which, in general, are indisputable must be viewed in terms of some important qualifications. Firstly, I have already indicated in the previous section that the reduction in costs would go through a first phase in which the balance between these reductions and the costs arising from transformation is uncertain. As regards the strength of the euro, I have already said that this would depend on the rigour imposed during all of the initial stages, as well as on the effective operation of the Stability Pact.

Another important economic advantage, related not only to membership of the EMU but also to the actual effort made to achieve it, is that of the rigour of macroeconomic policies and the responsibility of the social agents which this important step requires. This is made more important when one considers that Spain does not have a solid tradition of economic policies and social behavior based on rigour and responsibility. History seems to show without doubt that external stimuli have always been more effective in improving our policies and attitudes than our internal capacity for achieving this on our own. EMU would therefore, from one point of view, be a disciplining element which we cannot allow ourselves the luxury of turning down.

This line of argument is closely linked with the one classified as institutional in the initial list of advantages for Spain's joining the EMU. In fact, those defending the country's entry in the EMU are conscious of the fact that important changes have to be made to our economy, especially in the liberalization of the goods and services markets, in order to take part in the EMU with even the slightest guarantee of success. But at the same time, those who put this argument forward consider that these changes can only be achieved through the stimulus resulting from belonging to a group like the EMU, which does not allow any alternative but to carry out all the reforms which are absolutely necessary in order to follow the pace set by the more competitive countries in the EMU. Again, this argument would seem to place greater confidence in external stimuli than in our own internal capacity to modify policies and attitudes.

The disadvantages related to Spain's entry in the EMU acquire many subtle shades and variations but they can in fact be summarized in two general statements. The first is that Spain, given its economic development and structure, cannot get rid of the exchange rate as an instrument of economic policy. The second, closely related to the first, holds that Spain is not prepared for this fundamental challenge and that this would therefore involve a substantial increase in levels of unemployment. In effect, all other arguments against Spain's joining the EMU are variations or derivations of these two. The essays by Conthe and Feito in this book make a full analysis of the disadvantages that are claimed regarding Spain's membership of the EMU and the reasons which should lead to this being rejected.

The first argument is in fact the most important and certainly the most serious. It is undeniably true that, on examining Spain's economic history since the war, this country has been less competitive than its commercial partners and has had to carry out periodic devaluations in order to recover lost competitiveness. It is also true that the economy has reacted very favourably to these devaluations. However, it is equally clear that it has had to recover a competitiveness which it had previously lost through a combination of unwise expansionist policies and a lack of moderation on the part of the unions.

As a result, these devaluations have done nothing more than correct more profound mistakes which should not have been made. Furthermore, for nominal reductions in the exchange rate to become devaluations in the real exchange rate, it is necessary to have economic policies of containment and attitudes of moderation. The problem in Spain is that, in the medium term, the absence of this support has eroded the competitiveness gained by devaluation and the process has come round full circle. In short, devaluation is a temporary and short-lived solution for the problems of competitiveness suffered by the Spanish economy.

From this point of view, to abandon the exchange rate is effectively, for the Spanish economy, to cut itself free from a support with which it has clearly gone a long way but which it can no longer rely on. This is because, among other reasons, exchange rate policy, in the current circumstances, is not in the hands of the Spanish authorities in the way which those who fear the loss of control over this instrument for economic policy would have us believe. In reality, membership of the exchange rate mechanism of the EMS combined with the actions of the markets have turned exchange rate policy into a much less independent variable than it might seem at first sight. Under the current circumstances, the exchange rate of a currency like the peseta is more the result of market reaction to economic policy carried out than the consequence of a sovereign and independent decision made by the economic authorities.

As regards Spain's insufficient level of preparation to face up to the challenge of EMU and the single currency, it is clear, as has been demonstrated throughout this essay, that there are important problems in the Spanish economy which still separate us from the levels of efficiency and productivity shown by the more advanced countries in the European Union. But, on the basis of this type of argument, we would neither have joined the Common Market nor later the EMS. Although one may accept that in both cases it might have been possible to improve Spain's initial position to a substantial degree, there is no doubt that both challenges have fundamentally turned out to be a powerful incentive for progress in the Spanish economy.

Naturally, joining a monetary union is more complex and involves more risk than the two steps mentioned above, but the problem in fact always ends up being the same, that of having incentives which allow us to break free of our limitations. In order to achieve this we must take risks. The key question would be if, in our current circumstances, these risks are disproportionate or difficult to accept. The reply is that they are not, but always provided that arrival at the gate of the EMU is not reached in the position of an exhausted athlete who has spent all his or her energy on an excessive and concentrated last-minute effort to qualify, but as one who has done careful mental preparation for what will be a long and difficult race – EMU.

Spain cannot be sure of finding a solution to its problems outside the EMU. In this respect it lacks historical and geographical distance in relation to the EU as well as self-discipline. Furthermore, unless unforseen events occur at the last minute, it is certain that sooner or later all of the EU countries will end up by joining the EMU however little success it may have. It would also be incorrect, however, to think that the EMU will automatically solve all our problems. For this reason, all of the authors who favour Spain's entry in the EMU finally admit that this will be beneficial in practice if this country introduces the structural reforms which are now due, especially as regards the labour market. If it is not capable of progressing in a decisive way down the path of reform, the benefits brought by Spain's entry in the EMU become much more arguable and, in the best of cases, an act of faith.

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II. The Political Economy of Sustaining Monetary Integration: A Perspective on the EMU

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1. Introduction

According to the 1992 Maastricht Treaty, European Monetary Union (EMU) is scheduled to begin on January 1, 1999. While it remains unclear precisely what form such a monetary union would take, the train appears to be proceeding steadfastly down the track towards initiation of EMU as scheduled. Key European political and business leaders have signed on to this timetable and are undertaking requisite preparations. Notably, the Italian lira has just (November 1996) re-entered the exchange rate mechanism (ERM), after pulling out in the midst of financial market turmoil in September 1992.

This is not to say that derailment is impossible. Central features of the system remain unspecified. Which of the 15 members of the European Union would constitute the initial EMU will not be decided until early 1998. Other unsettled issues include how the European Central Bank would govern the common monetary policy and manage the common currency (the euro), which countries would be linked with EMU for subsequent membership, and what rules, if any, would govern the links between these currencies and the euro. In many countries, major fiscal adjustments are still required in the midst of already high unemployment and slow growth. Significant factions of the private sector in various countries seem to be clamoring for the train to slow or stop -- at least long enough to let them off. A recent opinion poll found that only 21% of German respondents support initiating an EMU in 1999.[1] Thus, difficult junctures ahead could quite conceivably cause a temporary detour, or even a derailment.

EMU raises a host of interesting and important issues and it is not surprising that a large and rapidly growing literature analyzing these issues has emerged. This literature encompasses a wide range of approaches and perspectives, including theoretical analyses, econometric studies and examinations of the political economy of further European integration. This paper cannot hope to do justice to the many views that are now on the table. Instead, its objective is to provide a «thought-piece» that is meant to be somewhat provocative. It develops a perspective that is sceptical of the short to medium-run prospects for EMU, based on concerns about the sustainability of further monetary integration. It suggests a research focus that highlights issues which have to date received relatively little attention, and discusses some existing work in this area along the way.

Increasingly, economists writing about the advisability of EMU seem to come down in favor of currency union. To simplify their perspectives somewhat, one might say that there have been a growing number of EMU «converts.»

(1) *The Economist*, November 30, 1996 (p. 45).

At least two rationales have been advanced for this conversion. The first is based on an assessment of net economic benefits.[2] On the benefits side, various studies have examined the implications of reduced transactions costs resulting from the elimination of the need for currency conversion and reduced uncertainty associated with exchange rate movements (which may reduce risk premia, and thereby real interest rates, and may spur investment and trade flows). Some have also suggested that a currency union would strengthen price stability and facilitate the emergence of a European international reserve currency. However, the welfare effects of these developments are difficult to quantify. On the cost side, analyses have focused on the implications of foregoing the ability to change exchange rates. As discussed further in the body of the paper, this may lead to more difficult and prolongued adjustments to certain types of shocks. Analyses have also explored the alternative mechanisms to facilitate adjustment. While some argue that an EMU is desirable on strict economic grounds (see for example Viñals), most of the «converts» develop a rationale that integrates political with economic considerations.

A second rationale is based on a relative assessment of the political and economic desirability of alternative exchange arrangements in the aftermath of the financial market turmoil since 1992.[3] Gros (1996) argues that concern about asymmetric shocks is less important that the systemic problem of financial market instability in a world with full capital mobility and potentially large changes in expectations about EU member's policies. Similarly, Eichengreen (1996) argues that, in a world with capital mobility, it has become much more difficult to maintain stable intra-EU exchange rates without an EMU. Both develop the view that significant exchange rate fluctuations may be politically undesirable. Thus, if flexible exchange rates are inconsistent with the existing degree of political integration among EU members, and intermediate regimes are difficult to maintain with high capital

(2) See Viñals (1994) and Commission of the European Communities (1990) for discussions of the economic costs and benefits of currency union.
(3) See CEPR (1996), Gros (1996) and Eichengreen (1996) for different explanations of this rationale for an EMU.

mobility, this perspective concludes that a currency union is the preferred long-run solution. (Eichengreen is careful to point out that he does not see monetary union as essential and to note that in virtually all historical experiences, political unification has preceded monetary unification.) However, it is not obvious why this comparison of difficulties with alternative exchange rate regimes should be taken to imply that an EMU would be sustainable in the current political and economic environment.

Others, including myself, remain more sceptical of the prospects for EMU. My perspective focuses on the potential difficulties for sustaining further monetary integration in a Europe with distinct national states and national identities. Given the mis-match between national political constituencies and cross-national monetary policy, a large, unanticipated «shock» could erode public support for a currency union and force its collapse. This is not to say that I am predicting a crisis and a currency union collapse. Nor do I have conclusive evidence about the degree of political commitment to maintaining a currency union. Recalling the many economists who expected the European Monetary System (EMS) to be unworkable in 1979 but were proclaiming it a major success some eight years later suggests that a degree of humility is appropriate for any predictions about the prospects for EMU. Instead, the point is that existing discussions may focus too much on expected or long-run outcomes, and overlook the need to develop contingency plans for coping with such a crisis were one to emerge.

The remainder of this paper is composed of four sections. Section 2 summarizes recent work that applies the literature on optimal currency areas to the EMU. It focuses on the relative importance of asymmetric shocks, and on the existence of alternative adjustment mechanisms. The section also describes what I see as key omissions from this literature in the context of European monetary integration. Sections 3 and 4 explore these omissions. Section 3 presents some evidence that giving up the ability to adjust the exchange rate may indeed be very costly in the face of certain types of shocks. Section 4 presents some new empirical evidence that is relevant for the political sustainability of EMU. This work suggests that national (not cross-national) political attachment of European voters may make a common monetary policy difficult to sustain in the face of disparate economic performance of member countries. Section 5 contains concluding remarks.

2. Optimal exchange regime choice

There is an extensive theoretical literature that studies the optimal choice of an exchange rate regime for an open economy. Much of this work asks which type of exchange regime will best stabilize domestic output and employment in the face of different kinds of shocks. A central conclusion is that the optimal regime will depend on the nature and magnitude of the relevant shocks and on the structure of the economy.[4]

Some of the most interesting work on exchange regime choice focuses on the optimal degree of intervention in the foreign exchange market. In this context, no intervention implies a freely floating rate, and «full» intervention implies a fixed rate. This approach incorporates the whole spectrum in between, including the «pegged-but-adjustable» regime (which best characterizes the ERM during most of its operation) as well as various managed floats. These analyses tend to find that intermediate options are preferable -- a result that is not surprising given that countries are actually buffeted by different types of shocks over a medium-run horizon.

A variety of studies have applied the theory of optimal currency areas to assess the desirability of establishing a European Monetary Union. The underlying objective is to provide some metric of how costly it would be for potential members of an EMU to give up the ability to realign their exchange

(4) For example, see Flood (1979), Melvin (1985) and Collins (1996).

rates. Thus, much of this work compares characteristics of European countries with those of regions in the United States -- a union with similar overall size and development level to the EU but with a common currency. (Of course, there are also many differences between the two unions including their fiscal systems, and language and cultural diversities.) One set of these studies asks whether European regions (where region refers to countries) suffer relatively more than U.S. regions from region-specific shocks. A second set of studies examines the availability of alternative mechanisms to facilitate adjustment and/or to cope with regional disparities in the two unions. It is useful to review the main findings of this literature.

2.1. The importance of regional shocks

Do asymmetric regional shocks account for a significant share of output variation in Europe? If so, giving up the ability to adjust exchange rates will likely be quite costly. However, if most of the output variation is attributable to industry or aggregate level shocks, exchange rate adjustment would do relatively little to facilitate adjustment. A series of papers have studied this question. Bayoumi and Eichengreen (1993) find that aggregate output shocks are substantially less correlated among European countries than they are among U.S. regions. This result suggests that maintaining a common currency would be more costly for the EU than it has been for the U.S. However, work by Bini-Smaghi and Vori (1992) and others has contested this view based on analyses of industry level data. They conclude that industry-specific shocks account for most of the explained output variation in both the EU and the U.S. These analyses are based on a subset of industries in the manufacturing sectors of each union.

Bayoumi and Prasad (1996) have revisited the question, using a more comprehensive data set that includes (1-digit) industry level data for eight sectors, including manufacturing. They decompose output deviations into a regional component (that affects all industries within a given region), an industry component (that affects a given industry across all regions) and an aggregate component (that affects all industries and regions simultaneously). The unexplained variation from their regression includes the residual variation that is industry/region specific.[5]

Their main results are reproduced in Table 1. They find that industry, regional and aggregate dummy variables are able to explain significantly more of the total output variation for the U.S. than for the EU. However, the decomposition of the explained output variation (see the numbers given in parentheses) is very similar for the two unions. Aggregate shocks are most important in both cases, accounting for somewhat more than a third of the total. Industry-specific shocks account for roughly a third of the total, and region-specific shocks account for slightly less than a third of the total in both cases. Although regional shocks account for a higher percentage of the explained variation in Europe (31% versus 26%), they contribute a smaller amount to overall R-squared (0.16 versus 0.19) These aggregate results mask considerable diversity across industries and country/regions. In particular, the U.K. stands out with almost no output variation attributable to union-wide or industry level shocks, and almost all attributable to country specific shocks.

Table 1

DECOMPOSITION OF SHORT-TERM OUTPUT FLUCTUATIONS

	Explained variation (R^2) due to various shocks				Unexplained variation
	Total	Aggregate	Industry	Country/Region	
European countries	0.52 (100%)	0.19 (37%)	0.18 (35%)	0.16 (31%)	0.48
United States	0.73 (100%)	0.29 (40%)	0.25 (34%)	0.19 (26%)	0.27

Notes: Figures in parentheses are % of explained variation. See text for explanation.
Source: Bayoumi, Tamim and Eswar Prasad (1996), «Currency, Unions, Economic Fluctuations, and Adjustment: Some New Empirical Evidence», IMF Working Paper (WP/96/81), August 1996 (table 3, p. 11).

(5) The methodology controls for industry/region fixed effects. The sample periods are 1971-87 for the EU and 1972-89 for the U.S.

These results do not support the view that region-specific shocks are significantly more important for potential EMU members than they have been in the U.S. Based on this most recent empirical analysis, it does not appear that the nature of shocks facing European countries overall points to significant difficulties with maintaining a currency union.

2.2. Alternative adjustment mechanisms – mobility and redistribution

However, as many analysts have stressed, the United States appears to have alternative mechanisms in place that help to mitigate the effects of those regional shocks that do occur. These alternatives arguably facilitate maintenance of a common currency in the U.S. Again, following the optimal currency area literature, the focus has been on the degree of inter-regional labor mobility and on the extent of cross-regional redistribution.

Movement of workers from a region with high unemployment to regions with relatively strong labor demand is a potentially important means for adjusting to region-specific shocks. Indeed, a well-known study by Blanchard and Katz (1992) finds that, for the U.S., most of the adjustment to a shock that lowers employment in one state/region occurs through movement of labor to other regions. Analyses of labor mobility in Europe reach strikingly different conclusions. Decressin and Fatas (1995) find that instead of labor mobility, most of the short-term adjustment to adverse employment shocks appears to occur through changes in rates of labor force participation. The analysis by Bayoumi and Prasad (1996) also finds evidence strongly supporting the conclusion that labor market integration across national boundaries in Europe is relatively low compared with significant cross-regional labor market integration in the U.S. It is worth noting that the lack of inter-regional labor mobility in Europe (both across and within countries) has remained, despite very high and persistent levels of unemployment in many regions.

Second, an extensive federal system of cross-regional taxes and transfers cushions the effect of an adverse shock to a particular U.S. region. The EU has a much smaller cross-national fiscal system in place -- and significant expansion of the existing system appears unlikely. The comparison presented by Sala-i-Martin and Sachs (1992) makes the point very starkly. They conclude that, through the automatic stabilizers in the U.S. federal system, a region that suffers a $1.00 decline in its per capita income would enjoy a $0.34 reduction in federal taxes plus a $0.06 increase in federal transfers, implying a total offset of some 40% of the initial shock. In contrast, they find that the EU's very small cross-national fiscal system would imply that a country suffering from the same $1.00 reduction in its per capita income would receive net relief amounting to only $0.005. However, Bayoumi and Masson (1995) conclude that Canada, another common currency area, exhibits substantially less cross-regional redistribution in response to adverse shocks. The U.S. may not be the appropriate benchmark.

Overall, analyses of the availability of alternative adjustment mechanisms imply that, even if the U.S. and the EU are similar in terms of the importance of regional shocks, there may be substantial differences in their abilities to adjust to these shocks in the absence of exchange rate adjustments.

2.3. Omissions from standard optimal currency area analysis

While interesting and informative, this now relatively standard approach to the analysis of optimal currency areas omits some considerations that are critical for an assessment of the prospects for -- and sustainability of – monetary union in Europe. These omissions are the focus of the remainder of the paper.

A first omission is that these analyses focus on *average* experiences of countries. The approach is to look at the types and sizes of shocks countries faced over some recent time period. This enables the analyst to assess whether a given country's shocks were primarily of one sort or another, and whether countries that are considering common currencies suffer primarily from country-specific shocks, versus aggregate or industry-specific shocks. The presumption is that the average experience during this reference period provides a forecast of the likely shocks that will arrive in the future.

But fixed exchange rate regimes are most likely to fall apart in the face of a particularly large, unanticipated shock. The typical experiences, that policy makers have grown used to coping with, are not usually what precipitates a crisis. Thus, an exchange rate regime that may be very sensible and defensible given «business-as-usual» may collapse when confronted with the unexpected. The history of the EMS supports this view, as illustrated by the two examples outlined below.

One example comes from the experience in the early years of the EMS.(6) When the ERM was initiated in March, 1979, member countries initially seemed committed to follow similar monetary policies, which would be consistent with maintaining fixed exchange rates. However, they did not anticipate the large oil price increase that came at the end of 1979. While the oil shock had roughly comparable implications for ERM members, which were all oil importers, member governments did not choose to respond in similar ways. In particular, Germany opted for maintaining relatively tight macroeconomic policies, with an eye towards keeping inflation from rising as it had in the aftermath of the 1973 oil price shock. In stark contrast, France opted for a more expansionary fiscal and monetary policy aimed at mitigating unemployment consequences of the shock. Not surprisingly, the sharp disparity in these two policy responses was inconsistent with maintaining fixed exchange rates. This policy gap was arguably the primary factor that precipitated the series of large ERM realignments during 1980-83, and threatened to end the fledgling exchange rate regime.

(6) For further discussion of this period, see Sachs and Wyplosz (1986).

A second example, discussed further below, comes from the unification of East and West Germany, beginning in 1990.[7] Unification entailed a significant fiscal expansion in Germany that pushed up German interest rates. After 1987, the ERM had evolved into a regime where realignments were to be staunchly avoided. Further, the elimination of capital controls opened the door to potentially massive amounts of exchange market speculation. Thus, maintaining the fixed ERM parities required tight monetary policies in Italy, the U.K. and other members, increasing their domestic interest rates as well. Most analysts have concluded that German unification was the large, unanticipated shock that precipitated the exchange rate crises of 1992 and 1993, in which Italy and the U.K. pulled their currencies out of the system, and bands were widened significantly for countries that continued to participate.

Some argue that the 1992-93 experience shows that a common currency is now the «best» solution for an economically integrated Europe with no capital controls, because a regime with fixed but adjustable exchange rates is too vulnerable to extremely disruptive financial market turmoil.[8] It is true that an irrevocably fixed exchange rate would avoid such circumstances. However, this observation does not imply that an interim situation is sustainable. In particular, it does not imply that a Europe with national political constituencies will be able to maintain adequate political support within member nations for fixed exchange rates during a multi-year intermediate period in which national currencies circulate alongside a proposed common currency (the «euro»). Indeed, the recent experiences in Italy and the U.K. are likely to be very fresh in the minds of voters throughout the EU. These countries pulled out of the ERM and allowed substantial depreciations of their currencies. These exchange rate adjustments have been associated with notably stronger economic growth and export performance than that exhibited by European economies that kept their currencies from adjusting.

(7) A large number of analysts have studied the implication of German unification for the EMS. See for example Eichengreen and Wyplosz (1995).
(8) For example, see CEPR (1996) and especially Gros (1996).

This raises the second difficulty with the literature on optimal exchange rate regimes. It omits a range of broader non-economic issues that are arguably critical for choosing and maintaining a fixed rate regime. Of particular concern in the present context is the mis-match between national political systems and a cross-national monetary policy. If political integration is to come to Europe, it is clearly on a very different time-table from EMU, as currently envisioned. Thus, EMU would need to be sustained in an environment in which policy makers in each member are (democratically) selected by the public in that member country. A key issue that arises in this context is whether voters in each region are concerned about performance in the union overall (which I will call exhibiting «social cohesion»), or only about performance in their specific region. This issue is explored further below, again in the context of comparing the EU with the U.S.

To recap, one omission of the optimal exchange regime literature is that it ignores the importance of outliers -- large, unanticipated shocks to specific regions. Thus, it fails to address questions such as: what are the characteristics of a shock that is most likely to cause the collapse of a fixed rate regime, and how likely are such shocks to occur? Furthermore, the standard approach to studying optimal currency areas does not incorporate potential difficulties that may arise if policy makers are beholden to national constituency, which may care little about developments in other parts of the union. The next sections focus on these two considerations. Section III asks whether countries with fixed exchange rates can have significantly greater problems in adjusting to shocks than those with more flexible exchange rates -- or the ability to realign. Section 4 provides some preliminary evidence on the extent of social cohesion in Europe.

3. Fixed exchange rates and adjustment difficulties: some evidence

As discussed above, there are some shocks which would cause much more difficult adjustments -- bigger and more sustained output declines – under fixed than flexible exchange rates. How relevant are such shocks in practice? Are there good reasons to expect that if European countries give up the ability to realign their exchange rates one or more may be hit by shocks that are significantly more difficult to adjust to under fixed exchange rates? This is a difficult question to answer conclusively, because we cannot forecast tomorrow's shocks and because there are no natural experiments to compare a country's adjustment to a given shock under alternative exchange regimes. However, recent work is quite indicative. These studies either empirically analyze how different economies have responded to disturbances over time or simulate macroeconomic performance under different regimes in response to shocks.

A study by Bayoumi and Taylor (1995) provides one interesting set of results. It empirically distinguishes between supply and demand shocks and studies the implication of each type of shock on macroeconomic[(9)] performance for eight industrial countries during 1973-1990. The sample includes four countries that were members of the ERM during the 1980s (1979:3 to 1990:9) – maintaining bilateral exchange rates vis a vis other members within narrow bands – as well as four non-members. Performance before the ERM was in operation is compared with performance under the ERM. This enables the authors to contrast responses of ERM members and non-members during a given period and also to contrast responses of ERM members before and after they limited their exchange rate adjustment. In interpreting these results, it is important to recall that the ERM did not imply irrevocably fixed exchange rates. The system was realigned repeatedly during the period of analysis. Also, the analysis maintains the assumption of no other structural changes between the 1970s and the 1980s, which may bias the results by attributing to the exchange regime change differences in responses to shocks that were actually due to other factors.

(9) They use the methodology developed by Blanchard and Quah that breaks down disturbances into supply and demand shocks. A key identifying assumption is that supply shocks are assumed to have a permanent affect on output while demand shocks are not.

Table 2 reproduces the Bayoumi and Taylor results on the responses of output and prices to supply shocks for both groups of countries in the same time periods. It shows how much of the long-run response had been confirmed within the first twelve months after the shock. It shows that, on average, the four ERM countries (Germany, France, the Netherlands and Italy) had adjusted by 89% of the their total long-run adjustment within the first year during the 1970s when they maintained flexible exchange rates, compared with just 47% of the long-run adjustment within the first year during the period in which exchange rates were constrained by the ERM. During the 1970s, both groups of countries appeared to have similar rates of first year adjustment, but there are marked differences during the 1980s. For the non-ERM countries as a group, the table shows that there was little change in the amount of output or price adjustment to supply shocks that occurred within the first year. In contrast, the figures show a sharp decline in the amount of adjustment within the first year for ERM members. Although not reported in the table, the authors reach a similar conclusion regarding the speed of adjustment of prices to demand shocks among ERM members versus non-members. Interestingly, they do *not* find evidence that ERM membership has led to an increase in the correlation of shocks hitting members.

Table 2

SPEED OF ADJUSTMENT TO SUPPLY SHOCKS

	Output response		Price response	
	1970s	1980s	1970s	1980s
ERM average	0.89	0.47	0.94	0.32
Non-ERM average	0.82	0.80	0.82	0.80

Notes: Figures are the ratio of the impulse response after twelve months to the long-run impulse response. The 1970s sample is 1973:1 - 1978:12 while the 1980s period is 1979:3 - 1990:9. Averages are arithmetic means. ERM countries are Germany, France, the Netherlands and Italy. Non-ERM countries are Canada, the U.K., the U.S., and Japan.
Source: Tamim Bayoumi and Mark Taylor, «Macroeconomic Shocks, the ERM and Tri-Polarity», *Review of Economics and Statistics,* May 1995 (table 3, p. 17).

Another approach to comparing adjustment to shocks under different exchange regimes uses the results from macroeconomic simulation models.

An advantage to this approach is that it enables the analyst to keep everything except the exchange rate arrangement the same for alternative scenarios.

McKibbin (1990) has used a multi-country computable simulation model (the MSG2) to examine the implications of the 1991 German unification for European countries. This exercise is conducted both under the assumption that ERM countries maintained fixed exchange rates and under the assumption that exchange rates were realigned. The experiment is a particularly interesting one to consider because German unification is widely believed to have been the «shock» that led to the 1992-93 turmoil in the ERM. A major component of the «shock» was that West Germany substantially increased government expenditure to help finance transition in the former East Germany. This spending was not matched by an increase in revenue collection.

McKibbin examines the implications of a large, permanent fiscal expansion in West Germany. Table 3 shows the behavior of key variables in the first five years after unification, measured as deviations from baseline performance in the absence of unification. Consider first the effects assuming no ERM realignment as shown in the left panel. The debt financed fiscal expansion pushes up German interest rates, causing a capital inflow, an appreciation of Germany's exchange rate and an offsetting deterioration of the trade balance. After an initial decline in German output, (due in part to the real appreciation), Germany enjoys an output boom. While there were global ramifications of these developments, the countries most affected are the other members of the ERM (treated here as a group) which peg their exchange rates to the German deutschemark. They too experience rising interest rates and a real appreciation of their exchange rates. But without a domestic fiscal expansion, these lead to sharply lower output, especially during the first two years following unification. Like Germany, however, the exchange rate appreciation helps to lower inflation.

The right-hand panel of the table shows the strikingly different performance of the rest of the ERM if these countries are able to devalue

Table 3

ANTICIPATED GERMAN FISCAL EXPANSION

	A. Without Realignment			B. With Realignment		
	Year 1	Year 2	Years 3-5	Year 1	Year 2	Years 3-5
Germany						
GDP	–0.82	1.11	0.99	–1.04	1.20	1.05
Net exports	–1.37	–2.99	–2.65	–1.81	–3.40	–3.06
Inflation	–1.15	–0.29	–0.04	–1.54	–0.25	0.04
Real exchange rate	6.76	8.81	6.82	5.86	8.14	6.35
Rest of ERM						
GDP	–2.04	–1.43	–0.63	0.01	–0.52	–0.20
Net exports	–0.30	–0.08	0.28	0.94	0.90	1.12
Inflation	–1.84	–1.49	–0.14	0.36	–0.54	0.07
Real exchange rate	6.08	6.46	3.87	–1.09	0.98	–0.88

Note: This table reports results using the MSG2 multicountry model. The policy experiment is a German fiscal expansion of 1.7 percent of GDP in year 1 and 3.3 percent of GDP from year 2 onwards. All variables are expressed as deviations from an initial baseline path. Net exports are reported as deviations from baseline in percent of baseline GDP. Inflation is reported as deviations in percentage points relative to baseline. A positive value for exchange rates indicates a real appreciation. Years 3-5 indicate average outcomes during that period.
Source: McKibbin, Warwick J. (1990), «Some Global Macroeconomic Implications of German Unification», *Brookings Discussion Papers in International Economics*, no. 81, May, pp. 14-17.

their exchange rates relative to the deutschemark. In particular, the simulations show that they avoid the large, sustained real appreciation as well as the sharp, persistent decline in domestic GDP.

Both the analysis by Bayoumi and Taylor and the analysis by McKibbin support the view that fixed exchange rates can seriously compromise a government's ability to smooth domestic economic performance. In this sense, there is a cost to maintaining fixed exchange rates -- at least in the face of certain types of adverse shocks.

4. Political sustainability of EMU

A key issue underlying this discussion is the «political sustainability» of an integrated monetary policy. Will residents of EMU member countries continue to support membership, even if economic performance in their own country deteriorates -- especially if it deteriorates relative to performance in other parts of the union? Alternatively, will they advocate pulling out, to regain some monetary policy autonomy, hoping to «jump-start» their economy through exchange rate adjustment?

Interestingly, voters within individual industrial countries do not appear to penalize their policy makers when the local economy performs poorly. Their voting behavior is much more closely tied to performance of the overall national economy. One interpretation of this finding has been that it provides evidence of «social-cohesion» within nation-states. If residents of EMU member countries are similar, in the sense that they care not only about the regional (national) economy but also about performance in the overall union more broadly, they may also tolerate relatively poor regional (national) performance while continuing to support the union -- as long as the union performs well overall. To explore these issues, this section summarizes relevant work on voting and economic performance. It then extends some of my previous empirical work (Collins, 1995) that relates attitudes towards membership in the European Community and economic performance. I argue that the results can be interpreted as an indicator of the extent of «social cohesion» across key European countries, with implications for the sustainability of a common currency and monetary policy in the event of a large adverse shock.

4.1. Voting and economic performance

Both economists and political scientists have examined the effects of economic performance on voting behavior and the popularity of elected officials in industrial countries. The literature includes a theoretical analysis of links between economic performance and voting behavior in addition to the empirical studies discussed below.[10]

(10) For recent studies that include reviews of the literature linking economic performance and voter behavior, see Fiorina (1991), Lewis-Beck and Rice (1992), and Peltzman (1992) and Collins (1995).

Analysts consistently find that economic performance is an important determinant of voting behavior. For example, Lewis-Beck (1988) finds that inflation and unemployment are important determinants of voting intentions at the federal level in Britain, Spain, Germany, France and Italy. Interestingly, he finds no evidence that these variables matter asymmetrically. Policy makers are «rewarded» for strong performance as well as «punished» for poor performance.[11]

Of particular relevance in the present context is the wealth of evidence for industrial countries that voters tend to care substantially more about aggregate national economic performance than about regional performance or personal well-being. Lewis-Beck (1988) has also addressed this issue at the federal level. He finds that, controlling for national economic performance, an individual's personal financial situation has no impact on vote intention in any of the European countries he considers. A number of analysts have found similar results using U.S. data, for various levels of office, and using different indicators of «local» economic performance. Campbell (1992) and Peltzman (1992) respectively find that national GDP growth matters nearly four times as much and more than seven times as much as state GDP growth in explaining the popular presidential vote by state.

However, determinants of voting for a national executive are less relevant for our purposes than determinants of voting for regional policy makers and/or for representatives to national policy making bodies. Currently, there is no clear analogue for such a «union» executive, such as a «president» or «prime minister» of either the European Monetary System or some type of G-7 «union» such as the exchange rate target zone systems that have been proposed. On the other hand, there are clear parallels (as well as important differences) between federal executives in EMS member countries and U.S. state governors and/or senators. There is strong evidence that voters in the

(11) The political systems in many European countries make study of these issues somewhat more complex than empirical study for the U.S. Lewis-Beck's (1988) approach is to examine determinants of individual's intentions to vote for the ruling party (Britain), ruling party coalition (Germany) or central opposition party (Italy and Spain) using data from surveys of individuals.

U.S. do not penalize senators, governors and other elected state incumbents for poor economic performance by their state. At the gubernatorial level, Chubb (1988) finds that national economic performance matters more that four times as much as state performance. In both gubernatorial and state legislature elections, it is primarily the president and national policies that are held accountable for poor state performance. Similarly, Stein (1990) finds that, in 1984, more voters assigned blame for their state's economic problems to Reagan than to their governor and a third did not attribute blame to either level of policy maker. Peltzman (1992) finds that voters put even less weight on whether their own state grew more slowly than the national average in senatorial elections than they did in presidential elections. He also finds only weak evidence that incumbent governors benefit from strong local economic performance when they attempt to get reelected.

There are two competing explanations for the finding that voters care more about national than local economic behavior.[12] The first stresses altruism. Kinder and Kiewiet (1979), for example, argue that voters are motivated by their perceptions of collective well-being, not simply by their own individual well-being. In other words, the results could be explained by a degree of social cohesion among voters in nation states.

Alternatively, some interpret the result in terms of a sophisticated form of self-interest. Peltzman (1992) spells out this view in some detail. The key point is that regions of a national economy have little scope for controlling local economic performance. A state in the U.S., for instance, can be thought of as a small, very open economy without an independent central bank, with relatively little scope for influencing cross-border flows and with limits on its ability to conduct independent fiscal policy. A rational voter would recognize that national policy makers have much more influence over the direction of the overall economy than over the deviation of local (and personal!) fortunes from national averages. Similarly, such a

(12) See Fiorina (1991) for additional references on the debate between sociotrophism and self-interest.

voter would hold state and local policy makers even less accountable than national policy makers for economic performance.

Existing evidence is consistent with both views. The survey results discussed above – that voters perceive national policy makers as more responsible than state and local officials for economic performance and that these perceptions influence voting behavior strongly – suggest that there is something to the «sophisticated self-interest» view. It is hard to see why perceived accountability would play such an important role if voters' actions were determined purely by sociotrophism. However, these results certainly do not rule out the possibility that altruism towards a community plays an important role as well. While it would be of considerable interest to be able to pin down the relative importance of each, it has been very difficult to devise conclusive means of doing so. It seems reasonable to assume that both play some role in explaining observed voter behavior, and to explore the implications of each for a multi-country system with an integrated macroeconomic policy, such as the EMS.

The central question is whether either explanation is likely to lead voters in EU member countries to play down the importance of national relative to aggregate economic performance in determining their support for union membership and for national policy makers who allow membership to act as a constraint on their policy choices. As discussed above, the issue is likely to become the most salient in the face of a crisis, such as a large shock that affects national economies differentially. Consider altruism first. This is most likely to play a role when residents of different nations perceive themselves as belonging to the same «community.» Presumably, this is less true of French, British and German citizens than it is of residents of Pennsylvania, Florida and California. What about sophisticated self-interest? Here again, it is likely to be less relevant for voters in different European nations than it is for voters in different U.S. states. National governments within the EMS have considerably more potential to influence national economic performance -- at least under the current institutional arrangements.

4.2. Economic performance and attitudes toward European integration: some evidence

This section provides an empirical analysis of the importance of national versus «union» economic performance as determinants of support for membership in the European Community (EC) in France, Germany and Italy. The empirical analysis focuses on France, Germany and Italy, all members of the EC and since 1979, of the exchange rate mechanism of the EMS. (Italy pulled out of the EMS in fall 1992.) Because of the differences in political systems across Europe and complex multi-party systems in individual countries, it is difficult to design a study based directly on voting behavior. Further, the current structure of the EC government provides no clear officials elected by member constituencies who are perceived to have significant policy making authority, comparable to senators in the U.S. Finally, voting intentions in individual EC countries, as studied by Lewis-Beck (1988), are not readily interpretable as indicators of support for staying in or pulling out of the union.(13)

One alternative is to use survey data on attitudes towards EC membership. *Eurobarometer* has conducted such a survey semi-annually since 1973. It provides a time series for a number of EC member countries on the percent of respondents who view their own country's membership in the EC as «a good thing.» Advantages of this indicator are that it provides a long enough series for empirical analysis, is comparable across countries and can be interpreted as an indicator of support for union membership. A disadvantage is that attitudes towards EC membership are clearly influenced by a variety of factors other than the extent to which membership (in the EMS) reduces the ability of national policy makers to set an independent macroeconomic policy. Further, the EMS imposed much

(13) There are some interesting exceptions here. For example, some have interpreted the election of François Mitterrand in 1980 as a mandate for reducing French unemployment, regardless of its implications for staying in the EMS. In contrast, the strong support for the opposition during the French mid-term elections of 1982 have been widely interpreted as a signal to Mitterrand to abandon the previous course and to adjust macroeconomic policy in a manner consistent with staying in the system. See Sachs and Wyplosz (1986) and Collins and Giavazzi (1993) for discussion of this episode in France.

greater restrictions on national macroeconomic policy in France and in Italy after the mid 1980s, when realignments became politically costly, than it did in the early years. In many respects, however, this difficulty of interpretation is also true of the country-level voting data discussed above.

The basic methodology is quite simple. For each country, a measure of support for membership in the EC is regressed on indicators of national and EC-wide macroeconomic performance and on a time trend to capture trend changes in attitudes toward membership. Surveys of individuals in each country are used to provide indicators of support. Both GDP growth and CPI inflation are used as measures of economic performance.

$$S_i = \alpha_0 + \alpha_1 g_i + \alpha_2 g_{EC} + \alpha_3 \pi_i + \alpha_4 \pi_{EC} + \beta_1 t + \beta_2 D + \varepsilon_i \qquad (1)$$

where S_i is support for EC membership in country i

π_i, π_{EC} are inflation in country i and in the EC overall

g_i, g_{EC} are GDP growth in country i and in the EC overall

t is a time trend

D is a dummy variable, equal to one for spring surveys (see below)

Each equation is estimated allowing for first-order serial correlation. In addition, the three country equations are estimated as a system so as to exploit the likely cross-equation correlation of the errors. If national performance is unimportant, then coefficients α_1 and α_3 should be insignificantly different from zero. If respondents care about EC-wide performance, then α_2 and α_4 should be strongly significant and large in magnitude. This form of the equation is useful for testing whether EC variables enter significantly, for both individual countries and for the three countries as a group.

It is also interesting to discuss the results from the related specification which enters the own country economic performance as a deviation from EC-wide performance. (For example, Peltzman [1992], uses this approach in his analysis of U.S. states.) For ease of discussion, estimation results for equation 2 are reported separately.

$$S_i = \delta_0 + \delta_1 (g_i - g_{EC}) + \delta_2 g_{EC} + \delta_3 (\pi_i - \pi_{EC}) + \delta_4 \pi_{EC} + ß_1 t + ß_2 D + u_i \qquad (2)$$

Data on support for EC membership come from various issues of the *Eurobarometer.* Respondents were asked: «Generally speaking, do you think your country's membership in the European Community is a good thing, a bad thing or neither good or bad?» Surveys containing this question have been conducted twice a year since the end of 1973 -- typically in April/May and again in October. (The dummy variable D is to pick up any systematic differences in attitudes in the spring versus the fall.) S_i is the percentage of respondents in country *i* who view EC membership as «a good thing.» CPI inflation rates and GDP growth rates for each country come from the IMF *International Financial Statistics*. These are semi-annual growth rates computed using quarterly data. Inflation and growth rates for the EC overall come from OECD *Main Economic Indicators.* (IMF quarterly GDP data are not available for all EC members.) Economic indicators are lagged one period in the empirical analysis to reflect the information available to respondents at the time of each survey. The sample period covers 1974 through 1993.

The regression results for equation 1 are reported in Table 4 while results for equation 2 are reported in Table 5. The explanatory variables are able to explain more of the fluctuations in attitudes towards membership for France than for the other two countries. The equation for Italy has the lowest explanatory power. As shown, there is no evidence of either a trend in French attitudes or of a systematic difference between the spring and the fall. In both Germany and Italy, support for EC membership appears to have grown during the 1970s and 1980s. In these countries, respondents tend to be somewhat more supportive during the end of the year than they are in the spring. We turn next to a brief discussion of the importance of economic performance for attitudes towards membership in each country.

Consider first the results for France. Growth rates, both in France and for the EC overall, appear to have no influence on the share of French respondents who support membership. However, respondents are quite sensitive to overall inflation and especially to French inflation. The interesting finding here is that the sensitivity goes in opposite directions. Higher inflation at home tends to reduce support for membership, while respondents feel more positively about the EC when its overall inflation performance deteriorates. Furthermore, the coefficient estimates on

Table 4

ECONOMIC PERFORMANCE AND SUPPORT FOR EC MEMBERSHIP
REGRESSION RESULTS: 1

Equation: $S_i = \alpha_0 + \alpha_1 *g_i + \alpha_2 *g_{EC} + \alpha_3 *\Pi_i + \alpha_4 *\pi_{EC} + ß_1 *t + ß_2 *D + \varepsilon_i$

	France	Germany	Italy
α_0	57.097 (6.760)	48.105 (6.843)	59.846 (8.463)
α_1	0.120 (0.279)	0.522 (1.785)	–0.249 (–1.061)
α_2	–0.212 (–0.509)	–0.701 (–1.660)	0.432 (1.231)
α_3	–1.105 (–2.533)	–0.394 (–0.586)	0.384 (1.990)
α_4	1.020 (1.899)	0.843 (1.403)	0.180 (0.375)
$ß_1$	0.232 (1.075)	0.308 (1.905)	0.402 (2.268)
$ß_2$	–0.753 (–0.663)	–2.424 (–1.809)	–3.361 (–2.978)
ρ	0.554 (4.267)	0.270 (1.982)	0.470 (3.778)
R^2	0.627	0.404	0.308
Observations	40	40	40
Mean of S_i	61.472	58.778	73.472

Note: *t*-statistics are given in parenthesis. See text for explanations of variables and data sources.

domestic and EC inflation are nearly identical in absolute value. If the equation is re-estimated in the form used by Peltzman (1992) to include EC economic performance indicators and the deviations of own country from EC indicators (see Table 5) one finds the opposite result to his finding for the U.S. Instead of only the aggregate variables entering significantly, these are consistently insignificant and only the deviation variables matter. This finding is most pronounced for the French equation.

Table 5

ECONOMIC PERFORMANCE AND SUPPORT FOR EC MEMBERSHIP
REGRESSION RESULTS: 2

Equation: $S_i = \delta_0 + \delta_1 *(g_i - g_{EC}) + \delta_2 *g_{EC} + \delta_3 * (\Pi_i - \Pi_{EC}) + \delta_4 *\pi_{EC} + ß_1 *t + ß_2 *D + u_i$

	France	Germany	Italy
δ_0	57.052 (6.752)	48.103 (6.843)	59.846 (8.465)
δ_1	0.120 (0.280)	0.522 (1.785)	–0.249 (–1.060)
δ_2	–0.092 (–0.306)	–0.179 (–0.576)	0.183 (0.673)
δ_3	–1.104 (–2.531)	–0.394 (–0.586)	0.384 (1.990)
δ_4	–0.820 (–0.168)	0.449 (0.929)	0.566 (1.320)
$ß_1$	0.233 (1.078)	0.308 (1.905)	0.402 (2.269)
$ß_2$	–0.753 (–0.663)	–2.424 (–1.809)	–3.362 (–2.979)
ρ	0.555 (4.277)	0.270 (1.983)	0.471 (3.784)
R^2	0.628	0.404	0.308
Observations	40	40	40
Mean of S_i	61.472	58.778	73.472

Note: *t*-statistics are given in parenthesis. See text for explanations of variables and data sources.

In Germany, respondents' attitudes towards membership are more sensitive to growth rates than to overall or especially domestic inflation. Again, the striking finding is that the coefficients on domestic and overall economic performance have opposite signs. If estimated in deviation form, only the excess of German relative to EC-wide growth is close to entering significantly.

For Italy, the only economic variable that enters significantly is domestic inflation.The coefficient estimate is somewhat surprising, because Italian respondents appear to have felt more positive about EC membership when their own inflation was higher -- the opposite of the result for France. This might reflect different perceptions about the influence of membership on domestic inflation in the two countries.

Are the EC economic performance indicators important determinants of support for EC membership? The likelihood ratio tests reported below can be interpreted as follows. For the three countries as a group, there is only quite weak evidence that EC performance enters significantly. (The null hypothesis that the EC variables can be excluded is accepted at the 0.10 significance level and rejected at the 0.20 significance level.) Similarly, there is weak evidence (at about the same significance level) that EC performance matters for Germans, even weaker evidence that it matters for the French and no evidence that it matters for Italians. Note that in all cases, similar test results were obtained if the tests are redone based on regressions which exclude explanatory variables that are insignificantly different from zero.

Likelihood ratio tests:

$$
\begin{array}{ll}
\textit{All Countries} & \chi^2\ (6) = 10.050 \\
\textit{France} & \chi^2\ (2) = 3.088 \\
\textit{Germany} & \chi^2\ (2) = 4.524 \\
\textit{Italy} & \chi^2\ (2) = 1.612
\end{array}
\quad (3)
$$

(Degrees of freedom for the χ-square statistics are given.)

Thus, there is at best weak evidence that attitudes towards union membership are influenced by EC-wide economic performance in two of the three countries -- France and Germany. In all countries, however, attitudes are influenced by macroeconomic performance at home (either growth or inflation). Where EC performance matters, it is much less important to respondents than domestic performance. These results provide no support for the view that voters in EC member countries are insensitive to economic performance at home relative to aggregate performance -- and consequently no evidence that they would be relatively tolerant of shocks that have a differentially negative effect on their national economy. Instead, poor domestic performance, particularly in France and Germany, appears to erode support for EC membership.

In summary, the main findings of this empirical work are as follows. Macroeconomic performance influences support for EU membership in all three countries. However, respondents differ across countries. They are especially concerned about inflation in France and in Italy and about growth in Germany. Most importantly, domestic economic performance matters significantly more than EC-wide performance in all three countries.

5. Concluding remarks

It currently appears that some form of European currency union will be initiated at the beginning of 1999 with national currencies of EMU members to circulate in parallel with the common currency for perhaps three years before being replaced by the euro. Is such a system likely to be sustainable? The central point of this paper has been to explain why it may not be. In particular, there remains the possibility that a large, unanticipated shock will adversely affect economic performance in one (or more) EMU members -- and that constituencies in the affected countries will view the resulting dislocation as something that could be mitigated through exchange rate adjustment. Such an event could create strong pressures for pulling out of the union. To repeat a point made in the introduction, I am not predicting that such an outcome will occur. My point is that existing analyses may under-emphasize this possibility.

Traditional analyses of the potential difficulties arising from such asymmetric shocks may underestimate their potential for disruption for two reasons. First, they focus on the average nature and magnitude of shocks facing potential EMU members. The relevant concern may instead be the likelihood of an «outlier» that is large enough to derail the system. Indeed, problems arose in the ERM in the context of large, unexpected developments, such as the 1979 oil price shock and German unification.

Second, traditional analyses stress that the European Union enjoys relatively weak alternative adjustment mechanisms, such as labor mobility and fiscal redistribution, for example, as compared with the U.S. These analyses do not adequately incorporate the additional difficulties posed by the mis-match between national political identities and common monetary policies. In particular, maintenance of a common currency in the U.S. appears to be supported in part by a significant degree of social cohesion -- with American citizens electing national level officials based on the strength of union-wide, not regional, economic performance. In contrast, this paper has presented some early evidence based on surveys of individuals' support for EU membership in different European countries. This analysis suggests relatively little EU-wide «social cohesion» in Europe. The degree of national versus union-wide cohesion and its implications for sustaining common policies are issues which warrant considerably more attention than they have received to date.

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III. Spain and the euro

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1. Prospects for the EMU

Since the far-off days of «Euro-optimism», when first the Delors Report was prepared and then the Maastricht Treaty was negotiated, the prospects for the effective introduction of a single currency within the European Union by the end of the century have been through many ups and downs.

Indeed, the Maastricht Treaty, which was prepared, negotiated and signed at the end of the period of economic expansion that had begun during the first half of the 1980s, began to encounter serious problems during the recession of 1992-93: firstly, the Danish electorate rejected the Treaty in a referendum of June 1992, then the so-called plebiscite called by President Mitterrand in favour of the Treaty was reduced to an extremely tight victory during the French referendum of September of that year and, finally, the serious crisis in the European Monetary System (EMS) from September 1992 to August 1993 made many people doubt the viability of the timetable agreed upon for monetary union.

But after many ups and downs (including ratification by the German parliament following the judgment of the Constitutional Court of Karlsruhe) the Treaty came into force in November 1993.

Experience since then has shown that the level of social and political support for the Treaty – and, in particular, for the idea of monetary union – is closely linked to the economic cycle: with a slight lag, this support increases during phases of economic expansion and falls away during periods of non-growth. In this way, the recovery in 1994 allowed for a re-launching of efforts to put the single currency into practice which reached an important milestone with the conclusions approved in December 1995 by the European Council in Madrid. Immediately afterwards, however, at the beginning of 1996, the continuing lack of growth experienced in Europe from the middle of the previous year again raised doubts regarding the timetable established in Madrid.

The end of 1996 saw a period of renewed confidence that monetary union would begin on the expected date (that is to say, January 1, 1999). Various factors seem to encourage this conviction:

– The growing anxiety of German businessmen about the excessive strength of the mark, both in terms of the dollar and in relation to other European currencies, which threatens the international competitiveness of German industry and undermines the bases for the socio-economic model (the «social market economy») applied in Germany from the end of the Second World War.

– The political perception that, if monetary union were to fail, this would endanger the timetable for the eastward expansion of the Community, an objective which is particularly important for the German authorities from the Chancellor down.

– The approval by the different European countries, during autumn of this year, of the budgets for 1997, deliberately designed with regard to convergence criteria on public deficit.

– The global political support (in spite of differences regarding certain technical aspects) received for the German idea of the «Stability Pact». This pact, in requiring that the countries included in the single currency stick to an even stricter budgetary discipline once monetary union has begun, would allow the European Council more leeway in spring 1998 when it came to judging the countries which fulfilled the stated criteria for convergence.

– The relative magnanimity that the Commission has shown when examining certain methods adopted by some states in order to balance their accounts in 1997 (in particular, the acceptance that France may include, as current income for this year, the financial compensation that it receives from France Télecom for including the company's employees in the public pensions system).

– And finally, a certain improvement in the Community's economic prospects, once the pause which began in the middle of 1995 has been overcome. In fact, according to the forecasts of the European Commission in autumn, the European Union, having ended 1996 with a modest aggregate increase in growth of 1.6% will see this rise to 2.3%.

As an indication of the general state of things, at the beginning of November the European Commission made a relatively optimistic evaluation of the state of convergence: practically all the member States, including Spain, if they persevered in their efforts towards convergence, would be in a position to fulfil the criteria in spring 1998.

It is important to emphasise two aspects of the selection process for the countries which, in spring 1988, must make up the European Council (that is to say, the heads of government of the member states):

– According to the provisions of paragraph 4 of article 109J, the decision as to which countries have fulfilled the convergence criteria must be adopted by qualified majority. It will therefore be necessary for a sufficiently large number of countries to agree on the list of countries without any group of countries emerging to effectively block the decision.

– In spring 1998 it is foreseeable that very few countries will comfortably and accurately fulfil the deficit and debt criteria, with the result that the European Council will be able to select a large group of countries only if it interprets these criteria relatively liberally.

Perhaps for this reason, certain voices which would prefer that Spain, Italy and Portugal were not included at the beginning of monetary union, but which do not want these countries to become tempted to block the Council's decision (something they could do merely by demanding a rigid and rigorous interpretation of the criteria), have recently suggested a compromise formula. They propose that, on adopting the decision to initiate monetary union, these countries should not be included initially among the countries forming the monetary union but that a later date should then be established, between 1999 and 2002, for them to be incorporated into the single currency. They would thus enter the single currency before monetary union had been consolidated (which would happen when all of the old national currencies had disappeared and the new euro notes and coins entered into circulation).

Indeed, when Spain negotiated and signed the Maastricht Treaty, unlike the British and the Danes, it did not reserve the right not to participate in monetary union even if it fulfilled the convergence criteria. Neither has any parliamentary group, with the exception of a section of the Izquierda Unida coalition, expressed doubts of any kind regarding the convenience of Spain's joining the single currency from the outset. Perhaps because of this general convergence of opinions, there has been no debate in Spain (unlike that which has occurred in other countries, a recent example being Sweden) regarding the risks resulting from participation in monetary union.

Faced with the renewed conviction that the euro will be a reality in 1999 and that Spain has an effective chance of being included in monetary union from the beginning, it seems, therefore, particularly timely to examine carefully why it is advisable for Spain to participate in the single currency and the risks involved in this decision.

In the following sections, therefore, I will explain the principal advantages which the single currency offers Spain. I will then examine the risks involved for this country in the disappearance of the peseta and its replacement by the euro. Finally I will deal with three specific arguments which are from time to time put forward in Spain by those who oppose integration in monetary union: that of the high level of unemployment which we currently suffer; the argument relating to the lesson we should have learned from the EMS crisis and, more recently, the view that the Stability Pact, advocated by Germany in order to limit budget deficits within the monetary union, is politically inadmissible and economically irrational.

2. The advantages of a single currency for Spain

2.1. Prior considerations

Any attempt to define with precision - or even worse, to quantify - the benefits which Spain would derive from its incorporation in the Economic and Monetary Union (hereinafter, EMU), encounters two serious problems:

– One of the principal benefits of the single currency, the perfecting of the Single Market, is diffuse: it can neither be quantified with precision nor can quotas be attributed to the different countries participating in the single currency.

– In addition, the term «benefits for Spain» (in the same way as «for Catalonia» or, in general, for any geographical region or zone) is not a very strict one in economic terms. If, as one can foresee, the single currency will benefit a great majority of people, but cause harm to others, would the generally accepted idea that a fall in interest rates is good for the country perhaps also be true for the «rentier»? An analysis which claimed to be thorough would have to study carefully the unfathomable depths of welfare theory and compensation criteria with the aim of evaluating whether the benefits obtained by the «winners» are superior to the disadvantages suffered by the «losers».

This essay will therefore avoid any attempt to quantify, restricting itself to identifying the foreseeable advantages and risks of the EMU for Spain: calculating the *net* benefit to a country of these advantages and risks requires an evaluation which goes beyond the economic framework and enters political territory, this being understood in the most noble sense of the term (that is to say, the art of weighing up and arbitrating between the opposing interests of different social groups).

We can separate the advantages of the EMU into two large areas: the microeconomic, applicable globally to all of the countries which form part of the Union; and the macroeconomic, principally applicable to those countries other than Germany which, if the EMU is introduced under the appropriate conditions and is perceived as being irreversible, will benefit from the general framework of macro-economic stability and low interest rates which have characterized post-war Germany.

As they are not very relevant from a long-term perspective, this essay will pass over the readjustment costs involved in the introduction of the new currency, the euro, and the subsequent substitution of the different national currencies (the modification of computer and accounting systems in financial entities; the cost of minting and issuing the new currency; the adjustment of the private citizen and industry to the new unit of value, etc.). Neither will it take into account other possible monetary effects which are not of great quantitative importance (for example, the impact on profit distribution by the different national central banks).

2.2. Microeconomic advantages: perfecting the Single Market

There are certainly no grounds for stating that «without the single currency, the internal market would be in danger». This is an argument which the French and Belgian authorities – with the Commission's support – have periodically reiterated at critical times of weakness in the Italian lira and the Spanish peseta (in particular as a result of the EMS crisis in 1992 and the weakness of the lira and the peseta at the beginning of 1995): the strong depreciation of the lira and, to a lesser extent, the pound sterling and the peseta, gave rise to a profound animosity among the countries whose currencies had followed the German mark against what they, clearly mistakenly, called «competitive devaluation».

The weakness of this argument can be seen at an international level: although the French authorities effectively attempted, during the Uruguay Round, to continue the debate on international monetary co-ordination parallel to the new round of commercial liberalization, the fact is that efforts to liberalize the exchange of goods and services on an international level have progressed, originally through GATT and currently through the World Trade Organization (WTO), without involving any attempt to revive the semi-fixed exchange regulations of the Bretton Woods system. Without doubt, the swings in dollar-yen parity have given rise in the United States to protectionist pressures similar to those which occurred in France and Belgium because of the weakness of the lira. But not even in the dollar's moments of greatest weakness (initially the summer of 1992 and then at the beginning of 1995, coinciding directly with periods of turbulence in the EMS) no-one in Europe proposed the adoption of commercial retaliation against the United States.

But the Single Market's being compatible with fluctuating rates of interest does not in any way preclude the fact that it is undoubtedly further improved by the single currency. In fact, the single currency contributes to the improvement of the Single Market in three ways:

– Firstly, the reduction in transaction costs as all transactions will be carried out in the same currency.

  On this point, some fervent defenders of the single currency again allow themselves to be carried away by their passion, exaggerating this benefit when they use the now classic example of the tourist travelling in the 15 member states. He changes all of his money into local currency each time he enters a new country and ends up «fleeced» by the exchange commissions and differences between buying and selling rates.

  Without the need for a single currency, this same tourist would do much better if, instead of using cash, he used his credit card or other similar methods of payment. Furthermore, the great majority of international transactions are paid through banks which, especially in the larger operations, apply very moderate differentials between buying and selling rates.

– Secondly, the reduction of uncertainty regarding comparative price and cost levels.

  The mere possibility that exchange rates may fluctuate produces uncertainty in the adoption of long-term economic decisions or those which involve initial costs: will a company start trading in a new foreign market if it fears that the small price advantage that it enjoys today may disappear tomorrow as a result of a modest variation in exchange rates? Will it also opt to move its production permanently to this other, currently cheaper, country if it feels that the cost advantage thus achieved may be short-lived? Will it look for a permanent supplier in another country if it knows that local producers may once again be cheaper as soon as the value of the local currency falls slightly?

Without doubt, the large multinational companies, extending across the length and breadth of the different national territories, have methods which enable them to adapt with a certain flexibility to fluctuations in exchange rates. But these are not perfect and neither are they accessible to companies whose production is geographically more concentrated.

It is indeed clear that the inhibiting effect on economic activity does not result from the actual occurrence of fluctuations in exchange rates: it is merely necessary for this possibility to exist *a priori*, even though it may not eventually materialize. This chilling effect produced by mere uncertainty is well known in other areas of international commerce: without modifying existing legislation in any way whatsoever, the threat by a national administration to resort to the well-stocked arsenal of protectionist measures at its disposal is sufficient to make the exporters in question become willing to enter into dialogue and even voluntarily restrict their sales. The approval of a law by the United States Congress (the so-called D'Amato Law), giving the administration the power to take sanctions against non-American companies investing in Libya or Iran, was enough to make European oil companies drag their feet and delay any plans to expand their activities in those countries.

Uncertainty inhibits many efficient economic activities which would be developed if it were not present. And uncertainty created by potential fluctuations in exchange rates is no exception to this economic principle.

– Thirdly, the full integration of financial markets.

The financial markets are, without doubt, the area in which the integrated effect of the single currency is most visible: until there exists a common currency in the European Community it will be difficult to consider that its financial markets are genuinely integrated, in spite of the Directives on the co-ordination of banking activity and investment services coming into force.

The above supposition is especially clear in the case of fixed income markets in that it results from the simple application of Keynesian law on the parity of interest: the absolute level of nominal interest rates will only become permanently balanced between two countries if there exists the certainty that the rate of exchange between the corresponding currencies will remain absolutely fixed (I will return to this subject when I deal with the irreversibility of the EMU).

In reality, Europe has, in the past, already succeeded in integrating its financial markets: this was thanks to the Eurodollar, in which the financial and issuing institutions of a number of countries participated actively for years. Similarly, during the period of «Euro-optimism» which preceded the signing of the Maastricht Treaty, the ECU market enjoyed moments of glory during which it welcomed issues from all of the large sovereign issuing institutions in Europe and seemed to aspire to the cutting out of the debt markets in national currencies.

But these were episodes in which a common currency (first the dollar, then the ECU) was taking root and spreading through the financial markets, acting «parallel» (a term which German monetary heads dislike) to the national currencies, never replacing them. This did not therefore involve full integration between the financial markets of the different countries.

The single currency is, therefore, essential in order to achieve the same prevailing rate of interest in the whole of the Community for financial assets of a similar type. Of course, the existence of the single currency would only guarantee that interest rates would be the *same* in every country, not that these rates would be *low*. This latter circumstance would only occur if the euro, the future single European currency, inherited the virtues of the German mark. If this were to happen, the single currency would have additional advantages for Spain at a macroeconomic level, to which I will now refer.

2.3. Macroeconomic advantages: low interest rates

International monetary history since the Second World War has been marked by one characteristic: the legal texts regulating international monetary relations have been very careful to treat all States as equals hiding the profoundly asymmetric shape which the existence of a dominant currency will inevitably create in the real world. This first happened with the dollar and the Bretton Woods agreement in which continual references to gold obscured from any inexperienced reader the fact that the dollar would be the currency of reference for the semi-fixed exchange rate system which it established. It also happened in Europe with the European Monetary System (EMS), the constitutional text of which, on insisting upon the central role of the ECU, the «parity grid» and the «divergence indicator», politically fogged the indisputable financial fact that the EMS would in practice operate asymmetrically, the German mark being the key currency around which all other parities would fluctuate.

This lack of symmetry was the logical consequence, not only of the greater relative size of Germany, but also of the country's success in achieving low inflation and moderate interest rates; political considerations apart, the principal economic motive which has driven France and the other countries to pursue the objective of monetary union with such enthusiasm has always been that of achieving interest rate levels, both nominal and real, which are as moderate as those in Germany.

The achievement of low interest rates would therefore undoubtedly be the most visible macroeconomic advantage enjoyed by Spain upon its integration in the single currency.

The above is borne out by events in the financial markets during the second half of this year, 1996: the view that Spain could effectively be integrated in the final phase of the EMU from the very beginning has provoked a noticeable and intense fall in long term interest rates, the difference with prevailing rates in Germany being suddenly reduced. As much can be said with regard to Italy. A remarkable consequence of the above (which has certainly not gone unnoticed in the British financial press) has been that the nominal long-term interest rates prevalent in both countries have got closer, with extraordinary speed, to the levels prevailing in the United Kingdom, finally succeeding in falling below them.

Logically, Germany does not benefit from this advantage in the reduction of interest rates. For Germany, the fear is exactly the opposite: that of making sure that the substitution of the German mark by the euro does not involve an increase in interest rates. This concern gave rise, first, to the convergence criteria of the Maastricht Treaty and then to the German proposal for the «Stability Pact»: the single currency must only include those countries which, by satisfying certain minimum economic policy requirements, were not going to send interest rates up.

German insistence on this matter was justified: the achievement of low rates of interest for the euro would benefit not only Germany but the whole group of countries included in the monetary union. Bear in mind that this view of moderation in interest rates for the euro could become suspect in various circumstances though these are fortunately improbable.

– Firstly, if monetary union is not perceived as being absolutely irreversible and the financial markets begin to fear that the euro will end up disappearing with each State re-establishing its former national currency.

  In the event of this happening, though it is fortunately not foreseeable, the equalization of interest rates would cease to be perfect across the monetary union: although calculated in euros, liabilities which, because of the debtor's place of residence or other relevant circumstances, might be suspected of eventually being repaid in a weak national currency, would immediately attract an additional risk premium, thus frustrating one of the principal advantages of monetary union. A recent example serves to illustrate this phenomenon: in spite of the fact that there has been perfect monetary union between Belgium and Luxembourg for decades (as a result the Belgian and Luxembourg francs have the same value), in summer 1993, when the EMS crisis gave rise to the doubt as to whether the Belgian franc would continue to be closely linked to the mark or, on the other hand, whether it would take advantage of the new wide band in order to depreciate against the German currency, the authorities in Luxembourg let it be known that they did not discount the idea of breaking their former union with Belgium and linking their own currency to the German mark; the consequence of all this was that public debt issued then by the Grand Duchy was issued at a significantly lower rate of interest than that of the Belgian franc, much closer to that of the German mark.

– Secondly, if any state affected by a serious budgetary imbalance is included in the monetary union, especially if it has to deal with a significant volume of public borrowing.

In fact, of all the convergence criteria, those of deficit and public borrowing are, in my opinion, the ones which acquire the most importance. This is because the criteria relating to inflation, interest rates and exchange rates, being inextricably linked to the former national currency, will become of purely historical value once the union has been introduced (in the way that a bad driving history is not relevant to the person who gets rid of their driving licence and irrevocably becomes a passenger on public transport). On the other hand, the participating states will continue to be exclusively responsible for the servicing of their own borrowings: incorporation into the single currency, although allowing them to benefit from the euro's moderate interest rates, will completely prohibit them from resorting to the indirect monetization of their borrowing, inflation and the devaluation of exchange rates. Without the presence of national currencies as «financial firebreaks», a financial crisis in one member State will have an immediate and violent effect, the shock waves of which will be felt throughout the monetary union.

3. Risks Spain faces in participating in single currency

Although Spain's participation in the final phase of EMU will bring great economic advantages, especially if it happens under the proper conditions, it is nevertheless appropriate to analyze the possible theoretical risks which may be involved. These theoretical risks may be grouped together under three main headings: the risk of external overvaluing of the euro; the risk of a cyclical imbalance between the Spanish economy and that of the rest of the union; and the risk of Spain suffering an unfavourable asymmetric «shock».

3.1. Risk of external overvaluing of the euro

Although one begins with the premise that the conversion rate between the peseta and the euro will be appropriate to our prices and expenditure situation as regards the rest of the members of the monetary union, there would, in theory, be nothing to prevent Spain, having been tied to the euro, from suffering the effects of an eventual overvaluing of the European currency against the dollar. And, as the dollar is the basic currency of reference for a large number of countries with great economic potential (for example Southeast Asia), this eventual overvaluing would undermine the competitiveness of our industries in relation to the rest of the world.

This risk is not purely theoretical: it has been stated many times that one of the motives driving chancellor Schmidt to push forward the creation of the EMS in 1978 was the desire to ensure that Germany would not suffer the effects of a weak dollar on its own, as was the case with the American currency during the Carter administration before the appointment of Paul Volcker as president of the Federal Reserve.

On the other hand, it seems probable that the severe corrections in parity which the EMS has experienced since September 1992 (including four devaluations of the peseta) have re-established the equilibrium of parities *within* the European Community, but in no way have they altered the overvaluing which, led by the German mark, collectively sweeps us along in *relation to the rest of the world*. This collective overvaluing, which could be holding back the capacity for collective growth in the European economies and increasing problems of employment and lack of competitiveness in relation to the emerging economies in Asia, will eventually be consolidated – in the absence of corrections in the euro's exchange rates – for all of the countries which join the single currency.

For the pessimists, this overvaluing of the European currency may even intensify during the first years of the EMU, for two reasons:

– Firstly, because the European Central Bank, worried about gaining the best possible credentials of anti-inflationist rigour and severity for itself from the beginning (especially if the Council of Europe is generous in its interpretation of the convergence criteria in 1998) may feel driven to maintain a policy of high interest rates thus driving up the value of the European currency.

  There is no lack of precedents for this in recent monetary history. In the United States, the intense overvaluing of the dollar at the beginning of the 1980s (which along with other factors would culminate in the international bond crisis of 1982) was the direct consequence of the Federal Reserve Board's struggle with the inflationary tendencies which had their beginnings in the American economy during the previous decade. In Germany, the Bundesbank's struggle against the inflationary effects of reunification exacerbated the external strength of the German mark and ended up being one of the causes of the EMS crisis which ended in August 1993 with the broadening of the bands. Or, to quote an example which is even closer to home, the efforts of the Bank of Spain during the second half of the 1980s to contain inflation and neutralize the effects of an excessively rash budgetary policy, produced a nominal and real appreciation in our currency which, nominally slowed by the entry of the peseta in the EMS, would years later traumatically correct itself during the crisis which began in September 1992.

– Secondly because, as a result of the fact that the appearance of the euro on the international scene would reduce the supreme role that the dollar still enjoys as a reserve currency, we would see a process of reshaping of portfolios by central banks throughout the world which would push the dollar lower.

Without underestimating the strength of some of these arguments, we can put forward some reasons which place these risks in perspective:

– Firstly, the overvaluing of European currencies against the dollar is already a fact, without any need to wait for the beginning of EMU. Indeed, it is hard to believe that the appearance of the euro could intensify it even further: this eventual further overvaluing of the European currency against the dollar, in intensifying problems of competitiveness in Europe and having anti-inflationary effects, would oblige the European Central Bank to direct monetary policy in a more cautious way and to moderate its interest rates. Experience bears this out. This, for example, has been the action taken by the Bundesbank itself during recent years: it raised its interest rates for the last time in July 1992 but it began to lower them in September – with moderation, as a balancing element to the isolated devaluation of the lira which preceded the EMS crisis – and it has since then followed an uninterrupted downward path. This was also the attitude of the bank of Japan: when it saw, in spring 1995, that the great strength of the yen was accentuating recessional tendencies in Japan, plunging the country into an authentic deflationary process and even threatening the solidity of the financial system, it was obliged to cut its discount rate to minimum levels (0.5%).

Experience shows, therefore, that all of the central banks are sensitive to the real economic situation and they seek a sensible balance – difficult to achieve when inflationary tendencies have already taken root – between a statutory objective to achieve price stability and their natural desire not to provoke deep recession. In the case of the future EMU, the authors of the Treaty were conscious of the economic relevance of policy regarding the euro's exchange rate. As a result, Article 109.2 contemplates the possibility of the Council of Ministers of Economy and Finance being able, by special majority and after consultation with or a recommendation from the European Central Bank, to draw up «general orientations» regarding policy for the euro's exchange rate. This provision adds that «these orientations will be understood to be without prejudice to the fundamental objective of the European Central Bank System to maintain price stability».

– Secondly, practically all European countries have made notable progress as regards price stability which appears to be well consolidated; the European Central Bank will therefore start from a favourable position as regards prices and there do not seem to be any reasons which might jeopardize this.

– Finally, the eventual attraction of the euro as an alternative international reserve currency to the dollar may be compensated by a drop in its interest rate, without a significant appreciation in the currency.

3.2. Risk of a cyclical decoupling of the Spanish economy

At times, the creation of a monetary union in the European Community has been criticized from the point of view that it could be seriously inadvisable to apply the same monetary policy throughout such a wide geographical area: the monetary policy which is appropriate to countries in a phase of economic expansion may not be the most ideal for those which are going through a recession.

This criticism was expressly put forward in the United Kingdom after the pound left the EMS; in fact, the crisis in the British currency was accentuated when in September 1992, in a period of great weakness for the British economy, the Bank of England had to raise its interest rates to defend the value of its currency.

In more recent times, at the end of October 1996, the Bank of England finally received the consent of the Chancellor of the Exchequer to raise its interest rates moderately (up to 6%), in view of the healthy pace of economic growth and the danger that it would manifest itself in future inflationary pressure. Meanwhile, the continental European economies continue to grow at a moderate pace, which one hopes will accelerate in 1997, without there being, for the moment, any perceptible inflationary pressures which might force the monetary authorities into raising interest rates in a similar way to Britain.

This argument is not to be scorned, especially for an economy such as Britain's, but it is doubtful that it would be valid in an integrated economic area like the European Community in which the rate at which economies are opening up to the outside is growing and, as a result, the synchronization of the economic cycle is tighter. In the specific case of the Spanish economy, it is difficult to imagine that under normal economic circumstances – the eventuality of an «asymmetric shock» is analyzed below – our economic cycle would be significantly out of step with the rest of the continental economies (especially France and Germany) and, once integrated in the monetary union, we would be subject to a monetary policy which would not be advisable for our particular cyclical situation.

On the other hand, the European Central Bank would foreseeably take notice of the prevailing economic situation in the monetary union as a whole, as opposed to the exclusive emphasis which the Bundesbank, undisputed leader of continental monetary policy, has of course given to Germany.

3.3. Risk of asymmetric «shocks»

One of the most frequent criticisms of the plan for monetary union consists of stating that the European Community is not an «optimum monetary area»: the mobility of labour between the countries is small, for reasons which are linguistic, historical and cultural: nor is there (nor will there be in the foreseeable future) a powerful community Treasury to centralize, on a community scale, the receipt of earnings and the existence of elasticity in the economic cycle (direct income tax, unemployment payments and services, etc.) and that could, therefore, act as an «automatic stabilizer» for those countries which are suffering specific economic crises. In the absence of these two balancing mechanisms, say the critics of monetary union, the states should not dismiss the possibility that their currency might depreciate, the only adjustment mechanism which, in the absence of the two mentioned above, would prevent the specific crisis from manifesting itself in an increase in unemployment. The rate of exchange continues to be a powerful adjustment mechanism, they say. The crisis in the EMS in 1992-93 shows that, far from being ineffective, devaluation and depreciation serve to restore the equilibrium in the balance of payments and economic activity of the countries which carry out such measures.

It has been said that, in the particular case of Spain, a likely «asymmetric shock» could consist of a rise in unit labour costs significantly higher than those of the rest of the countries in the union.

Critics of the single currency still consider their arguments more persuasive to the extent that the German idea of the «Stability Pact» prospers, as a result of which the limit of 3% of GDP will be applied to the letter as regards budget deficits, even in periods of recession. In the future union not only will there not be «automatic stabilizers» at a central level in the Community but even the capacity of the member states to compensate using their public budgets will be removed!

The argument of «optimum monetary areas» is, in fact, one of the most frontal attacks on the concept of monetary union within the European Community, especially that of a union which goes beyond the nucleus of countries most closely linked with Germany and which includes, for example, Spain. In my opinion, this criticism overlooks some important considerations:

– Firstly, this argument about «optimum monetary areas» is based on a beatific vision of the operation of floating exchange rates and presupposes the fact that fluctuations in exchange rates will always have a balancing effect. It overlooks the fact that these fluctuations may on occasion act perversely (in the form of *currency misalignments*), overvaluing the currency or partially neutralizing the favourable effects of an «asymmetric shock». In the particular case of the peseta, critics of the single currency only concentrate on the beneficial effect of the devaluations of our currency during 1992-93, but they forget that this was a simple correction of the dramatic appreciation which our currency had undergone during the period prior to its entry in the EMS, when it was floating freely (in reality, after its entry in the EMS in June 1989, the peseta moderated the unstoppable tendency towards appreciation which it was recording on the exchange markets).

– Secondly, this argument also overlooks the fact that, in economics, every choice has its price and every option its premium, as is shown by the level of interest rates in the United Kingdom, especially in comparison with Spain and Italy, following the rapid fall recently experienced by interest rates in both countries. The country which wishes to «keep its options open» and does not wish to renounce eventual devaluations of its currency in relation to more prestigious currencies (currently the German mark, in the future, the euro), has to be willing to pay the price of a spread in its long-term interest rates.

– Thirdly, on the basis that the states which enter the monetary union fulfil the convergence criteria prior to the initiation of the EMU, it is difficult to conceive of «asymmetric shocks» other than those produced by natural catastrophe. For crises of this nature – and for others which are not attributable to errors in the economic policy of the country in question – Article 103A.2 of the Treaty establishes the following:

«In the event of difficulties or in the case of serious risk of grave difficulties for a member state caused by exceptional events which this state cannot control, the Council may in certain circumstances decide, unanimously and at the proposal of the Commission, to grant financial aid to the state in question. When these grave difficulties have their origins in natural catastrophes, the Council will decide by special majority. The president of the Council will inform the European Parliament regarding the decision taken».

The syndrome «bovine spongiform encephalopathy» (better known as «mad cow disease»), of which the adverse effects on human health came to light in the spring of 1996 in the United Kingdom, might at first sight have been a good example of «asymmetric shock», given its special relationship with the British beef industry. But what happened in this particular case demonstrates the difficulty of coming up with real examples of «asymmetric shocks» which need to be remedied by an adjustment in exchange rates. In fact:

- Although the shock initially affected the British livestock industry, it rapidly left its mark on the beef sector throughout the Community, as there was a general fall in beef consumption. Although the shock was, therefore, initially asymmetric, it quite rapidly ceased to be so.

- As this involved the livestock sector, the «stabilizing» mechanisms of the Common Agricultural Policy came into play. As a result, the stabilizing mechanisms relied upon by the monetary union included not only the generic mechanism contained in Article 103A.2 but also those mechanisms linked to common policy in the sector.

- The impact of the British «mad cow» crisis on the level of the pound sterling has been, at best, unnoticeable and it has been fully compensated by other factors. The result has been that, a few months after the outbreak of the British beef crisis, the pound has reached its highest levels since it left the EMS in September 1992. It would not therefore seem that the floating exchange rate of the pound has been of immeasurable help to the United Kingdom in overcoming this crisis.

– Fourthly, the «Stability Pact» does not claim to limit a state's power to neutralize periods of recession: its principal proposal is to neutralize the bias which exists in democratic regimes towards the maintenance of large budget deficits, even in periods of great economic growth. According to the Pact, therefore, a state's budget deficit may exceed the 3% limit during a recession only if, in view of the arguments expressed, it obtains it authorization from the European Community's Council of Ministers. This therefore involves a process which reverses the burden of proof and makes it difficult to systematically or unjustifiably maintain high budget deficits but it does not prevent the unavoidable role of national automatic stabilizers in the event of serious crisis.

Once monetary union has commenced, would a rise in unit wage costs, to levels higher than those current in other countries, constitute one of these «asymmetric shocks», requiring an adjustment in the exchange rate, which would be then impossible? Would we in Spain run the risk of a «shock» of this type when it is too late to correct it painlessly by an adjustment in the exchange rate?

In theory, it seems clear that at the beginning of the monetary union there will be a tendency towards an equalization of the *absolute level* of prices for marketable goods, which would normally require an absence of any great difference, from one country to another, in the absolute level of *unit labour costs* relating to these products. To achieve this, absolute salary levels in these industries must be related, in each country, to relative productivity levels. It follows therefore that if, at the beginning of monetary union and the standardization of the use of the euro, *absolute salaries* expressed in euros tended to become similar to each other in these industries throughout the length and breadth of the European Community (as a result, for example, of a particular «demonstration effect» or of centralized salary negotiation at a European level), then in countries with lower levels of *productivity* salary increases would tend to be neutralized by cuts in employment. Companies in these countries would thus attempt to contain their unit labour costs and maintain their capacity to compete internationally.

There is, therefore, an effective risk that a premature equalization of salary levels across countries possessing different levels of productivity might involve employment cuts in those countries which begin with lower salary and productivity levels. This is precisely one of the reasons why, in Article 109J.1, the Commission and the European Monetary Institute are asked, when the Council will be drawing up its report on the convergence levels achieved by the different member states, not to restrict themselves to the Consumer Price Index but to include an examination of unit labour costs and other price indices.

4. The single currency and unemployment

In the preceding section we have analyzed the risk that Spain may suffer an «asymmetric shock» following its entry into the final stage of monetary union which, in the absence of the exchange rate as an adjustment mechanism, might produce *additional* unemployment. However, this debate is often mixed up with another completely different one, that is, the debate as to whether it is prudent for our country to adopt the single currency in view of the high rate of unemployment it *already* suffers.

This is a different question. In fact, while the first refers to the problems that the single currency would involve for Spain the moment it encountered a *new* «asymmetric shock», the second views the single currency as a restriction to the correction of the high rate of unemployment which *already exists*. Now, if the existence of the national currency allows us to confront the existing unemployment problem more effectively, why are we delaying a solution – presumably by devaluing the peseta – to the serious unemployment problems that we are currently suffering? Why do we not solve the problem *before* entering the monetary union and then join, confident of the improbability of a new «asymmetric shock» which might *afterwards* exclusively threaten employment in Spain?

In fact, if the exchange rate were the key to resolving the problems of unemployment in Spain, the ideal solution would be to join the monetary union from the beginning but at a suitably reduced exchange rate level. We would therefore be able to:

– Lock in a competitive exchange rate, avoiding the possibility, which would exist if the national currency were to be maintained, that future exchange fluctuations might make it rise again (bear in mind, for example, how the pound sterling has, to the consequent alarm of British industry, corrected a substantial part of the depreciation which it suffered after leaving the EMS in 1992; it is also worth mentioning the lira and the peseta in connection with the moments of extreme weakness which they experienced in spring 1995).

– Enjoy the low interest rates which would presumably prevail in the monetary union, avoiding the prospect that potential additional devaluations of the national currency would entail a burdensome risk premium in long-term interest rates.

But, would this alternative (that is to say, joining the monetary union but at an extremely depreciated exchange rate) be viable and effective? Two convincing reasons seem to oppose this:

– From a legal and political point of view, this approach would be incompatible with one of the convergence criteria, that is, the criterion which relates to the maintenance of the currency in the EMS for two years without any devaluation and without significant pressures. The Treaty's contention, basically, is that any country intending to join the monetary union must have demonstrated that it can join the single currency at the rate of exchange which it has maintained for the previous two years: this prior stability in its exchange rate would form a firm guarantee that conversion to the single currency would be made at a controlled rate of exchange which was close to «equilibrium».

– From an economic point of view, the selection of an exceptionally reduced exchange rate on entry would still not guarantee the indefinite maintenance of an increase in competitiveness. In fact, it is appropriate again to bear in mind the distinction between *absolute levels* and *rates of change*. As is true in the case of marketable goods, it would be absolute prices (expressed in euros) which would tend to level out in the monetary union; any reduction in absolute price levels occurring in a country through the use of a reduced conversion rate would progressively correct itself through a rise in prices greater than that experienced by the remaining countries in the union. In short, an excessively reduced exchange rate, rather than indefinitely consolidating an increase in a country's competitiveness, could translate into a positive inflationary differential *post monetary union*. The case of German monetary reunification illustrates this phenomenon: in spite of the fact that, in 1990, the East German mark was converted on a par with the German mark (although it used to change hands on the black market at a rate of 7 to 1) the inflation rate in East Germany remained significantly higher than the rate in the former Federal Republic; it was only in autumn 1996 that it appeared to have evened out.

Unfortunately, the high rate of unemployment which currently exists in Spain results from reasons which are fundamentally structural. These can be put down to the low level of flexibility shown by the different production sectors (especially industrial production) in absorbing the newly available workforce which resulted from the structural changes undergone by the Spanish economy at the beginning of the 1970s (in essence, the continuation of the downward trend in agricultural labour, the effect of the energy crises on industrial employment and the rapid increase in the number of women entering the labour market as a result of a rapid process of sociological modernization). The fact that the exchange rate is not the key to this problem is demonstrated when one notes that our unemployment levels increased significantly during the 1970s and the first half of the 1980s while the peseta fluctuated freely in relation to the American dollar and to the European currencies.

In short, Spain should certainly not enter the monetary union at an overvalued exchange rate. But equally, nobody should expect that, by staying out of the single currency and watching our currency depreciate, our economy would solve the unemployment problems which it is suffering.

5. Mistaken lessons learned from the EMS crisis

Another of the most common arguments against monetary union in Spain consists of invoking the experience of the devaluations of the peseta during 1992-93: Who said that devaluation would no longer serve as an adjustment mechanism? Who can deny that, in Spain, the result of the balance of payments and prospects for growth improved rapidly during the period which followed the three devaluations of the peseta at that time? If the exchange rate is, therefore, an effective instrument of adjustment, would it not be unwise to renounce it and involve the country in a venture (monetary union) which pursues fundamentally political objectives?

In my opinion, the deep crisis experienced by the EMS and the peseta during 1992-93 does not demonstrate the monetary union's lack of viability but rather the need for currencies not to join at overvalued levels. Thus, in the case of the peseta:

– The peseta joined the EMS at an already overvalued level in June 1989. In reality, its entry prevented it from continuing to appreciate, as it had been up to that point.

– This overvaluing could have been moderated by means of a subsequent adjustment programme based on containing public expenditure, as the economic authorities of the period wanted. But for various reasons (remember the prevailing climate following the general strike of December 1988), these budgetary adjustment measures were not undertaken, quite the contrary. Industry, for its part, continued to accept high salary increases in a prevailing climate of economic euphoria. As a result of all of this, the «fundamental imbalance» of the peseta, instead of adjusting itself, worsened between June 1989 (the point that the peseta entered the EMS) and September 1992 (the beginning of the EMS crisis). The Convergence Plan of spring 1992, although well-intentioned, came too late and, understandably, could not include the unavoidable devaluation of the peseta.

– Fortunately, speculative pressure made a significant devaluation of the peseta unavoidable, this being carried out in three steps. The depreciation of the peseta, in coming during the most contracted phase of the 1992-93 recession, had a moderate inflationary effect and effectively eliminated an overvaluation which was distorting our balance of payments and holding back economic activity.

The real lesson of the crisis for the peseta in the EMS is that a country should only pass on to the final phase of monetary union if it first fulfils certain economic conditions (among these, that its currency is not overvalued; that its rate of inflation and rate of increase in unit labour costs are moderate; and that its public accounts are relatively healthy). To enter a single currency without fulfilling these conditions could be prejudicial both for the country in question and for the remaining countries: it could have a depressant effect on growth and employment for the former and create financial instability for the remaining members of the union.

If we can draw one lesson from the past crises in the EMS, it is that economic convergence must be a prior condition for monetary unification, not a consequence of it.

6. Criticisms of the Stability Pact

One of the more recent criticisms of the idea of Spain joining the single currency comes from those who, distrustful of the restrictions that the Maastricht Treaty imposes on the management of economic policy according to a country's needs, see the «Stability Pact» as a pernicious complement to the Treaty which will finally prevent a state from taking any anti-cyclical action.

As is well known, the idea of the Pact came from a proposal made in November 1995 by the German Minister of Finance, Theodor Waigel, shortly before the Madrid session of the European Council approved the setting for the introduction of the single currency.

The German initiative has continued to be debated throughout the Community and last October the European Commission approved a draft regulation that the Economy and Finance Ministers have still not approved. Broadly speaking, the Pact would have two aspects: on the one hand, a mechanism would be established in the Community for budgetary supervision, over the medium term, of the states included in the monetary union; on the other, the putting in place of the procedure for excessive deficits would be speeded up and clarified.

As regards medium-term budgetary supervision, the changes would be as follows:

– States would have to provide the Community with so-called «stability plans», which would have to be regularly updated and which, similarly to those which up to now have been known as «convergence plans», would basically be pluriannual budgetary programmes. In these they would have to specify not only their numerical objectives as regards budget results and the development of public borrowing but also the budgetary methods adopted in order realistically to attain such objectives.

– The medium-term objective of these programmes must be to achieve a budget result which is «close to balance or in surplus».

– The European Commission and the Council of Ministers would study and discuss these programmes and would be able to make recommendations to the state in question when it considered that the programme needed to be reinforced.

As regards the penalty procedure in the case of excessive budget deficit, the changes would be as follows:

– Maximum periods would be established for each of the procedural phases, with a view to limiting its maximum duration.

– There would be a more accurate definition of the «exceptional and temporary» circumstances in which a state may have a budget deficit of more than 3% of its GDP without such a deficit being considered, in view of these circumstances, «excessive» and liable for sanction.

– The method of imposing sanctions on states infringing the regulations is specified. The initial sanction – which would have to be imposed by the Council of Ministers at the proposal of the Commission – would consist of the compulsory payment of a non-returnable deposit, the amount of which, calculated as a percentage of the infringing country's GDP and subject to certain absolute limits, would be in part fixed and in part proportional to the excess amount of deficit. The deposit would become a fine if, after a certain time had elapsed, the state had not adopted measures to correct the excess deficit.

The Commission's plan has yet to be approved by the Council of Ministers because, among other reasons, certain differences of opinion have surfaced between Germany – which wants the greatest of rigour in the drawing up of the Pact – and the majority of the remaining states. Germany in particular, conscious of the fact that the Economy and Finance Ministers will hesitate for political reasons when the time comes to impose a financial sanction on another state, is seeking more automatism in the adoption of the sanction and is advocating the reversal of the burden of proof – something which is difficult to reconcile with the Treaty, so that, the sanction would be applied automatically except when the Council of Ministers decided otherwise. Germany is also advocating that the «temporary and exceptional» circumstances allowing the limit of 3% of GDP to be exceeded be defined quantitatively, an aim which is opposed by both the Commission and a majority of the member states. Finally, there has still not been full agreement on the exact amount of these sanctions.

Nevertheless, although various of the German views regarding the Pact seem exaggerated, the essential nucleus of the Commission's proposal falls fully within the spirit of the Treaty, which expressly establishes a regime of sanctions against any country which has joined the single currency and, without just cause, maintains an excessive budget deficit. Without doubt, the Pact, in reinforcing the provisions of the Treaty, significantly limits the margin of budgetary autonomy enjoyed by each member state. But this restriction on budgetary autonomy comes from the Treaty, not the Pact, which limits itself to a rigorous orchestration of the sanction provisions in the Treaty.

It is worth emphasizing again that the Commission's proposal allows a member state which is experiencing an «exceptional» situation to «temporarily» register a budget deficit higher than 3% of its GDP without being penalized. However, it must convince the Commission or the member states that these exceptional and temporary circumstances are present in its case. In short, neither the Treaty nor the Pact will prevent the role of «automatic stabilizers» in a state which is experiencing a crisis. However, the Pact will involve the «reversal of the burden of proof»: if it does not wish to be penalized, the state in question must obtain the approval of the Commission or the member states.

In short, the Stability Pact has politically brought to the forefront a basic principle contained in the Treaty, involving the effective trimming of the freedom of any state forming part of the monetary union to incur excessive budget deficits. This therefore constitutes a special category of so-called «economic constitutionalism»; its singularity resides in the fact that limitation of the deficit is contained, not in an internal legal regulation at constitutional level, but in an international Treaty ratified by Parliament. It is, therefore, logical that the Pact tends to be rejected by those countries which, like the United Kingdom, have always been reluctant to accept such a loss of sovereignty and, therefore, have reserved their right to opt out. But it must be acceptable to those countries which, like Spain, ratified the Treaty in the full knowledge of its contents.

From an economic point of view, the Pact will, nevertheless, not prevent the role of «automatic stabilizers»: it will merely make it politically difficult for states to disguise serious structural imbalances in their public accounts as cyclical ones.

Finally, the Pact will require member states to weigh up their political and budgetary efforts and convictions well before finally joining the single currency: there would be little point in a country making strenuous budgetary and financial efforts in order to join the single currency from the outset only to be trapped, after a short time, by the sanctions procedure for excessive deficits.

7. Conclusions

There follows a succinct explanation of the principal ideas expressed above:

1. The introduction in the European Community of the single currency has a good economic basis and, contrary to statements which are often expressed, does not pursue eminently political ends.

2. The turbulences experienced by the EMS, firstly in the period from September 1992 to August 1993 and then in spring 1995, have left the

exchange rates of the different European currencies at ideal levels for the commencement of monetary union. On the other hand, the combined European currencies, led by the German mark, continue to be overvalued against the dollar and the remaining currencies directly or indirectly linked to it. This collective overvaluing is intensifying the problems of low growth and high unemployment which, resulting from more structural factors, have continually characterized the different economies of continental Europe.

Monetary union would therefore begin in a more favourable economic climate if all of the currencies forming part of the EMS were first to depreciate collectively against the dollar.

3. Of all of the convergence criteria established in the Treaty, the criterion relating to public deficit is, without any doubt whatsoever, the one which acquires the most importance. Paying attention to it will decisively contribute to the monetary union's being characterized by a low level of interest rates.

4. The incorporation of Spain in the single currency will involve a clear net benefit for this country, the most visible manifestation of which will be the permanent consolidation of a moderate interest rate level.

5. Nevertheless, monetary union is in no way a universal cure-all which will remedy all of the European economy's ills. In particular, monetary union, in isolation, will only marginally improve the situation in the employment market and will not, in itself, translate into a significant reduction of our high rate of unemployment. Quite the contrary, the disappearance of national currencies and the greater transparency and improved comparability of prices and payments throughout the union may result in a dangerous tendency towards a bringing into line of salaries between industries and companies with initially different production levels, which may in turn provoke attempts to contain unit labour costs by labour shedding.

As a result, the prospect of monetary union, far from removing the necessity of making the microeconomic and business sector reforms required to achieve a greater flexibility in the Spanish economy, will actually make them more advisable.

In the end, the combination of a *macroeconomic framework* for price stability, moderate interest rates and healthy public finances with a *microeconomic framework* for flexibility and competition in the market will be the best recipe for Spain and the remaining members of the future monetary union in achieving collective prosperity.

IV. European Monetary Union: economic requirements versus political temptations

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At the Madrid Summit (in December 1995), the European Council of Heads of State and Government from the member countries of the European Union (EU) took decisive measures with the aim of beginning the ambitious process of monetary integration in Europe, as established in the Maastricht Treaty (signed in February 1992), and bringing it to its third and final phase with the introduction of the single currency in the countries joining the European Monetary Union (EMU) from January 1, 1999.

– In the first half of 1998, the Council of Europe will decide, by special majority, which countries have fulfilled the conditions for inclusion in the unified monetary area. This decision will be adopted on the basis of the results of convergence achieved in 1997. The European Commission and the European Monetary Institute will issue various reports in this connection and the European Parliament will make its own report.

– From January 1, 1999 the exchange rates between the different national currencies of the countries gaining entry will be irrevocably fixed and three years later, at the very latest, the process of substituting national currencies with the common euro will be complete.

When the EMU comes into operation, the participating countries will lose their authority in matters of monetary policy, which will become the province of the European Central Bank. Fiscal policy, on the other hand, will continue to be the responsibility of the national parliaments and governments. This diversity in the allocation of fundamental macroeconomic policies is what is provoking so much scepticism regarding the viability of the EMU. If monetary policy is to be common (supranational), it would also have been reasonable for this to be the case with fiscal policy. But if there is no political union, the sovereignty of each of the member countries being maintained, it is also reasonable to assume that no one will wish to transfer control over their budget, considered to be a fundamental right of the national parliament, to the community institutions.

Apart from the logistical aspects, there are many open fundamental questions which must be resolved. Those which command the most attention are the following:

– The interpretation of the community's convergence criteria as established in the Maastricht Treaty. Given the ambiguity relating to the Treaty itself, either a «strict» (strong) interpretation or a «flexible» (weak) interpretation are possible. This process will condition the starting date and the number of countries forming the leading group.

– The shape of the interim period between the moment at which it is decided to initiate the European Monetary Union for a first group of economies and the date that it comes into force. The fundamental problem lies in the uncertainty regarding the conversion rate between the euro and the national currencies of the countries involved and the risk that the central banks, still in existence, may manipulate the exchange rates in their favour or that speculative turbulence may result in the currency markets.

– The exchange regulations between the euro and the currencies of the other countries in the community which have (for the moment) not joined, either because they were not admitted because of their failure to fulfil the convergence requirements or because they have reserved, in the Treaty, the right to reject the single currency, should they so wish, even though they satisfy the convergence criteria completely (this is the case with the United Kingdom's «*opting-out* clause» and Denmark's «*opting-in* clause»).

– The elements of the so-called «Stability Pact», initially proposed by Germany, the object of which is to ensure, to the greatest extent possible, budgetary discipline by the different governments once the single currency has been adopted.

For all the political desire that there may be to achieve EMU, it is extremely important to take the right decisions in these matters, so that expectations regarding the economic benefits of the single currency are not disappointed. Economic calculation will not preclude political error, but it will minimize it. Stability in price levels, which the Maastricht Treaty puts forward as a priority of the future European Central Bank, will not come on its own. It will have to be cultivated and it is therefore essential to bear in mind the teachings of monetary and fiscal theory and the lessons of historical experience. If the politicians show signs of strictness in their economic approach, if they give credibility to the plans and efforts made in matters of inflation and budgets, they will gain the approval of the financial markets (which will avoid economic turbulence) and they will overcome the reluctance shown by a large part of public opinion in various countries, including Germany and France, in connection with the single currency (which would contribute to the stability of internal political processes, especially as regards any parliamentary elections which take place during this period). Simple advertising campaigns, such as those carried out by the European Commission, the different governments and various pro-Europe organizations, are of only limited value in this respect.

1. Expectations of the single currency

The determination to achieve a common monetary area, although it may initially be for only a small group of countries in the community, provided that they carry a certain economic weight, has both a political and an economic explanation.

– The political explanation is rooted in the fact that the single currency could be the most expressive symbol of political union to date within the European Union. This would consolidate, if not increase, the specific weight of the Union in political decisions taken on a global scale.

– The economic explanation consists of the fact that the exchange of goods and services within the community would cease to be subject to the impact and corresponding bias of volatility in real exchange rates. As a result, real interest rates in the participating countries would no longer carry risk premiums based on the expectation of nominal devaluations. Investment calculations would have a firm exchange basis and, for foreign business, the costs of currency exchange transactions would be eliminated, including the costs built in by exporters and importers in order to protect themselves from exchange risks in the currency markets.

Independently of the consideration that one may wish to give to these reasons, one should neither exaggerate, nor should one raise expectations which later may be disappointed. Using the single currency as a lever in order to achieve political union in Europe would probably be an unattainable object in the foreseeable future. Whether we like it or not, it is a perfectly palpable fact that European thinking has not taken root among the people of the different countries, in many of which nationalism predominates (in the good sense of the word). In others, Spain amongst them, there are even decentralizing forces within national borders. European political union will come when the people unequivocally want it, not when the politicians invoke it, trusting in the attraction of the euro. To state, as it has been recently (with special vehemence in Germany), that without a single currency, there would be danger both to the European Union as it stands and to the different people's ability to live together in peace, does not have any basis in fact whatsoever. This is a fantasy.

In the economic sphere, the exchange problem will only disappear within the EMU when bilateral economic relations actually begin between the countries making up the leading group in this project. These countries also maintain important commercial and investment links with countries in the community which are outside the common monetary area as well as with third party countries, particularly the United States and Japan, along with the Far East and Latin America. In relation to all of these economies, the euro's level may vary in real terms, in a similar way to the national currencies it is replacing. As a result, the savings in transaction costs made by companies located within the unified monetary area may be quite small. And, in any case, one would have to subtract the immediate modification costs involved in the adaptation to the euro of company financial accounts, information systems, automatic bank cash tills, machines distributing goods and services to the public and telephone kiosks, among other things. The investment required in each case would be quite significant. Furthermore, one must bear in mind that during the three-year transition period each economy will be operating with two currencies simultaneously, the still existing national one and the euro (everyone will be able to use the latter in their transactions but no one will be obliged to do so); this is another appreciable load, above all for the smaller companies and retail businesses which are unaccustomed to dual accounting and effective procedures for currency conversion.

The argument that a common currency will greatly ease the struggle against unemployment, the chronic disease suffered to a greater or lesser degree by almost all of the countries in the community, is in no way convincing. Unemployment is fundamentally a problem of excessive labour costs and substantial inflexibility in the labour market, something which, in times characterized by the globalization of goods and services markets and the internationalization of production can only be counterproductive, especially for the employment prospects of unqualified or less qualified workers, the section of the working population in which long-term unemployment is concentrated. The monetary policy of the future European Central Bank cannot correct these structural deficiencies, just as the national central banks are unable to do so at the moment. The responsibility for employment rests, in the first place, with the parties which determine salaries and other working conditions, that is to say, the unions and employers.

2. The difficulty of nominal convergence

The advantages that may be gained from a common currency will only be noticed in an environment of monetary stability. The convergence criteria defined in the Maastricht Treaty are aimed at the creation of this stability (Article 109 J of the Treaty). There is good reason for placing emphasis on monetary stability. Inflation constitutes a hidden tax (something which is inadmissible in a state of law), it produces serious distortions in production structures (which in the long term slows down economic growth and the creation of employment) and it discriminates against all those groups which receive fixed incomes (including salaried workers and pensioners, a circumstance which is unjust). As a result, the EMU will only have meaning if it gives rise to an area of monetary stability, comparable to the current «German mark area» (which directly includes Austria, the Benelux countries and Denmark and indirectly includes France).

There are five criteria which, as stated in the Maastricht Treaty, must be borne in mind when the above mentioned examination is made in the first half of 1998. These relate to the rate of inflation, long-term interest rates, the budget deficit, total public borrowing and the exchange rate. All of these, therefore, point to a nominal convergence, not to an idea of the real economy of a country (rates of growth and unemployment, for example). The first four criteria have been defined in quantitative terms; two (the rate of inflation and interest rates) in relative form and the other two (the fiscal criteria) as absolutes. The quantification of these criteria does not respond to scientific calculation (there are no «optimum» values), but neither is it beyond reasonable consideration, if one takes into account the macroeconomic environment which prevailed when the Treaty was being negotiated. As one may recall, the accepted limit for public deficit is 3% of gross domestic product and for existing debt, 60%, but with the qualification that higher levels than these would be acceptable if they had fallen, substantially and continuously, during recent years and were thus approaching these reference values in a satisfactory manner. Exceeding these values is also exceptionally and temporarily allowed, but without getting too far away from them. The measure of inflation, the consumer price index, must not exceed the average rate of the three countries with the greatest stability by more than one and a half points; as regards (long-term) interest rates, the differential must not exceed the average of the three countries with the greatest stability by more than two points. As regards the exchange rate criteria, these require the participation of the corresponding currency in the European Monetary System (EMS), without devaluationary pressures, for the previous two years at least. As is stated in the Maastricht Treaty, the aforementioned convergence criteria must be fulfilled in their entirety.

There is a link between these criteria: interest and exchange rates reflect the verdict of the financial markets on targets achieved in controlling inflation and correcting fiscal imbalance. Those countries which do not succeed in fulfilling the inflation and budget criteria will have to support risk premiums in relation to interest rates, eventually along with a devaluation of their currency. As regards the fiscal criteria, it follows from the «primary budget» idea (excluding interest payments on borrowings) that, given the debt-to-GDP ratio, one can sustain a budgetary policy which does not increase this proportion, that is to say, the ratio of the budget deficit must not exceed the value obtained by multiplying the ratio of debt by the rate of increase of GDP at market prices. Applied to convergence values, this means that a public deficit of 3% of GDP can be sustained with a debt of 60% of GDP, if the annual rate of increase of nominal GDP is 5%; if economic growth were slower, the sustainable public deficit as a percentage of GDP would have to be lower, in such a way that the state could pay off its borrowings without exposing itself to financial strangulation or having to resort to an increase in fiscal pressure. The relationship between public deficit and price levels is not direct or unequivocal. High deficits in relation to GDP can co-exist with low inflation rates, as can be seen currently in Germany or France. But it is also conceivable that the economic agents, if they consider that the deficit is unsustainable, may anticipate tax increases, which may in turn have an effect on prices; either directly (in the event of VAT or special tax increases) or indirectly (if salaries increase excessively to neutralize the loss of purchasing power as a result of tax increases). As a result of all of the above, it is indeed proper that the Treaty should require public finances which are consistent with the objectives of monetary stability.

The convergence process is requiring more time than was originally anticipated in 1991. Fewer countries would seem to be in a position to fulfil all of the agreed conditions within the time provided.

– The only country which does not have any problem is Luxembourg; it has fulfilled all of the criteria from the outset. Germany, which has still not digested all of the enormous fiscal cost arising from reunification has exceeded the public deficit requirements (3.9% of GDP in 1996). Spain does not fulfil the two fiscal requirements or the one relating to inflation (at the time of this writing, in autumn 1996).

– The greatest advances have been made from the point of view of inflation. During recent years, inflation rates have fallen in most of the countries in the community, reaching historically low levels in much of them (even in Spain). This is the good news. The average is in the order of 3%, the lowest since the beginning of the 1970s. The three most stable countries (in 1996: Sweden, Finland and Luxembourg) showed an average of below 1%, which would place the level of the corresponding convergence criteria at 2.5%. Of course, it is true that the Bundesbank conditions the monetary policy of the other central banks to a great extent. But the majority of them, including the Bank of Spain, now voluntarily do what was originally imposed upon them by Frankfurt, when the narrow fluctuation bands still governed the EMS. The monetary authorities, as opposed to both politicians and union members, are perfectly aware of the fact that «with a little more inflation» one does not get more jobs (the «Philips curve» does not work, «rational expectations» dominate according to a theory of Robert Lucas, winner of the Nobel Prize for Economics in 1995). It is through stability that one builds the basis for self-sustained economic growth. It would appear that a new «culture of monetary stability» is being created in the EU, as if saying «no» to inflation were becoming an accepted view of the people, even the Spanish. The fact that Spain is still a certain way off fulfilling this convergence criterion (in spite of its laudable slowing of inflation in the recent past) simply because other countries have been even more successful, serves to underline the need for the Bank of Spain to be rigorous in its monetary policy and for the Government to adopt the measures necessary to increase levels of competition in the market, without which it would be very difficult to hold back the underlying inflation which is so tenacious in this country.

– In the field of public finances, things are going badly. In every country except the Netherlands and Ireland, the respective public administrations have increased the volume of existing debt in proportion to GDP. The situation in France is worrying, given that an EMU without the so-called

French-German axis is beyond all political consideration. Germany may also end up exceeding the reference value for the debt-to-GDP ratio, although not after having reduced this value both substantially and continuously (which would still allow approval according to the provisions of the Maastricht Treaty), but after having increased it from very low levels in relation to the reference level (1992: 44.1%), public deficit also growing in relation to GDP (1992: 2.8%). This circumstance is not provided in the Treaty as an argument for a flexible interpretation of the fiscal convergence criteria. Belgium and Italy are showing total debt ratios of well above 100% of GDP and one cannot see any serious efforts being made to bring these levels closer to the reference values which would, in any case, take years. This, in principle, dismisses the possibility of their participating in the EMU in the immediate future, even though they were two of the six countries which began the process of European economic integration in the 1950s.

– The case of Italy is particularly serious, given that the country abandoned the EMS in August 1993 and did not return to it until the end of November 1996. As a result, it can fulfil the convergence criteria relating to exchange rates only with great difficulty. Strictly speaking, the United Kingdom (which left the EMS at the same time as Italy), along with Greece and Sweden (which have still not joined the system) are also excluded for this reason.

– However, it is true that many people do not now take the convergence criteria relating to exchange rates into consideration. This is a mistake. Apart from the fact that these criteria appear in the Treaty, they continue to be a very important reference point. Economically speaking, only countries which do not need to use their exchange rates in order to counteract the effects of inflation differentials (according to the exchange theory of the acquisitional power of currency) or real shocks (according to the theory of optimum monetary areas) can form a monetary union. It is true that, since the widening of the fluctuation bands in the EMS to ±15% (in August 1993), the exchange rates of the majority of countries have remained relatively stable (with the exception of Spain and Portugal which had to devalue their currencies in March 1995). But no one knows how the financial markets would react in the event that the narrow bands (±2.25%) were reimposed, these being the «normal» margins when the Maastricht Treaty was signed, the later widening being classified by the Council of European Ministers of Economy and Finance as being «temporary», in order to salvage the viability of the EMS (which had been subject to strong pressure from June 1992). The recent proposal in France to devalue the franc (by 9%) is nothing but alarming.

It is very difficult to believe that, in the first half of 1998, the signs will be more encouraging, that is to say, that there will be a group of qualified countries which is sufficiently large to be able to obtain the positive economic effects which are expected of this important European project. The forecast of the European Commission in the middle of 1996 was that fiscal consolidation, at least with reference to budget deficit, would be achieved in 1997 in countries such as Germany and France (not in Spain); but the OECD and the International Monetary Fund were expecting the deficit criteria to be clearly exceeded by these and other countries. This is the reason why formulae are being studied in all the capitals of Europe which might permit a flexible interpretation as regards the fulfilment of the convergence criteria, without running the risk that the financial markets might consider these to be too arbitrary and react in their own way. This is a very delicate task because, amongst other things, one would have to treat all of the countries in the community equally, when in fact it appears that this departs from the hypothesis that with some countries, those which must form the «hard nucleus» of the EU, it will be necessary to be more generous in relation to a breach of the convergence criteria than with others. Germany and France, for example, are usually included in the first group with Italy and Spain in the second. It remains to be seen as to what point the Spanish government and others of those involved will accept this form of discrimination. It would not be good for the future of European integration if a chasm were to open between the countries of central Europe and those around the southern edges.

3. Building credibility of the European Central Bank

The European Central Bank will not be able to inherit the reputation enjoyed by the Bundesbank. It will have to earn it and reconfirm it continuously by means of a stabilizing monetary policy which is credible. The environment in which it will have to negotiate its way will be as complex and demanding as it currently is already, if not more:

– This environment is characterized by the globalization of the financial markets. There is great international mobility of capital, supported to good effect by advances in modern information and communications technology. This is positive from the point of view of the efficient application of resources.

– The financial markets have become a kind of «traffic police» for the global economy. They assess and penalize («fine»), on an almost daily basis, the monetary and fiscal decisions of the issuing banks and governments (as well as decisions relating to salaries taken by unions and employers). They also compare the policies of one country with those of another, for which the Maastricht convergence criteria act as pointers.

An evaluation of economic policy cannot be made by government itself (which would involve convincing us that it was doing everything very well); neither can it be made by parliament (where the opposition parties would state the contrary); evaluation is made by international investors through their operations in the financial markets. The issuing banks and governments have completely lost their immunity. If they make mistakes and cause basic imbalances without correcting them rapidly, there is a price to pay in the form of risk premiums on the returns on public borrowing and devaluation of the currency. Spain has suffered this during its recent history: the official devaluation of the peseta, spreads over the German bond which reached over 400 basic points (they later fell again to under 100 points at the end of 1996). In such situations, international investors seek quality and look towards safer horizons and countries which have a proven solidity and strength in terms of their currency. This «refuge-currency effect» explains to a great extent the strong appreciation of the German mark in 1994-95 (corrected in 1996).

The future European Central Bank will not be able to avoid this challenge of competition in monetary (and fiscal) quality between the EU and other countries. It is good that the Maastricht Treaty guarantees the autonomy of the Central Bank in relation to the different governments and the European Commission. In a paper-currency system, this is the best institutional provision which can be adopted so that the monetary authority can protect itself from political pressures seeking low interest rates (with the aim of stimulating the economy or alleviating budget loads). But no one knows whether the politicians at community level, particularly in summits and committees, will respect this autonomy in sufficient measure. France has already made it understood that it wants a political counterbalance to this autonomy, in institutionalized form. As a result, in the beginning, the European Central Bank will have to be ready for the possibility of scepticism reigning in the financial markets as regards its ability to impose its autonomy and fulfil its objectives relating to the stability of price levels. The best, if not the only, way of gaining credibility consists of the Bank defining, immediately after its formation (which will happen as soon as the countries which will initiate the EMU become known), its strategy and the fact that it has the adequate facilities to be able to control inflation.

As regards strategy, it is important that the European Central Bank adopts rules of action which limit optional elements thus contributing to a stabilization of the expectations of the economic agents as regards price levels. The European Monetary Institute has just officially made this recommendation. There are two models: that of orientation towards intermediate monetary objectives (the «German model») and that of direct orientation towards the final objective, i.e. price stability (the «British model»). In favour of the fixing of intermediate objectives for monetary policy (in terms of the most appropriate aggregate M), it can be said that the Central Bank has the ability to control the money supply. In the event that the corresponding aggregate monetary demand shows, in the medium term, a stable relationship between the nominal cost of goods and services (technically speaking, the correlation would be positive as regards income and negative as regards interest rates), monetary expansion in conjunction with nominal growth in the productivity potential of the economy would result in a favourable evolution of price levels. In opposition to this model, one can allege problems relating to the instability of monetary demand as a result of financial innovations; at least in the short term, the volatility of the monetary aggregates is notable. Furthermore, the Central Bank cannot directly influence the rate of inflation. The transmission processes of specific measures to prices continue to be unknown to a great extent, in spite of the large amount of theoretical and empirical research which has been carried out on the subject. Furthermore, it is difficult to foresee how prices will behave in the common monetary area during the initial period, while the euro is replacing the different national currencies.

All of this leads one to think that the European Central Bank may generate sufficient confidence in its actions by using the rule relating to intermediate objectives. Recent empirical studies indicate that, at European level, the demand for money supply shows reasonable signs of stability, in particular the aggregate M1. There is also the possibility that this rule might be combined with the rule relating to inflation.

Decisions to be taken regarding monetary instruments will be less complicated, given that there is already enough compatibility between the issuing banks of the different countries; the key element must be the «repos», through which the monetary authority can have great influence both on short-term interest rate development and on money creation by the banking sector. Most disputed is the question as to whether the European Central Bank will or will not possess an instrument for the imposition of minimum reserves; the Bundesbank advocates this, claiming that it is a necessary means of intervention in order to have better control over the basic money stock, but the majority of its European partners and, most of all, the Bank of England do not support it, considering that this rate is a kind of tax on investment banking which would reduce their competitiveness in the financial markets. In view of the fact that the rates for this instrument have fallen markedly in Germany, it is not likely that an insoluble argument will arise at the final hour in this regard.

An underlying threat to the credibility of future monetary strategy is that the Maastricht Treaty has granted powers relating to exchange policy to the European Council of Ministers of Economy and Finance. It would have been better to leave this in the hands of the European Central Bank. There would be less temptation to pursue certain exchange rate objectives for the euro in relation to important currencies such as the dollar or the yen and to claim a special role for the single currency as an international reserve currency. It is necessary to insist, therefore, that the politicians demonstrate an attitude of extreme caution, thus contributing to the most calm environment possible, so that the European Central Bank can convince the markets of the seriousness of its promise to supervise stability in price levels.

In order for things not to become too complicated at a later point, it will be important to establish an exchange system between the euro area and the other community countries which is effective and which does not counteract the monetary policy of the European Central Bank. There are three essential aspects to bear in mind:

– Firstly, the euro must be the «anchor currency» for the other currencies. This can be properly shaped either through various bilateral agreements, which would give rise to an EMS II with (narrow?) fluctuation bands for exchange rates, or through a country's unilateral link to the common currency (emulating the so-called «Austrian model» by which Austria has, since 1971, maintained a fixed exchange rate for the shilling against the German mark, its central bank thus becoming a passive partner of the Bundesbank and its anti-inflationary policy). In the case of bilateral agreements, it is essential that the central banks of countries which have not joined are independent, as is already required by the Maastricht Treaty as a condition of admission.

– Secondly, the European Central Bank must not be obliged to unlimited interventions in the currency markets for the purpose of supporting the exchange rate of outsider currencies which are in decline. If it wishes to, it should intervene voluntarily but only in a limited manner and without anyone being able to hurry it; it is important that the national authorities do not cease in their efforts towards convergence and desirable that speculation in the foreign exchange markets carries the risk of losses which is inherent in this type of activity. Obligation to intervene without restriction against market forces would constitute an invitation to speculate (without risk) and would give rise to serious inflationary dangers for the euro's area of operation which would make it extremely difficult for the European Central Bank to gain the reputation which it needs so badly.

– Countries which do not participate (initially) in the common monetary area are exclusively responsible for the value of their currencies. It is these countries which must apply an economic policy which is adequate in order to contain inflation and reduce fiscal imbalance. In this way they would demonstrate that the undertaking towards convergence is made in all seriousness. In the event that costs and prices shoot up in these countries, parities will have to be realigned, that is to say, the currency in question will have to be devalued against the euro without too much delay. The European Central Bank should have the right to demand this realignment; if the European Council of Ministers of Economy and Finance were to take no notice of this demand, the Bank could make it public thus informing the financial markets. In this way a «politicization of the exchange rates» such as repeatedly occurred in the EMS (and as the crises of 1992 and 1993 demonstrated in no uncertain terms) would be avoided.

The worries which prevail in some political and economic sectors, particularly in France, concerning the chance of competitive devaluations in community countries which have not joined the single currency, with the subsequent distortion of the single market, have given rise to the proposal that fixed parities be established between the excluded currencies and the euro. This proposal is questionable for two reasons. The first is that a country which wants to obtain a competitive advantage in this way possesses the means to do so; it can embark on a monetary policy which is excessively expansionist, thus provoking devaluation. The second is that the desire for co-operation probably prevails; it is the path which outsider countries will have to take in order to be able to converge as quickly as possible with the countries in the common monetary area and join this area themselves.

The European Central Bank must be able to trust in the fact that the euro's exchange rates vis-à-vis the national currencies are correct, that is to say, that they reflect the fundamental macroeconomic data of the different participating countries. This is a necessary condition for the stabilization of the euro. One serious problem arises from the fact that these rates cannot be announced beforehand, once examination for admission to the single currency has been made, as this might give rise to unforeseeable reactions in the financial markets. Probably the most adequate formula would be that of announcing the process which will apply at the moment that the euro comes into being. One possibility would consist of working from the basis of an average of the values registered during the two previous years, or even with the further consideration of earlier levels, with the aim of counteracting the effect of an eventual last-minute exchange manipulation by one monetary authority or other. In this connection, the key also lies in the credibility of the decisions adopted. The national issuing banks of the countries chosen for EMU can and must contribute to the Union through the co-ordination of their monetary policies while these are still being executed.

4. A European fiscal pact for stability?

The effectiveness of the European Central Bank will depend to a great extent on whether the fiscal policy of the different governments is or is not compatible with the aims of stability. Almost every country finds itself caught in the excessive public deficit trap. They attempt to reduce their deficits through raising taxes and social contributions, which depresses internal demand in such a way that fiscal receipts decline and public expenditure (unemployment subsidy) rises. As a result, instead of diminishing the deficit grows. If a country were to produce large public deficits year upon year, especially if these were structural in nature, this would inevitably create conflicts with common monetary policy: this would either become too relaxed (allowing inflation) or too strict (depressing economic activity). In this latter case, the situation could become even more complicated if countries in crisis exerted pressure to obtain transfers.

The fiscal problem is the weak link in the whole EMU project. This is due to the fact that an absence of budgetary solidity is treated asymmetrically according to the phase of monetary integration that we find ourselves in. In the current phase, any country which does not fulfil the fiscal requirements for convergence may not join the union. There is, therefore, a stiff penalty – that of non-entry (always assuming that there is strict application of the indicated criteria). This situation changes radically in the third phase. Once the EMU is formed, fiscal policy will remain in the hands of the different national governments. But these governments will no longer possess a state monopoly over their money. As a result the «inflation tax» will not be available to the state in order to reduce the actual burden of its debt. In these circumstances, the inappropriate behaviour of a government could have undesirable effects for the other member states and the common monetary area. Of course, it is true that the Maastricht Treaty contains a «no-bail-out» clause which expressly prohibits the future European Central Bank from granting credit to governments in order to finance their public deficit. It is also true that it establishes a penalty mechanism (including fines) in the event that a government demonstrates a lack of budgetary solidity. But the penalty mechanism is very complex, lending itself to delays and political interpretation. Furthermore, decisions regarding penalties require the approval of a special majority of member States, meaning that a minority could prevent this happening. This is quite apart from the fact that the Council of Ministers may only act if the European Commission presents a report regarding the existence of a fiscal imbalance in the country in question. And aside from all of this, the Treaty does not provide for the expulsion of a country which fails in its duties regarding fiscal solidity. It is, therefore, unlikely that the markets really believe that disciplinary measures will actually be applied; they are more likely to think that the other countries will provide help for the member which finds itself in difficulty. The consequences will be paid by everyone: more inflation, higher interest rates and the devaluation of the euro, with the loss in terms of real earnings which this would produce.

As a consequence, it is essential that the countries which wish to join the EMU put their budget accounts in order as soon as possible. This means eliminating public deficit, preferably doing so through the control and reduction of costs of consumption (compensations to staff, grants, social services) and avoiding, to the greatest extent possible, raising taxes which would remove the incentive for savings and investment. Budget adjustment would not be achieved through ingenious accounting, however imaginative this might be, or by manipulating the statistics, however much or little one might want to conceal. This would do nothing more than transfer the current public deficit to future financial years. An adjustment can only be achieved by a real and permanent saving. It is clear that any serious programme for the cleaning up of public finances (including Social Security) is unpopular, having to confront an endless number of created interests, and for this reason the unions and other interest groups will not hesitate to put up fierce resistance (and not only in France). If the politicians do not have sufficient courage and instead pull back, the plans for budgetary consolidation and reform of the welfare state will come to little.

For this reason, it was appropriate to complement the Maastricht Treaty with a fiscal agreement. Ever since the Madrid Summit, there has been talk of a «Stability Pact» and at the European Summit in Dublin at the end of 1996, agreement was reached: it is a positive move that, in theory, every country now recognizes that a public deficit which exceeds 3% of GDP will not be sustainable in the long term. The European Commission and Ecofin will pay closer attention to budgetary development. The penalty amounts have also been specified. Of course (and this is the negative side), this supervision will not necessarily have specific consequences. In fact a country may produce a higher deficit in the event of an acknowledged economic recession (an actual fall in GDP of 0.75% or more in one year) without fear of sanctions. And in no case (including that of a slight recession with a fall in GDP of less than 0.75%) will the sanctions be automatic, as a process of political decision will always be carried out first. The fact that the Dublin «Stability Pact» is now called the «Pact for Stability and Growth», as a result of successful pressure by the French, is a point to be noted: it opens the door to any of the governments (including a German government) being able to increase expenditure excessively, claiming that it wishes to create employment (although everyone knows that Keynesian recipes do not get us very far). We would thus depart on an inflationary path without creating more employment.

In order to convince the financial markets of the seriousness of the undertaking made, it would be useful for each participating country to adapt its own Constitution, incorporating the fiscal convergence criteria as links with national budgetary policy. Ideally, the rule should be that the annual public deficit must not exceed public investment, assuming that such investment is made to increase, modernize and preserve basic infrastructure and facilities which would, in theory, have positive repercussions for economic development.

It is clear that even this would not provide a cast-iron guarantee that governments and parliaments would demonstrate budgetary discipline. The temptation for politicians to spend more than they should is a fact of any democratic system, because of the votes that can be bought in this way (the theory of *public choice* explains it perfectly). And in periods of economic weakness there will always be pressures for the introduction of expansive fiscal policies (Keynes's theories continue to be popular). Nevertheless, it is desirable that everything possible is done to minimize these risks. The result would be an increase in credibility in the euro which would translate into lower interest rates and a reasonably stable exchange rate against the dollar and the yen (and other important currencies). In the final instance, the pact would also give credibility to the undertaking already made by various governments to apply economic policies which favour supply, with the result that economies will grow dynamically, without inflationary pressures and with sufficient capacity to generate employment. With public deficit under control, a state would cease to increase fiscal pressure continually, reducing such pressure at the same time as reducing the proportion of its deficit against GDP, thus increasing the field of operations for private initiative.

5. Increasing flexibility in the labour market

Apart from nominal convergence, an even greater actual convergence will also have to be cultivated, that is to say, an equalization of levels of economic development and productivity. The Maastricht Treaty did not make any explicit ruling in this regard, although it did deal with it implicitly in considering financial assistance from cohesion funds for countries with a per capita income of less than 90% of the community average (Spain being included in this group).

It would be nonsensical to wish to form the EMU with the inclusion of countries having levels of development which are too far apart. The theory of optimum monetary areas dictates that, if one does not have an exchange rate whose adjustment could cushion actual divergence between the different regions and mitigate the effects of unexpected external shocks, wages and the geographical mobility of labour and capital would have to be extremely flexible. Neither of these conditions is met in the EU to a sufficient extent. As a result, it is necessary to make transfers from the more advanced countries to those which are less advanced. But it is an illusion to think that one could mobilize resources to the extent necessary. This has been carried out from West to East Germany since unification but it has involved the reallocation of resources within a single country where it is easier to achieve public consensus regarding the loading of additional pressure on contributions. The EU however does not have a «European population» and the solidarity of people in prosperous nations in relation to the need to finance other countries has its limits. Neither would it be desirable to merely increase structural funding because this would distort the incentives system and, in the end, structural imbalances would remain.

It is therefore of the utmost importance that, in the process of convergence towards EMU, inflexibility in the different national labour markets is gradually eliminated (this is also essential in Spain). It is only in markets showing flexibility in matters of wages and other working conditions that the mechanisms for nominal adjustment can operate in the face of eventual losses in competitiveness once the exchange rate has disappeared as a correcting measure.

In the EMU, the unions of a particular country which make excessive wage claims may not rely on the future European Central Bank to provide monetarily for the increase in labour costs. The bank is «distant» and does not have to feel forced to act contrary to its objectives for the simple fact that unemployment is occurring in some part of the common monetary area as a result of the wages policy being pursued there. The consequence for the unions in the different member countries is that their responsibility for the high levels of unemployment currently being suffered (though some may deny it) will be even greater in the EMU. They will have to accept that, in the market, they can only directly influence nominal wages. In directing themselves towards wages and increasing them excessively the unions satisfy the desires of the workers who are in work at the expense of those who, for the same reason, lose their jobs or are looking for work without success. But if they were to modify their approach and accommodate wages policy to the development of productivity and market conditions, they would substantially contribute to an improvement of prospects in the labour market. With moderate wage increases there is less inflation, with less inflation you have lower interest rates, with lower interest rates there is more investment, including direct investment from other countries, and with more investment there is more opportunity for employment. Countries such as Spain could progress down the road towards actual convergence at a higher level of development.

6. Before «squaring the circle»

Current debate (in politics, the business sector, the unions and academic circles) centres around the likelihood of adhering to the timetable established at the Madrid Summit for entering the third stage of EMU. The different governments and the European Commission currently never tire of stating that EMU will begin on January 1, 1999, that the convergence criteria will be strictly applied and that it is expected that a number of countries will participate. When all is said and done, I feel that we are faced with a problem of inconsistent logic, let's call it a «trilemma».

These three statements are not consistent with each other and one of them will have to be rejected. Either the convergence criteria will have to be relaxed or dates postponed or there will only be a «mini» monetary union.

If economic convergence is not achieved between a sufficient number of countries within the time predicted, the most reasonable attitude would be to wait, that is to say, prolong the second stage beyond 1999 («stop the clock», as has already happened on more than one occasion in the process of European integration). This would not mean frustrating the plan for the single currency. On the contrary, any postponement would be made in a regulated manner, according to the terms which the Maastricht treaty itself considers. All member States would accept the «rule of exception» established for the countries which do not initially participate (Article 109 K), in such a way that the evaluation for convergence could take place two years later, that is to say, during the first half of 2000 and EMU would begin on January 1, 2001. The alternatives have their disadvantages:

– If the convergence criteria were to be generously relaxed with the aim of allowing many countries to join, there would be a risk that the EMU might get off on to a bad start, being classified by the financial markets as a union with a weak currency. If this then translated into an appreciation of the dollar, protectionist pressures would increase in the United States in relation to European exports. Furthermore, if the criteria were relaxed for the first session, the same would have to be done when the countries which were not admitted at the beginning subsequently wished to join the single currency. But the situation could arise that the countries which have already joined would demand strict fulfilment of the criteria, being motivated by concern for the credibility of common monetary policy.

– If, on the other hand, the convergence criteria are applied rigorously from the outset, there would be no more than a «mini» union at best. If this happened, the countries forming the EMU would have gained little or nothing with regard to the elimination of undesired fluctuations in real exchange rates and, above all, in respect of the loss of international competitiveness due to an actual devaluation of currencies which are (for the moment) excluded. German industry, for example, fears competitive devaluation of the lira and French industry, devaluation of the peseta, if Italy and Spain are excluded.

It is clear that it would be preferable not to have to choose between these three alternatives. But, if a choice has to be made, it is the fault of the politicians who clearly did not take seriously the document that they were signing in December 1991 and did not confront with determination the task of budgetary consolidation which already then showed itself to be unavoidable. They simply wasted precious time which is what they now lack. What must be avoided is that the different governments, worried about the proximity of the examination date for the first session, embark on short-term budgets which are adjusted to fit the criteria, without taking the possible negative effects on economic activity into account. It may appear to the general public (mistakenly, of course) that without Maastricht cuts in public expenditure and in social services would be inevitable. The cleaning up of public finances is a very delicate task which requires both determination and perseverance but not the taking of *ad hoc* actions. A wise adjustment must be concentrated on the structural components of the deficit (not the cyclical components which are transitory). This would create positive expectations among economic agents as regards a fall in interest rates and tax levels, which would propel economic activity, particularly that of investment (*crowding-in*), especially if this budgetary consolidation is accompanied by other economic polices on offer (including the deregulation of markets). The European economies would return to the way of self-sustained economic growth. This is the objective by which economic policy and governments must be guided. And, if this happens, there will be no reason to fear the concern which is often voiced – that to suggest the possibility of a regulated postponement would lead the different governments to relax their efforts towards cleaning up public finances.

No one knows how the international financial markets will react if confronted with an eventual postponement of the date on which the single currency is to come into force. To state, as many do, that there would be a strong appreciation of the German mark, together with serious dangers for the international competitiveness of companies and consequently for the attainment of a satisfactory pace of economic growth in the whole Community, is pure conjecture, and exaggerated at that. The financial markets do not behave in such an irrational manner that they persistently ignore the macroeconomic fundamentals. And, for Germany, these values would not have changed, let alone improved, for the simple fact of postponing the date that the single currency were to come into force. The risk of speculative attacks on certain currencies is no less in the event of the desire to begin EMU in a hurry, on the basis of a purely headstrong policy decision, than it would be in the event that convergence were cultivated in a clear and conclusive fashion. The financial markets have the «memory of an elephant» and they would not allow themselves to be dazzled by good macroeconomic data at a given moment. They would instead take into account the quality of the convergence policy followed in the past. If they consider that the various governments have not respected economic analysis and have allowed themselves to be tempted into masking the figures in order to hide their problems, it is highly probable that such disruption would be unleashed that the whole monetary project might be buried. The future of the European Union is not in danger if EMU takes longer to achieve. It is in danger however if the politicians take a leap into the void. History has shown that the various monetary unions that have existed between different countries since the last century have disintegrated sooner or later because of a lack of convergence, especially in fiscal matters. In the future, history will judge the EMU not on the basis of the date on which it came into force but on its good (or bad) operation.

However, if for «political reasons» the date of January 1, 1999 has to be adhered to at all costs, it would be advisable as soon as possible to agree on a method for making the convergence criteria more flexible. To wait until 1998, when the key decision is to be taken, is not a good idea, because the markets will continue to carry the burden of an unnecessary and troublesome uncertainty and because tension will increase greatly at a political level. Before reaching the moment of assessment for entry, the governments will have to explain how they understand the exceptions established in the Maastricht Treaty as regards the two fiscal criteria and how they expect to manage the exchange rate criterion. It goes without saying that the criterion regarding price levels cannot be given a lenient reading, given the high constitutional priority that the Treaty gives to the objective of monetary stability.

Having given these warnings, and by way of conclusion, one can predict that there will eventually be a single currency within the European Union. Some 70% of analysts in Germany accept the probability of this happening on January 1, 1999. They feel that, after so much technical preparation, we have passed the point of no return and that, when the moment comes to decide which countries are going to begin the EMU, the requirements established in the Maastricht Treaty will be eased (though without being too tolerant), in particular the fiscal criteria, subsequent fulfilment of which will be imposed by the Stability Pact. Furthermore, an acceleration of the economic expansion of the different economies during the coming year, which many experts believe to be a certainty, will alleviate budget problems. There is, nevertheless, unanimity in the prediction that events will unfold at two (or more) different speeds. The leading group (the «hard nucleus»), through which the single currency would currently obtain most credibility and respect, would be composed of seven States – Germany, France, Austria and the Benelux countries, with the addition of Denmark, if it wished to participate. These countries commonly have a good background of stability and high economic potential so they would thus be able to form an «optimum monetary area». Returns on government bonds (over ten years) are very similar from one country to another, which can be interpreted as a vote of confidence by the financial markets in the sense that they do not expect bilateral variations in exchange rates.

Spain would find it difficult to become eligible for membership in the first wave if it were to back in the convergence process. The probability of its admission would be greater if assessment favoured the purer political components. This scenario (the «broad view») contemplates the immediate entry of the majority of countries (including Italy and Portugal). In any case, the competent Spanish authorities must not cease in their serious efforts to contain inflation and consolidate public finances thus advancing along the road towards nominal convergence. They must do this, of course, without neglecting the economic policies (basically the structural ones) which are also necessary to improve real convergence and to approach, more successfully than has so far been achieved, levels of productivity in the Spanish economy and a competitive capacity for its companies equal to those of its central European partners. It would not gain very much by remaining (indefinitely) on the outside. Even the possibility of competitive devaluation does not have any value over the medium term as the price for this would be an increase in inflation and, as a result, a loss of well-being. On the other hand, participating in the EMU would involve, if all goes well, being part of an area of stability which would give support to the markets, both financial and real, of great weight within a world economy which is ever more globalized. However, independently of when Spain joins this new monetary area, the challenge to modernize the economy will continue to be a major and difficult one.

V. Basic guide to debate on costs and benefits of single currency to Spain(*)

(Pseudo-arguments against the single currency)

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1. Introduction

The aim of this article is to clarify and further promote the debate regarding the costs and benefits to Spain of the single currency through a critical examination of the principal arguments put forward advising against our country's participation in the euro.

(*) This article develops and extends a first approach to this debate by the author published in *Economistas*, No. 72 (1996).

The objective of adopting the euro as soon as possible is one which is shared by almost all the political parties along with the majority of trade union organizations. If the principal vehicles for the expression of public opinion and the organized interests of a country are in agreement regarding a particular choice of economic policy, to begin or continue a debate regarding the costs and benefits of this option would seem to be of little practical use and even less political relevance. Furthermore, everything points to the fact that Spain will be among the first countries to join the single currency or, at worst, that it will join the currency one or two years later. Nevertheless, I feel that the political and social importance of intensifying debate does not only not recede, it in fact gets stronger with the entry of the peseta in the single currency. If, at least in the political and professional circles responsible for guiding public opinion in matters which are difficult to comprehend, the differences are not properly understood between the operation of the Spanish economy according to a regime of variable exchange rates and its operation with exchange rates which are irrevocably fixed, if these differences are unduly exaggerated or minimized, one runs the risk that all of the ills or all of the prosperity experienced in our country after 1999 may be put down to the euro.

The popular view of the single currency will inevitably be coloured by the state of the Spanish economy during the first years of the euro's existence. If these are years of growth, all of our good fortune will be put down to our membership of the single currency; if they are difficult times, the single currency will be equally completely blamed. It is precisely for this reason that it is essential, in the rhetoric of the evangelist, to carry out an exercise in the division of responsibility and to distinguish between that which is Caesar's and that which comes down to Divine Providence. It is, in my opinion, especially important to separate, with the greatest possible precision, the risks which the single currency adds to the operation of the Spanish economy from the risks which are inherent in the deficiencies of various of our country's economic institutions.

Throughout this essay, I have tried to limit discussion to the most relevant arguments put forward in this debate. I have also made an effort to concentrate on an analysis of the theories and data which provide the clearest evaluation of the arguments under consideration, avoiding wherever possible any theoretical references and empirical analyses which might distract the attention of many readers from the principal questions in play. I hope that these efforts have not resulted in any loss of rigour as regards theoretical reasoning or that some argument which is worthy of consideration has been left unexamined.

2. «The design of European Monetary Union bows to political and not economic considerations»

This sentence, which supposedly dismisses the economic reasoning behind the plan for European Monetary Union, opens or closes many of the analyses which oppose the single currency. Whether this statement is true or false, it nevertheless does not necessarily tell us anything good or bad about the value of this project.

Any economic project or decision with consequences which are visible and important for all of society has always been subject to political considerations, especially matters relating to currency, the origin and vicissitudes of which are closely entwined with the fortunes of the sovereign state. The fact that it is primarily political impulses which determine an economic decision does not necessarily mean that this decision is mistaken or that it might be more costly than an alternative decision basically recommended for economic reasons. On some occasions, political and economic analysis may coincide in recommending the same decision. On others, the information available regarding the different time profiles of the costs and benefits associated with each of the alternatives in question does not allow one to reach a precise conclusion based exclusively on economic analysis. Of course it may also be (it is not infrequently the case) that both the political and economic calculations used in the approval or rejection of a particular plan which is finally put into practice are not in the end validated by the real data. It could then happen that the potential successes or failures which should theoretically result from the materialization of such a plan turn out to be the opposite, whether this be because of errors in prior analysis or because of the appearance of developments which were unexpected when the relevant decision had to be taken.

What interests the economist is to carry out the most complete economic analysis possible of the option under consideration, independently of whether the decision originates from one sphere of reasoning or another. It is clear that the fuel that has driven European Monetary Union over the course of recent years comes essentially from the intensification of the project for the political integration of the European countries occurring during this period. This does not put the success of Monetary Union in doubt but neither does it ensure it. The euro might be positive for the economic future of many countries or it might not be (it could also be insignificant) but none of these judgments may be put down to the political origin of the project. Those who dismiss the single currency because they simply do not wish it to be the basis for a more politically integrated Europe should not run away from the economic arguments regarding the intrinsic merits of the project and neither should those who believe that this project is only justified if it permits the strengthening of European political union. On entering the economic debate on the costs and benefits of Monetary Union, these agruments should be abandoned *a priori*. On the other hand, both those who fear the single currency for political reasons and those who long for it on the same basis perhaps exaggerate the impact of the monetary project on the construction of a supranational Europe. The former should remember that the monetary regime most similar to the single currency as recorded in history (similar but, of course, not identical) is the gold standard and, while that regime was in force, Europe experienced political periods of both integration and disintegration. The latter, those who long for a single currency because they feel that it will give more power to a federal State of Europe, should accept that, if the single currency is not set on sound economic foundations, there will be other more efficient monetary schemes for preserving at least the possibility of reaching their objectives.

3. «The single currency will prevent economic growth in Spain from being able to exceed that existing in Germany»

Stated in these or similar terms, concern is frequently expressed that the irrevocable fixing of the peseta's rate of exchange against the mark and the currencies of other countries more economically advanced than ours will also fix our place on the ladder as regards per capita income and the relative progress of the different European countries. The similes which compare the disappearance of the peseta into the euro with «falling into a trap» or «climbing into the gorilla's cage», used repeatedly by some businessmen and economists, clearly demonstrate this concern.

The economic history of this country and that of other western countries does not, however, justify this concern. To put it another way, there is no substantiating evidence to indicate that a fixed exchange rate regime imposes a distribution of long-term economic growth rates on participating countries which is any less varied than one resulting from a system of variable exchange rates. On the contrary, one can show casual but nevertheless strong evidence that different countries, including Spain, have grown much more rapidly than other countries for long periods operating under a regime of fixed exchange rates, as well as regions which have grown more rapidly than other regions within the same country. One can also find similar long periods with floating exchange rate systems in which many countries, Spain among them, have not exceeded the average growth of the other countries participating in such systems.

Before continuing to develop this line of reasoning I should clarify something which is repeated in other parts of this article as it is essential in order not to distort the argument. One must not confuse a fixed exchange rate regime (or one which is fixed and in exceptional cases adjustable), such as the gold standard, the Bretton Woods system or the EMS, with the voluntary establishment by a country's authorities of objectives limiting, to a greater or lesser extent, any variations in its currency's exchange rate. The fundamental difference lies in the fact that in the first case, the authorities are usually unable unilaterally to vary the parity agreed in the fixed exchange system, however much they might want to, whereas in the second case, they can. In the case of a system of floating exchange rates, even though the authorities may establish objectives for the exchange rate, it is always possible to allow market pressures to raise or lower the exchange rate, for brief or longer periods, placing it outside the band targeted by the authorities. The mere existence of this possibility alters the nature of expectations and with it the actual operation of a variable exchange rate system in relation to what would happen with fixed exchange rates (even when, in a floating exchange rate system, the authorities decide to intervene continually in the foreign currency markets in order to place their currency within a particular band). In the foreign currency markets, the intensity of speculation is proportional to the difference between the exchange rate existing at a given moment and the level which market participants calculate that it may reach without intervention, a level which has no defined limit in a system of variable exchange rates. This implies that if, in a system of flexible exchange rates, the authorities wished to slow an appreciation (or depreciation) imposed by market forces, they would have to support an expansion (or contraction) in liquidity exceeding that which would result from fixed exchange rates and this expansion (contraction) would end up by provoking an actual appreciation (depreciation) greater than the one which would be recorded with fixed exchange rates under the same circumstances. That is to say, when there is a possibility of varying the nominal exchange rate, for example, when the market is gambling on an appreciation, the authorities can intervene to fix the nominal exchange rate and prevent a nominal appreciation. However, they cannot completely sterilize the monetary consequences of this intervention and cannot therefore prevent the appreciation of the real exchange rate which will be produced through an increase in the rate of inflation. In other sections of this essay I will illustrate in more detail this difference between systems of fixed and variable exchange rates.

Returning to the relationship between exchange rate systems and long-term economic development, one can indicate some historical episodes in order to ease the concerns of those who consider that fixed exchange rates impose a ceiling for economic growth in the less wealthy countries governed by the growth rate achieved in the richest countries. The first example is the operation of the gold standard during the 19th century, which did not prevent the continuous relative progress of France and Germany in relation to England, the richest country during that century. One can also mention the Bretton Woods period between 1950 and 1972 in which an essentially fixed exchange rate system did not prevent the level of economic growth in the United States being greatly exceeded by the majority of European countries. Curiously, the European nation with the lowest rate of GDP growth during this period was the United Kingdom, the country which recorded the greatest exchange rate devaluations while the Bretton Woods system was in force. In fact the devaluations of the pound sterling in 1949 (by 30%) and 1967 (16%) were the most marked devaluations carried out by an industrialized country under this system. Nevertheless, during the height of the Bretton Woods system, between 1961 and 1970, the United Kingdom was the industrialized country which recorded the lowest growth in GDP – an average of 2.9% per annum against an average of 4.8% in the European countries and 3.8% in the United States (the evidence for the 1950s gives similar results). The single currency existing within individual countries has also not prevented some regions from growing much more rapidly than others or the fact that, on occasion, the wealthier regions have slipped down the scale of per capita income within a particular country. For the purposes of illustration, and restricting ourselves to the case in Spain, one can mention the instances of Asturias and Cantabria which were among the regions with the highest per capita incomes in the beginning and middle of this century but which have now fallen below the average, or the cases of Aragon, La Rioja and the Balearic Islands which are currently well ahead of the position they occupied fifty or sixty years ago.

A comparison of economic growth in Spain with that experienced in Germany, or with the average growth shown by the 15 countries currently forming the European Union, during the Bretton Woods fixed exchange rate system and the subsequent period of variable exchange rates also offers no support for the pessimism regarding the influence of a fixed exchange rate system on our potential for relative progress, indeed, much the contrary. Table 1 shows the relevant information involved in making this comparison.

Table 1

GROWTH OF REAL GDP IN SPAIN AND OTHER EUROPEAN COUNTRIES
(Figures shown as percentages)

	Fixed exchange rates	Variable exchange rates		
	Ø 1961-70	Ø 1971-80	Ø 1981-90	Ø 1993-95
Spain	7.3	3.5	3.0	1.3
Germany	4.4	2.7	2.2	1.6
EU 15	4.8	3.0	2.4	1.6

Note: Ø actual growth in real GDP as an annual average for the indicated periods.
Source: *European Economy*, No. 60, 1995, page 114.

It is perhaps worth mentioning that average annual levels of economic growth practically do not change at all if we extend the period of fixed exchange rates up to and including 1972 or if one considers it necessary to increase the last period of variable exchange rates to include the official predictions for growth in GDP for 1996 and 1997 in the countries under consideration.

There is a clear and unambiguous message offered by Table 1. This message is not that fixed exchange rates assist economic growth or that variable exchange rates slow it down. The differences in long-term economic growth during the periods recorded in Table 1 are, without doubt, due to the differing behaviour in one period or another of the factors which actually determine economic growth, factors in which the exchange rate does not play a big part. In my opinion, the exchange rate system is practically neutral as regards the long-term growth process and, in any event, its influence is indirect and subject to the operation of a multitude of variables, both psychological and political. The influence of the exchange rate system on long-term growth essentially depends on the effects which one exchange system or the other might have on the behavioural habits of the individuals and institutions which are vital to a country's prosperity (discipline and habits of work, quality of the educational system, responsibility to face up to the uncertainties of the future through savings and individual effort, the efficiency with which the goods and factor markets operate, technology, the strength of the spirit of enterprise and the social consideration of the profit motive, the ability of the political system to discipline its public accounts and provide a context in which the above-mentioned healthy individual behaviour can flourish, etc.). This does not mean that the exchange rate system does not have an effect on economic cycles, that is to say, on the span and intensity of phases of expansion and recession. This is an aspect which will be covered in other sections of this article.

The really clear message which one can draw from Table 1 is that fixed exchange rates do not prevent this country from being able to achieve a rate of economic growth which is, for extended periods, greater than that of Germany and the major European countries. This message can also be expressed negatively: the variable exchange rate system does not protect this country against a weakening of the sources of economic growth and it does not therefore prevent the possibility of our being frozen on the European ladder as regards per capita income. For the purposes of this article, it is not necessary to go into an analysis of the factors which could slow or accelerate our economic progress in relation to the main European countries. The most important corollary is to record that flexibility in exchange rates has not prevented a slowing of our progress towards achieving the average European level of per capita income. It must also be pointed out that, if the factors which drive the pace of long-term economic growth are allowed free rein, a system of fixed exchange rates such as the one inherent in the single currency will not prevent Spain from achieving faster growth rates than those of the most advanced European countries.

4. «Spain should not throw away the possibility of devaluing its exchange rate»

This is, without doubt, one of the strongest and most frequently used arguments against the disappearance of the peseta. Note that it does not involve any rejection or acceptance of the fact that Europe is an optimum monetary area. What it does involve is a discussion as to whether, once various European countries have decided to adopt a common currency (whether challenging the prescriptions of the theory of optimum monetary areas or not, according to one's own opinion), Spain must also merge the peseta with this common currency and thus abandon the possibility of varying its exchange rate against the common currency of these countries.

Supporters of the argument summarized in the above heading usually justify it in the following way. If Spain suffers a shock which weakens its economy more noticeably than those of the other European countries, Spanish real wages being inflexible downwards and the possibility for Spanish workers to emigrate to other European countries being very limited, unemployment will increase and a devaluation of the nominal exchange rate would be the only instrument which might generate an adjustment in real wages thereby inducing an escape from crisis. Spain does not therefore, as the supporters of this argument conclude, form part of an optimum monetary area along with the main European countries and it should not therefore abandon the peseta as it needs to preserve the possibility of being able to devalue its exchange rate.

This argument has been often criticised stating that the occurrence of asymmetric shocks in European countries (above all shocks in aggregate demand which are the most relevant to this argument) is exceptional and would be even more so under the single currency. It is also countered with the argument that strong inter-European commercial relations and the high level of intra-industry trade between European countries reduce the effectiveness of variations in exchange rates and make them politically difficult to carry out. Furthermore, the inflexibility of real wages is not broken by a devaluation of the nominal exchange rate but by a rise in the rate of unemployment generated by this inflexibility. That is to say, an increase in unemployment, not attributable to fixed exchange rates but rather to the downward inflexibility of real wages, would be the real adjustment mechanism which would end up by altering labor costs. Devaluation could undoubtedly intensify a fall in real wages but only if the increase in levels of unemployment had been sufficiently great. The process of adjustment with variable exchange rates would therefore not differ much from one resulting under a single currency. One should also point out that this theory, if strictly applied, would give rise to doubt about the advisability of having a common currency in many countries. As an intellectual curiosity, one could also add that the founding fathers of this theory, Richard Mundell and Ronald McKinnon, consider that the world, or at least the industrialized world, is an optimum monetary area in that they have for a long time advocated a return to a system of fixed exchange rates. In fact, Mundell has frequently called for a return to the gold standard and McKinnon for a system of exchange rates essentially fixed between the mark, the yen and the dollar. In other words, their position could be summarised by stating that «the world is not an optimum monetary area in the way that such an area is defined by our theories but it did not operate badly under the systems of the fixed exchange rates provided by the gold standard and the Bretton Woods system».

However, I do not want to enlarge upon the conventional criticism of the conventional application of the theory of optimum monetary areas to the debate about the single currency. I should prefer to mention other aspects of the argument being discussed in this section which usually pass unnoticed and which, in my opinion, when they are properly analyzed, considerably weaken the position of those who use the theory of optimum monetary areas in order to advocate the option of varying the exchange rate. The first aspect is that these so-called asymmetric shocks do not have to be exclusively negative, intense and irreversible, as is tacitly suggested by the above argument. The factors which occasionally prejudice one country in particular may be transitory and may turn back on themselves to become particularly favourable. There may also be positive asymmetric shocks which benefit one country in particular in relation to the other countries in the monetary area. The second questionable aspect is the vision of the operation of variable exchange rates which is implicit in the argument regarding optimum monetary areas in the form described above. This vision tacitly implies that a country's authorities can implement an adjustment of the exchange rate in the amount and at the precise moment necessary to compensate for the asymmetric shock, ignoring the fact that the freedom of movement of capital might generate exchange rate dynamics which are radically different from those foreseen in this theory. For example, a country which for some reason experiences a particular benefit in relation to other countries could record a sudden appreciation of its real exchange rate, in excess of the amount which might be justified by these special factors, and furthermore its real exchange rate may remain overvalued long after these factors have ceased to have any effect. It may also be that the markets provoke an intense and lasting appreciation in the real exchange rate in response to a combination of economic policies which is mistaken but profitable in the short term for those gambling on appreciation.

The above considerations should be illustrated with reference to the Spanish experience. The past has been much longer than the immediate future will be, to the extent that the relative frequency of positive and negative shocks experienced in the past should be a reasonable guide, at least in terms of the phases to come in the immediate future. In other words, what asymmetric shocks have been recorded in Spain over the course of the last twenty years of almost uninterrupted floating exchange rates and what role have exchange rates played?

Without doubt, everyone can here draw up their own personal list of asymmetric shocks because there will always be considerable differences in the performance of the economic and social indicators for each country. Nevertheless, I believe that it is no exaggeration to state that one cannot detect a preponderance of negative disturbances. In any case, in the following paragraphs, in order to analyze the case most favouring supporters of floating exchange rates, I will restrict myself to an examination of the role played by exchange rates in the face of two phenomena which undoubtedly had a particularly negative effect on the Spanish economy, namely the political transition and the strong upward movements in oil prices. Between 1976 and the beginning of the 1980s, the uncertainties and pressures resulting from political transition created, without doubt, a notable asymmetric shock. The acute rises in the price of oil also affected the Spanish economy more deeply than they did the majority of the other European economies because of our greater relative dependence on imports of crude oil. For the same reason, the consolidation of democracy and the acute fall in oil prices which occurred towards the middle of the 1980s, together with this country's entry in the European Economic Community created a singularly expansive impetus for our economy, in that these did not occur, or were less intensely felt, in other European countries. Did the flexible exchange rate system, under which the Spanish economy operated for the whole of this period, contribute in assisting adjustment to these forces and disturbances, as the theory of optimum monetary areas submits? Or rather did the system of flexible exchange rates generate its own disturbances which hindered the achievement of balance in our economy? The following sections contain an analysis of the function of the exchange rate system during the period of expansion prior to the crisis of the 1990s. I will therefore concentrate here on an analysis of the period of recession experienced at the end of the 1970s and the beginning of the 1980s.

Anyone who knows about the evolution of our rate of unemployment must agree that the strong use of flexible exchange rates, the continued nominal depreciation of the peseta during a large part of the second half of the 1970s and the first half of the 1980s, did not serve either to correct the unemployment problem or even to prevent its acute increase. Table 2 shows the data for unemployment and economic growth in Spain and the other countries in the European Union during the recession referred to here (1977 to 1984).

Table 2

ECONOMIC GROWTH, UNEMPLOYMENT AND EXCHANGE RATE FLEXIBILITY

	1976	1977	1978	1979	1980	1981	1982	1983	1984	1985	1977-85 Ø
Spain											
GDP [(a)]	3.3	2.8	1.5	0.0	1.3	–0.2	1.6	2.2	1.5	2.6	1.4
Rate of unemployment	4.9	5.3	7.1	8.8	11.6	14.4	16.3	17.5	20.3	21.6	
Nominal exchange rate [(b)]	124	108	98	107	100	90	84	70	68	67	
Real exchange rate [(c)]	85	85	86	98	94	98	91	81	84	84	
UE 15											
GDP [(a)]	4.5	2.7	3.0	3.6	1.4	0.1	0.9	1.7	2.3	2.5	2.0
Rate of unemployment	4.5	4.9	5.1	5.3	5.8	7.4	8.6	9.1	9.7	10.0	
Nominal exchange rate [(b)]	93	91	90	97	100	82	78	67	60	59	

Notes: (a) Percentage average growth per year in real terms.
(b) Effective nominal exchange rate indicator in relation to the top 19 industrialized countries (a higher value indicates an appreciation). Decimal points have been excluded without rounding (1980 = 100).
(c) Real exchange rate indicator measured by relative consumer prices in relation to the OECD.
Source: *European Economy*, No. 60, 1995, except for the real exchange rate data (Bank of Spain series, 1990 = 100).

The strong devaluation in nominal exchange rates during the greater part of the above period did not allow our economy to respond to the asymmetric shocks experienced during this period without producing a profound deterioration in our relative growth in relation to that of the other European countries and a sharp upturn in the rate of unemployment. Remember that until 1976 (see Table 1) our economy had shown a growth which was more than 50% higher than the average growth shown in the other European countries and our rate of unemployment was, until 1975, similar to the European average.

This argument does not mean to suggest that, if political transition and the shocks relating to the oil crises had occurred in the context of a single European currency, our economy would have fared any better in relation to the European average. But it is difficult to defend the position that, under the regime of a single European currency, our economic performance during the period to which we are referring would have been even worse than it actually was. This is especially true if we bear in mind that a good part of the strong depreciation in the nominal exchange rate during that period was lost in the strong increases in our inflation differential vis-à-vis other European countries, as can be seen from the evolution of the real exchange rate indicator shown in Table 2. Furthermore, an argument which is even more significant than the one mentioned above in support of the hypothesis that things would have been no worse under a system of irrevocably fixed exchange rates, the dynamics of flexible exchange rates itself permitted a strong appreciation in the nominal and real exchange rate of the peseta at the end of the 1970s. This pronounced appreciation was the result of the application of an anti-inflationary monetary policy combined with a strongly expansionist fiscal policy in the face of powerful distortions in the labour market, an explosive mixture which would be repeated in the second half of the 1980s. As the theory of flexible exchange rates maintains, when an overshooting of the real exchange rate occurs, the overvalued exchange rate tends to remain through a long period. As can be seen from Table 2, following the strong appreciation of the real exchange rate which occurred in 1979, previous levels of competitiveness were not regained until 1983.

The peculiar idea of an exchange rate moving at the appropriate time and in the correct direction is, perhaps, the most significant weakness diminishing the relevance of the theory of optimum monetary areas as a guide to economic policy. Due, undoubtedly, to the fact that when this theory was developed there was not sufficient experience regarding the operation of a regime of flexible exchange rates under full freedom of movement of capital. The theory's ideas regarding economic policy envisage an optimum movement of exchange rates which is far from being proven in the real world. When one leaves the way open for a variation in the exchange rate, one should not think that this option only exists to devalue and accelerate the adjustment of an economy suffering a more intense deficiency in demand than that being suffered by others, an adjustment which furthermore will always involve an increase in unemployment when real wages are inflexible downward, whatever the exchange rate regime may be. One has to realize that this option to vary the exchange rate also entails periods of overshooting of the real exchange rate, intense appreciations of the real exchange rate which carry it a long way from its long-term equilibrium level, whatever this level may be, for extended periods of time thus introducing distortions into the economic system which are more serious than those which, in other ways, might contribute to an alleviation of the situation.

5. «The recession experienced by the Spanish economy in 1993 would have been avoided if the peseta had not entered the EMS»

This is a myth which has firmly implanted itself in the collective memory of our recent economic history. In 1992 and 1993, the Spanish economy recorded an average annual fall in real GDP of 0.5%, the deepest recession in this country's history since 1960. Without any doubt whatsoever, one of the factors which unleashed this recession was the excessive appreciation in the peseta's real exchange rate. However, the actual fact that the peseta was excessively overvalued at the beginning of the 1990s, the fact that the peseta was overvalued on its entry in the EMS, demonstrates that the process of overvaluing must have occurred prior to its entry in the EMS exchange rate system. As a result, if the peseta entered a system of fixed exchange rates at an overvalued parity level in 1989, the reasons for this overvaluing must be sought in the events occurring during the period prior to this decision being taken.

In fact, the greater part of the increased loss of competitiveness in our economy between 1986, the year in which real exchange rates started to appreciate, and 1992, the year in which they started to depreciate, happened prior to the entry of the peseta in the exchange rate mechanism of the EMS (June 1989). Table 3 summarizes the evolution of the effective real exchange rate for the peseta against the countries of the European Union (EU).

Table 3

APPRECIATION IN REAL EXCHANGE RATE OF PESETA

	1985	1986	1987	1988	1989	1990	1991	1992
Effective real exchange rate index against the EU (1990 = 100)	85.6	85.9	86	90.5	97.3	100	102.1	101.4
Appreciation in accumulated real exchange rate for the period 1986-91: 17.8%								
Appreciation in accumulated real exchange rate for the period 1986-89: 13.6%								

Note: The real exchange rate series uses the relative rates of inflation to deflate the nominal exchange rate.
Source: Bank of Spain, annual report (1994) and *Summary of Economic Indicators* (Spanish Ministry of Economy and Finance).

As the data in Table 3 highlights, more than 70% of the appreciation in the real exchange rate during the period 1986-91 occurred prior to entry in the EMS. In the first two full years of the peseta's operation in the relatively fixed exchange rate system in the EMS, 1990 and 1991, the speed of appreciation in the real exchange rate which had occurred since 1986 slowed considerably. More important than these facts in rejecting the argument with which we are dealing here, the peseta would have appreciated much more in nominal terms and somewhat more in real terms if it had not entered the EMS exchange rate mechanism. The principal evidence in favour of this statement is Table 4, which shows the strong accumulation of central reserves by the Bank of Spain in the period under discussion, unequivocal proof of its massive intervention in foreign exchange markets in order to slow the peseta's appreciation during that period. Remember that the peseta was at the upper limit of the flotation band permitted by the EMS during the two years following its entry into this exchange rate mechanism.

Table 4

EVOLUTION OF CENTRAL FOREIGN CURRENCY RESERVES
Thousand million dollars

	1988	1989	1990	1991
Volume at 31/12	39.8	44.4	52.1	66
Annual increase	9.8	4.6	7.7	14

Source: *Summary of Economic Indicators*. Spanish Ministry of Economy and Finance.

The existence of increases in the central foreign currency reserves during this period removes the basis for another macroeconomic adage regarding our experience under the fixed exchange rate system of the EMS. I refer to the view which states that the high level reached by nominal and real interest rates in this country during that period was caused by the need to fulfil our exchange rate compromises within the EMS. If the sole objective of monetary policy had been that of maintaining the peseta within its fluctuation band in the EMS, interest rates would not have needed to rise so much nor would they have had to be maintained at such a high level for as long as they were, as demonstrated by the increases in foreign currency reserves during this period. The real causes of the high levels reached by our nominal and real interest rates during this period originate from the need to compensate for the strong inflationary forces resulting from a highly inflationary fiscal policy and sharp wage increases produced by distortions in the labour market.

With the freedom of movement of capital and downward rigidity of real wages, the mix of monetary and fiscal policy implemented by the Spanish authorities during this period would have produced a strong appreciation in the real exchange rate under any exchange rate system, somewhat stronger with variable exchange rates. That is to say, if instead of entering the EMS the Spanish authorities had continued to apply their economic policy under the variable exchange rates system within which our currency operated prior to 1989, the peseta would have appreciated more in real terms because it would have continued to appreciate in nominal terms, in spite of the massive foreign currency purchases made in order to ease the appreciation, as occurred between 1987 and the first part of 1989. Perhaps not all of this additional appreciation would have translated into an appreciation of the real exchange rate because inflation would have been a little lower than it actually was. A little, but not much lower, because the rigidity of the labour market and the persistence of conflicts between monetary and fiscal policies would have continued to establish a very high level of inflation in Spain. Furthermore, although the appreciation of the real exchange rate up to the end of 1991 would have been significantly higher under a system of variable exchange rates, recession and depreciation would have begun earlier under this system. In any case, there is no doubt that if the peseta had not entered the EMS and it had continued to operate under a floating exchange rate regime, the accumulated appreciation up to the beginning of the recessionary phase would have been greater, inflation slightly lower and, very probably, both recession and depreciation would have intensified earlier. As a result, one cannot attribute the recession to the peseta's participation in the relatively fixed exchange rate system of the EMS until 1992.

What is really shown by the recession of the beginning of the 1990s is that a flexible exchange rate regime cannot protect an economy from the consequences of a destabilizing fiscal policy and a labour market plagued with distorsions. It is, of course, true that a fixed exchange rate regime is also unable to prevent the destructive influence of these distortions on the health of an economy. But the recession would not have been avoided nor would it have been at all eased if the peseta had continued to float during the latter years of the 1980s. Only a reform of the labour market and a fiscal policy different from the one implemented would have been capable of preventing the harshness of the recession.

A variation of the argument quoted in the heading to this section is that which considers that the peseta operated in a system of fixed exchange rates from 1988 claiming that variations in the nominal exchange rate between the end of that year and 1992 were relatively small. In this way one could continue to blame the entry of the peseta in a fixed exchange rates system for the excessive loss of competitiveness which increased the recessionary forces. As I have already pointed out, the error in this argument is based on confusing a more or less stable nominal exchange rate with a system of fixed exchange rates. Until summer 1989, the peseta operated under a regime of variable exchange rates, not because its level actually varied to a greater or lesser extent but because it could vary. That is to say, the peseta operated under a system of variable exchange rates because it was under no obligation to other countries or international organizations which might prevent a strong variation in the nominal exchange rate of the peseta, if this were imposed by the markets and tolerated by the authorities. One should not therefore confuse a flexible exchange rate regime in which the authorities may intervene, should they so wish in order to direct foreign exchange levels, with a regime of fixed exchange rates in which they must intervene, whether they like it or not, when the currency reaches certain levels and furthermore in which the amount of exchange variation is limited by international agreement. Market pressures to induce an appreciation in the real exchange rate, whether this is achieved by an appreciation in the nominal exchange rate or whether it comes about through an increase in the inflation differential if the monetary authorities buy foreign currencies in order to slow nominal appreciation are so much greater when there is a higher possibility of exchange variation allowed by the exchange rates system. Put another way, if the peseta remains outside the single currency, whatever intervention policy is followed in the foreign exchange markets, we could again see a situation such as the one experienced in the period prior to entry in the EMS, characterized by a strong real overvaluation of our currency.

6. «If Spain adopts the single currency it will not be possible to use the exchange rate as a way out of recession»

The data and arguments expressed in the previous section demonstrate the fact that entry in the EMS in June 1989 involved fixing the nominal exchange rate at a level which entailed a considerably appreciated real exchange rate. This overvaluing of the exchange rate, contrary to the expectations of the economic authorities, was not only not eliminated but was actually accentuated afterwards because the causes of the loss of competitiveness (defects in our fiscal policy and labour market) were not corrected as a result of our entry in the EMS. In view of this experience, one could ask «What would happen if, as occurred in 1989, the exchange rate of the peseta were fixed irrevocably at an overvalued level and a recession occurred without one being able to correct this overvaluing through devaluation?»

Firstly, one should point out that the arguments against entry in the EMU at an overvalued level are shared by everyone and these are not arguments against the irrevocable fixing of exchange rates but rather arguments concerning the proper level of entry in such a regime. However, if the deficiencies in our public sector and labour market persist, then even if we were to enter at an undervalued or balanced real exchange rate, sooner or later an excessive appreciation in the real exchange rate would be generated through an increase in the differential between the rate of increase in our unit labour costs and that of the other countries in the EMU. How would we therefore avoid recession and how would we come out of it with the single currency?

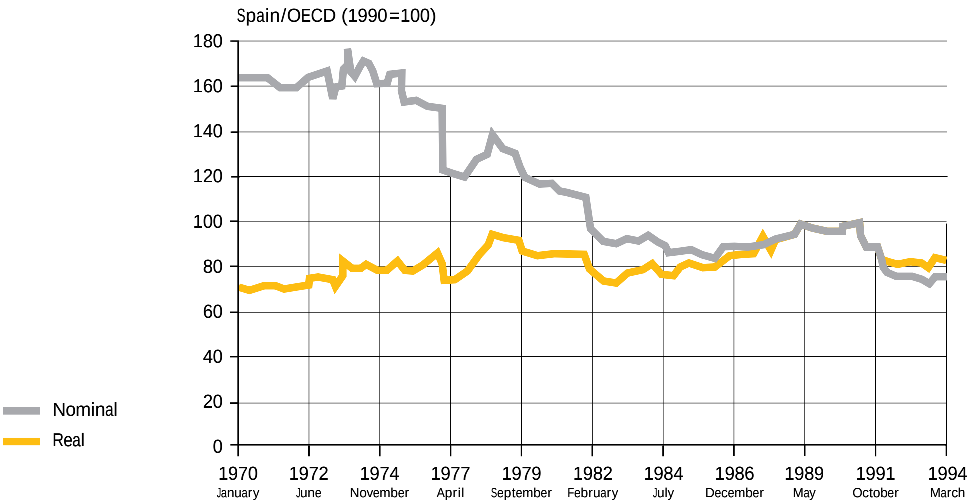
Recession would not be avoided either inside or outside the single currency. If one applies a distorted economic policy which considerably amplifies the difference in the pace of advance of our unit labour costs with respect to our partner countries, nothing (not even, of course, the type of exchange rate system) would be able to prevent recession. With a system of flexible exchange rates, one normally sees a more intense appreciation in the real rate of exchange during an expansionary or inflationary phase in the cycle, either because the differential in inflation and unit labour costs increases more rapidly or because the nominal exchange rate appreciates. Real depreciation would also clearly be more intense during recession because the nominal exchange rate could depreciate.

Variations in the nominal exchange rate have an effect on the real exchange rate, this being of greater or lesser intensity and duration depending on the changing flexibility of the economy during the course of the cycle, as those who are concerned about the single currency claim. But these effects work in both ways which these supporters of floating exchange rates tend to forget. Doubtless it is true that in conditions of marked economic weakness, a devaluation in the nominal exchange rate becomes largely a devaluation of the real exchange rate. But it is no less true that, in conditions of economic prosperity with buoyant hopes of growth, or even in the event of an application of a distorted combination of economic policies in order to reduce inflation, an appreciation in the nominal exchange rate translates into an appreciation in the real exchange rate. And if under these conditions one attempts to slow nominal appreciation through intervention in the foreign currency markets, the real appreciation will not be avoided because the inflation differential with other countries will increase. Contrary to the view of those who see the exchange rate as an instrument of economic policy which can be freely manipulated by government, the lever which regulates the nominal exchange rate in phases of both expansion and recession will not be the economic authorities but rather movements of capital. Put another way, with the freedom of movement of capital, the nominal or real exchange rate is not an instrument which is independent of economic policy. It is essentially the result of the combination of monetary and fiscal policies.

Figure 1 illustrates that the effective nominal and real exchange rates of the peseta have followed opposing tendencies during the last 25 years since the breakdown of the Bretton Woods system although there have been periods in which both have behaved similarly (simultaneous appreciations or depreciations in nominal and real terms).

Figure 1

EFFECTIVE NOMINAL AND REAL EXCHANGE RATES



As can be seen from the graph and also from Table 2 in section 4, there have been extended periods in which an overshooting of the real exchange rate has occurred, a continuing appreciation in excess of the parity which existed at the beginning of the period in question. These periodic over-appreciations in the real exchange rate are frequent occurrences in regimes of floating exchange rates. Over-appreciation can result from the implementation of an anti-inflationary monetary policy when a country's inflation is superior to that of its trading partners. Remember Dornbusch's classic overshooting model in which this policy provoked an appreciation due to the different speeds of adjustment in the financial market on the one hand and in the goods and labour markets on the other. Appreciation may also be the result of a boom provoked by exceptional factors which benefit the country in question to a greater extent than its trading partners (*e.g.* the response of an economy which is more dependant on imported energy in the event of a fall in oil prices).

Furthermore, under a system of variable exchange rates, real interest rates would be higher during recession than they would be under a fixed exchange rate system, because during this stage of the cycle, expectations of depreciation would exert an upward pressure on interest rates in contrast to what would happen with fixed exchange rates. During recession, therefore, the development of the recovery process under fixed exchange rates would occur at lower real interest rate levels and more appreciated exchange rates than those which would be recorded under a system of variable exchange rates. With fixed exchange rates, recovery would rely more on domestic demand than on external demand (*e.g.* the recovery in 1994 of Germany and other countries which did not devalue). If there is serious rigidity in the labour market, a part of the competitiveness lost in the boom (this loss of competitiveness being less under a system of fixed exchange rates) would be recovered under both systems through increases in labour productivity provoked by rising unemployment. Put another way, in the presence of inefficiencies in the labour market which establish inflexibly downward real wages, both the recovery of competitiveness through nominal devaluation with variable exchange rates and the recovery of competitiveness with fixed exchange rates by means of a greater deceleration of unit labour costs than that occurring in other countries is achieved at the expense of growing unemployment. Real growth in the economy, as well as average levels of unemployment and other real variables throughout the cycle should not be very different under one regime or the other. We should not forget that the nominal devaluation of 1993 was effective because unemployment rose to levels of nearly 25% and this increase in unemployment reduced real wages and decelerated unit labour costs thus permitting a recovery of lost competitiveness. That is to say, the devaluations did not prevent an increase in unemployment and the course followed by unemployment levels in Spain and Italy, two of the countries which made marked devaluations, has not been different from the course followed by France and Germany, two of the countries whose currency appreciated during the crises at the beginning of the 1990s. Only the United Kingdom, a country which carried out a serious reform of the labour market, has brought about a considerable fall in unemployment during the phase of economic recovery.

7. «If the single currency is adopted, our exchange rate will follow the ups and downs of the euro, which will involve a tendency to appreciate»

This argument is essentially identical to the one discussed above so I will therefore deal with it briefly.

Firstly, one must not confuse a tendency for appreciation in the nominal exchange rate, whether this relates to the effective or the bilateral exchange rate, with an appreciation in the real exchange rate and the subsequent tendency towards a loss of competitiveness. Put another way, a tendency towards depreciation in the bilateral or effective nominal exchange rate of the peseta does not necessarily imply a tendency for the real exchange rate to depreciate. In fact, as Figure 1 shows, the tendency of the effective nominal exchange rate of the peseta to depreciate has co-existed with a tendency towards appreciation in the effective real exchange rate.

The other error made in this argument is that of considering that, if the peseta remains outside the euro, there would not be real appreciations in our exchange rate against the euro or other currencies, such as, for example, the dollar. Outside the euro, as was reasoned in the previous section, the peseta would record periods of overvaluation in relation to the euro itself and possibly also in relation to the dollar.

8. «Entry in the single currency will force us to implement German monetary policy»

National monetary policies, at least those of the countries which have relatively small and open economies, lost their independence with the freedom of movement of capital. The greater exchange rate flexibility used both by the European countries whose currencies have moved within the broad bands of the EMS and by the countries which abandoned the system has not dissociated the behaviour of their interest rates from the course followed by interest rates in the German mark area. The irrevocable fixing of exchange rates brought about by the single currency will, without doubt, accelerate the transfer of German monetary policy to the Spanish financial markets, but it will not involve a significant modification of the current system given the powerful degree of monetary integration which already exists.

More surprising is the concern suggested in the above argument that the single currency involves a hardening of Spanish monetary policy in relation to the policies followed over recent years. Equally surprising is the argument, identical to the one mentioned above, according to which the single currency will mean that our country will be obliged to implement a monetary policy contrary to the one which would be required in order to correct our main economic imbalance, unemployment. In Spain, short-term interest rates, the only ones which the central bank can control, have always been higher than those in Germany and if they have not fallen further this has not been because of the Bundesbank's monetary policy but rather because our inflation rate has been systematically higher than that of the countries in the German mark area. As regards real interest rates, which have also been and continue to be much higher in Spain, one of the reasons for their high level in this country is the particular tendency of the peseta exchange rate towards devaluation. This is undoubtedly one of the higher costs which results from leaving the possibility open for a variation of the exchange rate: the country must bear higher real interest rates in order to pay the risk premium which results from keeping open the possibility of exchange rate changes.

Table 5 compares our short-term interest rates and inflation with the corresponding figures in Germany.

As can be seen from Table 5, both nominal short-term interest rates and real rates in Spain (measured by the difference between the figures in the two lines) have been systematically higher than those in Germany, even in the years immediately following German reunification when the

Table 5

SHORT-TERM INTEREST RATES AND INFLATION IN SPAIN AND GERMANY

	1988	1989	1990	1991	1992	1993	1994	1995
Spain								
3 month rates	11.6	15.0	15.1	13.2	13.3	11.7	8.0	9.3
Inflation (CPI)	4.8	6.8	6.7	5.4	5.9	4.6	4.7	4.7
Germany								
3 month rates	4.3	7.1	8.4	9.2	9.5	7.3	5.3	4.5
Inflation (CPI)	1.2	2.8	2.7	3.6	5.0	4.5	2.7	1.9

Source: *Summary of Economic Indicators*, Ministry of Economy and Finance.

Bundesbank radically hardened its monetary policy. One can recall that during those years, the peseta was at the limit of its appreciation within the EMS (as it is at the moment), in such a way that one also cannot claim that restrictive Spanish monetary policy was indirectly provoked by the Bundesbank, inferring that it was only in this way that the peseta was able to be maintained within its band in the EMS. One should rather say that the rise in German rates facilitated a rise in rates in Spain which, given the fiscal policy and operation of the labour market, was unavoidable in order to reduce inflation. Unavoidable and costly, because, as has been repeatedly argued in previous sections of this essay, this combination of economic policies leads inexorably to recession and unemployment. However, if monetary policy had been more relaxed, given fiscal policy and the operation of the labour market, inflation would have been higher and sooner or later interest rates would have ended up by rising even more than they did, probably provoking an even more serious recession.

These considerations are relevant to the current situation. What is the floor for reductions in interest rates by the Bank of Spain? Certainly not at Bundesbank levels which are almost four points lower than the Bank of Spain's intervention rate. The differential between short-term rates in Spain and Germany is approximately proportional to the differences between the growth of the corresponding unit labour costs, corrected upwards or downwards by the impulses resulting from the fiscal policy of one country or the other. If interest rates in Spain fall more than this equation allows, the inflation differential between Spain and Germany would get wider instead of closing and sooner or later the interest rate differential would widen again. The floor for interest rates in Spain is therefore essentially determined by the operation of our labour market and our own fiscal policy.

The problem which the single currency presents for Spanish monetary policy is more likely to be the opposite of the one suggested by the statement heading this section. That is, if during the next two years inflation in Spain does not approach German levels to a sufficient degree, and sufficient in this case means below the Maastricht one and a half points, entry of the peseta in the single currency may result in a monetary policy which is unduly expansionist. Supposing our fiscal policy continues to be similar to that implemented by Germany and the other European countries, as it has been during the last few months of 1996 and in the budget for 1997, the fall in real interest rates which would result from the entry of the peseta in the single currency could involve a monetary policy which is unduly expansionist if our nominal labour costs continue to grow at double the rate experienced in Germany. This risk once more accentuates the importance of reforming our labour market bringing its operation into line with the practices which exist in other countries involved in the single currency.

9. «Entry in the single currency will not increase the willingness of our society to carry out necessary reforms»

Fortunately, almost all economists, be they supporters or critics of monetary union, agree at least on the urgent need to achieve budgetary discipline and undertake a series of structural reforms especially reform of the labour market. Most of them are also in agreement in indicating that strict budgetary policies and structural reforms are vital for the welfare of our country and that they should be carried out even if the Maastricht Treaty did not exist, although none of them feel that we have made much of an impression on Spanish public opinion which tends to associate the single currency and the Maastricht conditions with sacrifices which would not have been necessary if the Treaty had not been ratified. It has to be said that economists and politicians in other European countries have been no more capable of avoiding this damaging association of ideas among their own people.

However, those who are opposed to the single currency consider that structural reforms, especially in the labour market, should be carried out prior to entry in the single currency. They maintain, along the lines of the argument with which this section is headed, that if the reforms which are unavoidable in order to guarantee economic prosperity within the single currency are not carried out prior to entry, they will not be carried out afterwards, resulting in a subsequent accelerated loss in competitiveness and a consequent increase in unemployment. As I have tried to show in previous sections, a loss of competitiveness and an increase in unemployment would also occur outside the euro and probably to a greater degree than if we were a part of it. But this is not the moment to discuss this question. Instead it is appropriate to examine whether participation in a system of exchange rates which are irrevocably fixed in relation to the countries which form the single currency may break down some of the resistance which is impeding the implementation of the extensive structural reforms which our society needs.

In this regard, it is true that the experience of our participation in the EMS was not very promising. One must, however, be careful in making an automatic extrapolation from that experience to the single currency given that these are very different exchange rate systems. Firstly, one should not forget that the former exchange rate undertaking was not really hard and fast because we never entered the narrow band of the EMS exchange rate mechanism and, furthermore, there was always the possibility of devaluation. The EMS was a system of fixed but adjustable exchange rates, while the single currency is a system of irrevocably fixed exchange rates. The main advantages of a single currency are: firstly, that the loss of competitiveness is much more visible than it is under any other exchange rate system and secondly, that it is much more distressing (because one cannot correct it by devaluation) and it is therefore foreseeable that it will be much less tolerated and remedies will be sought earlier to slow such a loss in competitiveness.

Within the single currency, would Spanish employers offer the same wage increases which they would offer outside the single currency, when they would be able to compare, with a greater degree of accuracy, their own costs and prices in euros with those of the other European countries? Do they think that, if they agree to excessive salary increases, these will be approved by the European Central Bank in the same way as the Bank of Spain might have validated them at some times in the past? Will the Spanish trade unions continue to press for wage increases in euros which cause unit labour costs to grow faster than in other countries when it can be clearly seen that this will imply the automatic export of jobs to the rest of Europe? Will successive Spanish governments continue to be willing to accumulate public debt in euros at the same pace as they have in pesetas, when their responsibility for raising the risk premium for Spain in relation to other countries would be much more obvious and therefore more costly in political terms? And if inflationary discipline and budget restriction is more severe under a single currency, if one cannot foster the hope that devaluation will compensate for any loss of competitiveness which may result, will the carrying out of structural reforms not then be unavoidable in order to eliminate the obstacles which destabilize our economic future and prevent us from achieving potential for growth in our economy?

If the answer to these questions is that monetary integration will not change anything, there is therefore no consolation: either inside or outside the euro we will have a gloomy economic future.

10. Conclusions

The intention of this essay, as I mentioned at the beginning, is to present a guide to the debate regarding the costs and benefits of the single currency, examining the validity of the contrasting opinions regarding Spain's adoption of this currency. The idea is that the reader refers to each section which he or she regards as important and decides whether the reasoning made in that section represents an effective response in dismantling the arguments put forward against the single currency. As a result, this essay does not, by its very nature, lend itself easily to a section presenting conclusions. Nevertheless, for the purposes of driving home certain ideas and of offering new perspectives on others, I should like to make the following considerations.

The principal source of all of the concerns raised by the introduction of the euro in Spain is the complete loss of the option to devalue the currency. Usually, this concern is reinforced by the theory of optimum monetary areas and it is empirically justified by experiences suffered during the crisis at the beginning of the 1990s and the effectiveness of the devaluation of the nominal rate of exchange during this crisis in order to recover competitiveness lost during the second half of the 1980s.

As regards the theory of optimum monetary areas, and in limiting ourselves to only one of its suppositions, economic history suggests that negative asymmetric shocks which would demand a devaluation in the real exchange rate are no more frequent than positive asymmetric shocks which would require an appreciation in the real exchange rate. History and the theory of flexible exchange rates also shows us that, in the presence of serious imperfections in the labour market and the considerable inflexibility which characterizes fiscal policy, nominal devaluations are transferred to the real exchange rate at the expense of an increase in unemployment, while nominal appreciations amplify the loss of competitiveness and provoke an intense and lasting overvaluation of the real exchange rate.

This latter characteristic of flexible exchange rates is what weakens the argument of those who oppose the single currency by claiming that the possibility of devaluation is the only way, or the most effective way, to recover the competitiveness which would be inexorably lost if our labour costs were to grow much more rapidly than those of the main European countries. The weakness of this argument rests on the fact that if the peseta were to remain outside the single currency, and supposing that no market reforms were carried out either as a part of or outside the single currency, the real exchange rate would appreciate more strongly than it would if we were a part of this currency. If we remain outside, it is possible that in the first period the peseta would weaken against the euro, although this would depend on the initial attitude of the markets to the new currency. However, independently of the nature of this initial market reaction to the currencies of the countries which remain outside in relation to those which join, and supposing that our labour costs and inflation continue to be higher than those in the area in which the euro is introduced (as is supposed by those who are opposed to the euro), sooner or later a monetary policy would be imposed which is more restrictive than the one operating in the euro zone, with the resulting strong nominal or, in any case, real appreciation of the peseta. To leave open the possibility of varying the exchange rate, therefore, involves running a considerable risk of significantly increasing the loss of competitiveness which would result from fixed exchange rates. It is true, in the event of a crisis one could devalue the nominal exchange rate and recover lost competitiveness. However, continuing with the supposition of an unchanged labour market, competitiveness would be recovered through substantial increases in unemployment, in exactly the same way as with the single currency. In the case of irrevocably fixed exchange rates, one could obviously not devalue, but the level of competitiveness lost would be lower. It would be lower because the disparity between the pace of growth and wages in Spain and those in the other countries in the euro system would be greater with variable exchange rates than it would if they were fixed and because with floating rates there could be a nominal appreciation. As I have already mentioned, with fixed exchange rates and without a reform of the labour market, lost competitiveness would also be recovered through increases in unemployment levels.

Furthermore, while there are still those who consider that if one were to maintain the possibility of varying the exchange rate this would always vary «positively», and while there are those supporters of floating exchange rates who deny that the rate of exchange can vary «negatively», provoking unnecessary adjustments, they have to admit that this possibility of exchange rate variation does not come without its cost. This cost is bearing real interest rates which are much higher than those existing in countries with fixed exchange rates, in that holders of assets quoted in the currency of a country with a propensity for devaluation demand a risk premium to defend themselves against these propensities. None of the dubious benefits which may be offered by floating exchange rates compensates for the permanent costs of higher interest rate levels.

To sum up, if within the single currency we do not correct the structural deficiencies which hamper the efficiency of our economy, especially the acute problems in our labour market, we will have a bad time. But lest any one be misled, if these structural reforms are not made, even if we do not adopt the single currency, we will have, in the best of all possible scenarios, an equally bad time.

VI. The politics of Monetary Union

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1. Introduction

The European Monetary Union (EMU) was conceived, proposed and promoted as a link and an incentive in the process of European federation. Rather than an economic project it is a means to a political end and must be examined as such.

If an economic analysis of the consequences of the EMU still seems plagued by uncertainty and questions without conclusive answers, a political analysis presents even more problems. Economic analysis offers conceptual anchors which are absent in political theory. The economic aims of the players (whether they be governments, corporations or individuals) are conceptually homogeneous and in principle measurable. These include incomes, wealth, employment levels, the value of the currency, etc. Economic analysis furthermore is founded on the hypothesis of rational behavior of those involved in economic activity which makes possible to formulate propositions of a general nature whose validity does not depend on whether we are referring to the French or the Germans to the 16th or 20th century. The fact that a continuing excess in the creation of money supply above the demand of means of payment brings about a continuing rise in prices is a proposition of general validity at all times and in all places.

Political analysis has not yet reached this type of conceptual anchor. The aims of the players are heterogeneous and thus not comparable, do not easily lend themselves to objective definition and especially the relation between end and means is always to a greater degree the result of speculative reflection supported by interpretations of history and other subjective elements rather than the result of knowledge of causal relations proven over and over again, such as that between prices and money supply mentioned above.

The EMU was conceived and promoted in the Treaty of Maastricht (hereinafter referred to as TM) as a means to a political end: «a growing (political) union among Europeans» as it says therein. What is the relation between the means – Monetary Union – and the end – greater political union? What wisdom supports and gives a basis to the idea that the EMU is an essential link in the construction of Europe? The reply to this question is simple: none whatsoever, if by wisdom we mean the capacity to foresee events on the basis of relations of causality already experienced. The construction of the European political union is a unique and peculiar historical project, that is to say, it has no precedent because never before has anything like it been attempted by peaceful and democratic means. It is a process which has been developed experimentally, sometimes moving ahead and sometimes falling back, with its successes and failures, trials and errors and one in which, just to make it more difficult, the objectives have been worked out by seeking a consensus along the way. No one can therefore pretend to know for certain the final consequences of the actions undertaken, neither the men of action, nor the experts who surround them, nor the critics of the whole process. We have all formulated merely hypothetical propositions based on our own personal interpretations of experience accumulated in varying areas of experience, such as economy, politics and law. These hypotheses do not stop being hypotheses no matter how much conviction and emphasis is used to express them. I believe it is essential to always keep this safeguard in mind and warn the reader accordingly.

In section 2 I examine the political views and positions prevalent in each of the countries promoting the Union as well as their concept of the relation between Monetary Union and political union. I shall refer only to the cases of Germany and France because these are the two countries which really are fostering and directing the process.

In every human endeavour the means tend to take on the value of the ends they serve. When for some reason or other an instrument aimed at an end is considered unique (although in fact it may not be so) it acquires all the value of the end. This is what has happened with Monetary Union. For historical and circumstantial reasons, the TM confirms Monetary Union as the privileged instrument of political union. Thus Monetary Union acquires a political value which of itself it does not have. Furthermore, it therefore makes no sense to analyze it in its own terms, that is to say, in terms of its economic costs and benefits.

In section 3 I set out some critical judgments about the supposed relations between Monetary Union as a means and political union as an end while concluding with a reference to Spain's case in section 4 which faces up to the dilemma of the follower, that is to say, the player in a cooperative game whose options have in fact been established by other players and for whom the only free choice is to select between them.

2. The engine of Germany

2.1 An historical accident

Monetary Union became a keystone of political union through an historical accident. In December 1989 the member states decided in Strasbourg to call an Intergovernmental Conference for the end of 1990 in order to negotiate a treaty on economic and monetary union. Following the Delors Report on Monetary Union the question appeared ripe. In April 1990 in view of events in Eastern Europea, Mitterrand and Kohl proposed that the Conference should be broadened to deal with the matter of political union. Germany was negotiating its reunification in a rapid operation and the formulation of a Treaty on political union was the best guarantee it could offer, and which it was asked for, by means of which it would continue firmly linked to the European project. But at that historical moment there was no matter of a political nature which might take it forward with success in the framework of European Community institutions. By such chance as this, the Treaty of Maastricht which came out of the Conference settled on monetary union as the primemover of political union limiting itself to the enunciation of two other pillars of political union – common policy on security and foreign relations and cooperation in justice and police without integrating these in the institutional framework of the European Community. Monetary Union was thus the cement ready at hand, the more accessible project in order to bind a political union whose formalization had to begin immediately.

2.2. Objectives of German policy

On August 30, 1994 the majority group in the German Parliament (CDU/CSU), that is to say, the governing majority, published a document in Bonn (the Lammers Report) which expressed the place the Monetary Union held in German interests as a whole. This is a document of great value for its clarity and breadth of vision. The German majority political elite in favour of the euro set out German interests in the following terms:

«...German interest is to integrate its neighbours of Central and Eastern Europe in the Western system and to establish a broad association between that system and Russia. There must never again be a destabilizing power vacuum in Central Europe». «Thus Germany has a fundamental interest in broadening political union toward the East and strengthening it through increasing consolidation. In fact, deepenning is a precondition to broadening». «Monetary Union is the foundation stone of political union (and not, as it is sometimes felt in Germany, just another element of integration along with political union)».

It could not be stated more clearly just what it is that drives the German government to give up sovereignty over its currency or, if you will, to share such sovereignty. The deutschemark gives ground in favour of an objective of higher significance defined in terms of geostrategic security. Chancellor Kohl recently expressed this on various occasions with surprising frankness: political and monetary union was essential in order to secure the absence of conflicts and war. The programme of the CDU is clearly and explicitly federative or, to put it more exactly, in favour of a federal Europe and in that party the Monetary Union is seen as a unifying element in the economy and in the institutions which regulate it and as an engine for the construction of a federal Europe. We do not find in these texts any greater detail about the view linking Monetary Union with the creation of federal institutions. Probably this gap is not so much due to the fact that such thoughts have not already taken place but to the possibility that their public statement would challenge opposing views of other partners in the Union. It may be supposed that in the mental scheme of the German defenders of the euro there is a sequence which goes as follows: the single currency will bring about an homogenization of fiscal systems as well as involve a control of deficits, a sharp increase in the necessary cooperation between governments on matters of economic policy, a transfer of sovereignty to federal bodies equipped with a decision-making process based on majority vote in a growing number of fields and jurisdictions and finally, as the organs of political union become accepted through the establishment of more democratic mechanisms, a transfer of resources of the members of the Union to the federal government which would make possible intra-European redistributive policies required by the existence of a single currency.

It is obvious that in German society there are other opinions about the wisdom and effects of Monetary Union. At this moment majority public opinion rejects it. It is to be expected that a survey among bond holders would result in greater percentages of rejection than a survey of the overall population. The Bundesbank opposed the project in various forms until it had no other option but to go along with it. Members of the board of the Bundesbank have come out against the EMU even through publication of extensive analyses and arguments (see, for example, the book *Unser Geld* by Wilhelm Nöllig, president of the Hamburg Central Bank and a member of the Bundesbank board between 1982 and 1992).

The opponents of EMU may be considered as a «pro-stability coalition». They are brought together by fear of a less solid and orthodox monetary policy than that which has characterized the Bundesbank up to this time. It is difficult to say if their position is due to the fact that they ignore or want to ignore the causal relations attributed to Monetary Union in relation to the construction of a federal Europe, if they are opposed to such a federation or if, while accepting it, consider that the route of the Monetary Union involves an excessive cost. Nevertheless, their role in coming events is crucial, given that they make up a powerful coalition of forces which is opposed to the incorporation in the initial stage of the process of those countries with traditionally weak currencies, such as Italy and Spain. The pressure from those opposing EMU explains the dauntless efforts of the German government to obtain a rigorous «Stability Pact» for after monetary union. It was necessary to offer the opposition guarantees of stability for the euro. The opposition to the euro in Germany shows the limits to the possibility of reaching a political agreement by closing our eyes to French account juggling in order to meet the economic convergence criteria in matters relating to the government deficit, given that such an attitude would make it easier for Spain and Italy to resort to the same procedures. But this is not the whole story. If the German government does not obtain significant progress in strengthening the institutions of political union with institutional reforms discussed at the Intergovernmental Conference for revision of the TM, it may be accused of giving up the deutschemark and getting nothing in exchange. In this context, the export industries, natural allies of the government in its aspirations to put for ever an end to the long-standing strength of deutschemark in relation to other European currencies, would be of little help.

Thus, German domestic policy will play a determining role in the final agreement on which countries will form the Union and indeed whether it will or will not happen, how broad it will be and the pace at which it comes into being.

2.3 France's contradictory wishes

Jacques Delors' dream of a federal and socially progressive Europe is not shared by the French political elite which however has not been capable of clearly forming an alternative definition of France's national interests in the process of European construction. France knows better what it rejects than what it wants. It rejects the federal conception of Europe although it fervently wants Monetary Union, from which we may take it that the French elite does not share the German vision that the single currency carries within it the germ of a federal Europe. For France, Monetary Union is an end in itself. In terms of its vision of the future Europe, France advocates the independence of Europe from the United States, the development of the capacity to carry out an active trade and industrial policy and the protection of France's cultural identity along with its social model.

France wants Monetary Union in order to gain sovereignty not to lose it, given that the EMU means access to a strength it now lacks. Furthermore, Monetary Union symbolizes its economic equality with Germany, an intangible but essential question. In no way, however, should political union mean any renunciation of its role in the world as a nation. France wants a strong Europe in order to be more French and not less.

The drama of French politics is that national pride demands its support for Monetary Union in order to be on an equal footing with Germany, while at the same time refusing to fully accept the rules of the game required by a common market and a common currency – the drastic reduction of economic interventionism and reform of its system of government subsidies and protection. The Delors project was aimed at extending this model right across Europe. The present government does not appear to have any project in this regard and waffles between confusion and doubt while set upon by a multitude of social and economic groups jealous of their privileges.

The extraordinary efforts carried out by French governments over the past 14 years to maintain the parity of the franc in terms of the deutschemark has left France in a state of economic lethargy from which it must emerge with all urgency. It is also because of this that the Germans are afraid of the role France could play within the European Central Bank, as well as a continuation of its lack of fiscal discipline and herein lie the major difficulties of reaching an agreement on the Stability Pact. With 12% unemployment and in the face of growing difficulties in reducing government spending there is increasing opposition to the policy of a «strong franc» even within the governing majority. The political articulation of forces opposing the Monetary Union is a possibility still not to be dismissed.

3. The Conventional view of Monetary Union and some criticisms

Defence of the single currency rarely begins with political arguments. It usually begins by setting out the hoped-for economic benefits, minimizing its costs and holding on to the political ramifications as the final trump card in the argument. This procedure has created a whole school and has been refined over the years. Now it is not a matter, as it was at first, of emphasizing the savings of an imaginary traveller in the European Union crossing frontiers and changing currency at each border.

Monetary Union as an economic project is put forward as the ideal means of a) ensuring a continuation of the single market; b) ensuring the stability of prices throughout the Union and therefore the strength of the euro; and c) definitively eradicating the monetary shocks which have brought so many sorrows to European industrial exporters and the subsequent conflicts between the respective countries.

The single currency must make it possible not only for the single market to consolidate and become strong but also give it its full potential. According to this idealized model, freedom of movement of capital, goods and persons in a framework of competitiveness and price stability, will ensure a better and more efficient allocation of resources and, as a result, increased economic growth. This in turn will make it possible to rescue the threatened public systems of social protection and overcome the enduring stage of unemployment over the past 20 years. This in essence is the message to the general public.

In more expert and political circles emphasis is put on the fact that the single currency will force fiscal harmonization, require greater cooperation in the design of economic policies and, as a result of all this, facilitate the strengthening of European Union institutions. The European economies will tend to converge in incomes and wealth under the management of an increasingly integrated politico-administrative apparatus. More discreetly and only in limited circles, the federalists also admit that over the long term the single currency will help to strengthen and broaden the still rather lean budget for the Union. How could it otherwise transfer income to more depressed areas in sufficient quantity?

The conventional view minimizes two essential questions to the point where they are forgotten: the first and less discussed question refers to the geographical relocation of economic activities which over the long term may be expected from freedom of movement of productive resources not subject to exchange rate risk and especially of and finance physical capital but not of labour. This and nothing else is what a better allocation of resources implies. But with the same ardour with which people champion the single market and single currency they also defend maintenance of economic activities on their own territory and under their own flag. No champion of the single currency fails to become exasperated in the face of a change in location of a factory which encounters better conditions in another country. This contradiction is understandable given that mobility of productive resources is not in fact accompanied by labour mobility.

The single market and the single currency will make possible and inevitable the growing concentration of economic activities in growth areas with an accumulation of external economies and a gradual relative desertification of the rest of Europe. Economic growth always proceeds along these lines and that in itself would not necessarily be negative if it were not for the fact that the geographical concentration of economic activity increases the costs of the adjustments which end up being needed in growth centres or hubs however more necessary and less diversified the activity concentrated in these areas may be. And this brings us to the second point played down in the «conventional view»: the single currency imposes a rule that economic adjustments, up or down, which require decreases or surpluses in aggregate demand for products of a region or growth centre cannot now be carried out through the exchange rate but only through price adjustments of production assets, wages, employment and prices of real estate. But, given the lack of flexibility of labour markets in Europe, the rigidities imposed by the systems of social protection and the slowness of price adjustments in non-financial assets, adjustments dealing with upward or downward movements in aggregate demand are going to turn out quite painful.

The stability of a European price index which would serve as a reference for the purchasing power of the euro could mask major swings in «local prices» which might not occur if there existed the adjustment factor of the exchange rate of the «local currency». It is a well-tried empirical law that those economies which grow fastest tend to bring about an appreciation of their currencies in terms of the currencies of those countries which grow less. The strength of a currency is not exclusively due to the orthodoxy of the issuer. When sustained growth takes place in an area, and this area lacks its own currency, prices rise. If for any reason there is a drop in aggregate demand in the area, for example, because of a drop in demand for the goods the area «exports», prices would begin a downward adjustment because there cannot be an adjustment of the currency exchange rate. The adjustment necessary is then greater than what would have been needed if prices had risen less due to the cushioning effect of revaluation of the currency. A sizeable downward adjustment of prices and wages is an exceedingly slow process, inefficient and painful (Keynes fully exploited this fact). The «local recession» would be more serious than it might have been if the currency had first been revalued and then later devalued.

A euro of stable value may hide sharp swings in prices in various areas of the Union and this risk increases with geographical concentration of economic activity around regional hubs with a homogeneous base, which is precisely one of the effects of the better allocation of factors which is the aim of the single market and single currency. These hypotheses appear to coincide with experience in the United States. One of the few European studies[*] which has examined it in this respect concludes as

(*) A.B. Atkinson, O.E. Blanchard *and others*. *PREMIER RAPPORT Groupe International de Politique Économique de l'OFCE.* Seuil, 1992.

follows: «What is seen in the American states allows us to imagine certain features of the future Europe (under Monetary Union). Growing specialization of member states will imply that specific shocks in one country will continue to be a major cause of macroeconomic fluctuations and, as labour is less mobile than in the United States, these shocks will generate persistent fluctuations of unemployment in the countries affected; what is more, even a degree of wage flexibility similar to that in the United States would not be enough to compensate for the real effects of such shocks on competitiveness. It will therefore be necessary to mobilize other instruments of economic policy to combat its ill effects» (op. cit. p. 157).

In fact, from a strictly economic point of view it would be socially less painful and economically more efficient that in a continental economy with multiple growth centres where there was a concentration of economic activity with a low degree of diversification that a large number of currencies be employed. In somewhat more technical terms *it may be stated that the concentration of economic activity in growth centres on a continent with low labour mobility would increase rather than reduce the number of optimum currency areas.*

Without monetary or fiscal instruments at its disposal, how would a government deal with the unemployment created by a process of adjustment through prices and wages? Could this be the logic of the proponents of the EMU who in this situation would have no option but to shift political responsibility for unemployment to a European federal government which had sufficient resources to deal with it? This seems a rather risky way of seeing Monetary Union as the engine of a federal Europe. And, if this shift of responsibility upstairs does not take place, could we not expect sharp disagreements and serious conflicts between governments frustrated about relieving a problem for which they lack the instruments?

In the framework of the prevailing economic institutions in the countries of Europe, the Monetary Union and the reduction of *unemployment are incompatible objectives.* This idea, shared by some leading U.S. economists (M. Feldstein, R. Dornbush, M. Friedman, P. Krugman, among others) who have indeed had the experience of a single currency in an economy which has acquired continental proportions, has not managed to penetrate conventional wisdom in Europe. It is not difficult to foresee (because signs of this have already filtered down even to the man on the street) that this incompatibility is going to be the main source of political conflict, both international and intranational, in coming years.

The currency cannot bring about the institutional changes the European economies need. Nor can the European Central Bank and its policy do this. Nevertheless, it has been repeated *ad nauseum* that the single currency is the ideal incentive to undertake reforms. At this point, it is clear that this incentive has not been sufficient in France, Italy and Spain nor even in Germany. The budget cuts produced and those which may come up until 98 are insufficient and above all are superficial, in spite of the high political cost which governments imposing them have had to bear.

Using a monetary system as a political instrument is a poor idea. The single currency would make sense in a Europe already federated with harmonized and operating institutions, with democratically based political bodies to carry out the necessary redistributive policies. In other words, the Monetary Union ought to be the final stage of a federalization process and not the engine for it or its initial stage. Loading the weight of a process of political union onto the currency is nothing more than to admit the extreme difficulty, if not impossibility, of developing it in the political sphere. As Ralph Dahrendorf has so rightly said, the Monet doctrine died of success on the achievement of the Single Market. From now on the construction of Europe should proceed along political paths without the subterfuge of economic cooperation.

4. The Spanish position

Spain joined the European Community in 1986 and six years later, while it was still learning the rules of the EEC game, the Spanish parliament unanimously ratified the Treaty of Maastricht without previous debate. Why? Where did these feverish and unanimous pro-Europe feelings among the political elite come from? Were they perhaps moved by that famous dictum of Ortega: «Spain is the problem, Europe the solution»? No. No one now reads Ortega. Spain's pro-European feelings are the product of a deep sense of political incapacity combined with the astuteness of a trader. Legatee of a corporative regime and a history of extreme state intervention, the new Spanish democracy felt impotent to break up the corporative framework. The democratic move out of the previous regime would require growth of public redistributive spending (it should be remembered that fiscal reform at the end of the Seventies came before the signing of the democratic Constitution and perhaps was one of its prerequisites). The growth of spending rose as a result of the recession brought on by the second oil crisis in 1979. When the Socialist Party came to power in the middle of the recession in 1982 what could be expected of it but that it would follow the path of growth in spending and an increase in the deficit? When toward the end of the decade (in 1989) it tried to halt the process it alienated its trade union base and was confronted with the first successful general strike under democracy.

Being imposed from outside, the Treaty of Maastricht provided the excuse for containing spending and getting rid of the ample remains of corporativism and the subsidized economy. At the same time it offered an opportunity to finally abandon Spain's long-standing political isolation during the 20th century in exchange for a few pesetas (Cohesion Funds) which would somewhat soften the reform efforts to be carried out.

It was said that what the Treaty of Maastricht imposed was good in itself but it was not said why. It is thus not surprising that the excuse has not turned out to be effective. In spite of the fact that it was stated again and again that the aspiration to a single currency would spur the necessary reforms, we arrived at 1996 to find these reforms weak and insufficient. It is not necessary to go over them here as they are in every text on Spain's economy written in recent years.

Public opinion has been successfully sold the idea that inflation and the fiscal deficit are not good for the country but what has not been sold to the public, because no one has wanted to do so, is that the level of public spending reached (basically of a redistibutive nature) takes up resources which should be invested productively, that excessive taxation reduces employment, and that a public pension system of the spread, coverage and nature as that inherited from the Franco era and then extended reduces savings and investment in production. When all is said and done, the rhetoric of Maastricht has served to hide from the country the fact that its income and wealth depend on the country itself and not on the fact of associating with other more prosperous countries and sharing, in exchange for money, their rules of play and their currency.

It should not be surprising that serious people have accepted the conventional wisdom regarding the exchange rate policy imposed on Europe around 1990: «Devaluation is not an effective policy because the gain in competitiveness it brings is lost over a short period of time by a return of inflation while the problems still remain to be solved». Any reference to experience running in the opposite direction seems useless. Neither the undoubted and quantified effects of devaluation of the dollar between 1985-1987, nor the effects of the Italian and British devaluations in 1992, nor Spain's devaluations in 1992 and 1993 make any impression on those who buttress their convictions more on what their peers repeat than by resorting to observation and measurement of the facts.

This is a really unfortunate situation given that Spain, because of its high level of unemployment is the European country worse positioned to renounce such an adjustment mechanism as the exchange rate (which in case of need would be brought about by the markets, not the government). Spain suffers from one of the most rigid labour markets in Europe, a high proportion of long-term unemployment, an extremely low labour force rate in comparison with other European countries and a geographical distribution of unemployment which shows a stubborn and unbreakable durability. In these circumstances it must choose between renouncing its own currency for ever and joining the euro or staying outside at an historic moment it did not have any opportunity to choose, a moment dictated in any case by the demands of France and Germany to strengthen Germany's links with Western Europe following reunification. If the government felt, as the author of these lines feels, that it could turn out as bad for Spaniards to abandon the peseta as to stay permanently outside the Union, it would seem logical for Spain to at least give itself the chance to choose the right moment to join. In other words, to opt to wait and see while on the domestic front continuing on its own with dismantling corporativism and the subsidized economy. Perhaps Spain would thus avoid the humiliation of not being accepted when it wanted to be which is a possibility given the framework of German interests described above.

Having opted for joining the euro right from the beginning and once the process is completed, it will be necessary to speed up market reforms or accept living (for how long?) with a higher level of unemployment than at present.

In any case, much as it may hurt, there is little Spain will be able to contribute to European construction. Possibly because it stands at an historical stage of low creativity as a society, immersed in domestic political and institutional problems and is suffering from a lack of worldly ambition, distinctive thinking or projects of great import. As a result, it feels obliged to resort to the projects of others. Outside interests and foreign conventional wisdom are being imposed on us much too easily.

5. A final (philosophical) thought

The attempt to pass over nearly fifty years of European intergovernmental cooperation and promote European political union has become a moral ideal and an inescapable historical design. Who today, apart from some recalcitrant Briton, would dare to declare himself skeptical? It seems that once more in the ill-fated history of Europe in this century the destiny of the European peoples has now been set out and that there is only one road to follow. We can argue about the speed to travel but not the direction we must go. But the remaking of the European national states into one supra-national entity is a very risky experiment. All of these states are the result of the blood of many generations and they stir up deep loyalties and rock-solid identities. To argue as Chancellor Kohl has that the alternative to Union is nationalism and that this means the risk of war is to present political union as a moral imperative and an experiment in salvation. Our century has known various experiments, each as great a cause of human suffering. On the other hand, our history shows it very unlikely that the democracies will make war among themselves. When a social experiment is put forward as a moral imperative and the only road to salvation it is essential to think it over many times without ever accepting its inevitability.

VII. Monetary union seeks a country

Alfredo Pastor

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1. Introduction

It does not currently seem very rash to assume that Spain will enter the European Monetary Union (EMU) during the coming decade. We will be participating, as a result, in the next stage of the European project, which Spain joined at a very late point, without having taken part in the events which gave it its initial impetus. The pros and cons of this participation have been discussed almost solely on the basis of the immediate consequences of admission from the outset or of being excluded at this time. Nevertheless, Monetary Union is no more than the first step in an extremely long-range undertaking which is full of uncertainty and which will most probably lead to a political union whose range, depth and form we do not yet know.

Given the alternatives which are currently available and the level of convergence already achieved by the Spanish economy, it seems pointless to ask whether it is appropriate to try to be among the founding partners in the EMU. However, as the new arrivals that we are, we must question, more insistently than others, the nature of this commitment which we say we want to make, the risks and opportunities presented by Monetary Union and what we must do to confront the former and take advantage of the latter.[1] The intention of this essay is to discuss these questions. The following section is dedicated to emphasising the interaction between political forces and economic results which form the history of the European project to the present time. There follows a review of some of the risks which the Spanish economy will have to confront (with or without Monetary Union) during the coming years, risks which result from a still dubious inflationary history, the existence of a high level of unemployment and a certain weakness in productive structure, coming to the conclusion that the degree of success achieved in confronting these risks will essentially depend on our ability to adapt.

That concludes the more conventional part of this essay. The following section is devoted to a presentation of the opportunities which may be offered by that part of the expansion of world business which is based, not on the principle of comparative advantage, but on the principle of specialization, reaching the conclusion that the most essential element in order to take advantage of these opportunities is not so much the ability to adapt but more what we define as the level of cohesion, for want of a better term. There then follows an opinion, not too flattering, on our level of cohesion. The final section speculates about a possible explanation.

It is not necessary to stress the tentative nature of the greater part of that which follows: it would have been less risky to limit oneself to strictly economic matters! However, it is becoming necessary, in order to face up to undertakings as important as Monetary Union with a full knowledge of the facts, to think about what will happen after 1999. Experience indicates that in order to do this, it is necessary to introduce elements as essential as economic ones, even though they are more difficult

(1) With the single currency, «some will gain and others will lose (in relation to the course of events without monetary union). We must be careful that we are not among the latter» (Mas-Colell, 1996).

to quantify or even to define. As is suggested by the old joke, we must look for the keys where we lost them, not where there is more light.

2. Economics and politics in the construction of Europe

It has become a cliché to state that Monetary Union is a stage in a process which is not economic but in fact political. This is partly true, for the steps followed during the process of European construction have, in general, had favourable economic consequences for the participants. But the process itself, the «European project», was begun with the aim, not of maximizing the per capita income of the citizens of Europe, but of guaranteeing peace in Europe once and for all. When one comes from the periphery, from a country which ceased to participate actively in European affairs a long time ago, one must from time to time remind oneself of this non-economic origin in order to understand, among other things, that the relative position of each of the members of the Union does not exactly correspond with the importance of its economy. However, it is not a «purely political» project: to be accepted by the citizens of each member State, each stage has had to offer the promise of tangible economic benefits for everyone. The reason, as has often been stated, is that no one is willing to make sacrifices for Europe. This requirement means that the process has developed by leaps and bounds and periods of recession have emphasized its fragility, all the more so in that during recent decades governments have been judged more and more by the economic results which they have achieved, as if they were boards of directors.

It is worth recalling this balance between political objectives and economic reasoning which has been present throughout the whole of the European project. The first stage (1948-1953) was explicitly political: it began with the formation of the Council of Europe, at the request of the Truman administration, for the management of financial aid under the Marshall Plan

(1948); this was followed by the Monnet-Schuman proposal for the creation of an Economic Coal and Steel Community (ECSC). But in 1951, the United Kingdom decided not to sign the ECSC Treaty. In the words of prime minister Attlee «a supranational institution cannot be democratic». Two years later, a proposal for political union was rejected by the French National Assembly. As one can see, the British do not have a monopoly on mistrust. These two failures forced the Europhiles to look for an alternative route: at the Messina Congress (1955), the ECSC member countries announced their intention of creating a common market; in two years the Monnet Committee had presented the heads of government with the treaty which was signed in Rome on 25 March 1957. The Common Market had been created but as a pragmatic alternative towards an objective which, it appeared, could not be tackled directly.

The Treaty of Rome foresaw the creation of a common market, that is to say, something more than a customs union in that it established the principle of the free movement of goods, services and people, but less than an economic union in that common monetary and fiscal policy were not discussed. It also foresaw the adoption of a common agricultural policy (in practice since 1969) and common transport policy. It provided for the creation of two institutions at community level, the European Social Fund and the European Investment Bank. Finally, it established a period of 12 years for the fulfilment of the agreed provisions. Once this period had elapsed, the political intentions behind the project once again came to the fore: instead of being content with fulfilling the Treaty and having a purely technical community structure in order to administer the programmes in force, the community partners decided, at the Hague Council (December 1969) to go further. The Council of Europe, not provided for in the Treaty, was created and this replaced the «summits» of heads of state and government, thus consecrating the inter-governmental model instead of the federal alternative. The Community was given its own budget and the first European Parliament was elected by direct vote. In 1969, the Common Market was, in terms of the conception of its actual nature, very close to the European Union of today. The following step, the signing of the Single Act in February 1986, allowed great practical advances to be made, thanks to the adoption of more speedy decision-making procedures. But the broader picture continues to be that of the Treaty of Rome.

The 1970s were dominated by changes in the monetary aspect and it is worth remembering this so that one does not make the mistake of thinking of the European project, in its current state, as being made up of two completely separate elements: one, indisputable, the single market and the other, added at the last moment for reasons which are not at all clear, the plan for a single currency. Whatever one may think of the opportunity of a monetary union as the next step in the European project, the truth is that the idea is an old one and it has its logic. The first proposal for monetary union (which foresaw the creation of a single currency in 1980) arose from the Hague Council in 1969, as a response to the need for a system of stable payments as an alternative to the Bretton Woods system, based on the dollar, which had been subject to growing tensions since 1958.(2)

Insistence on a system of stable exchange rates and insistence on removing customs barriers between European countries are responses to the same objective: avoiding a repetition of the events which led Europe from the Great Depression to the Second World War. In effect, during the 1930s, each country defended itself against recession through the use of two instruments: commercial protection and the exchange rate. If the single market eliminates commercial protection, a European monetary system could prevent so-called «competitive devaluations». As a result, the two aspects of the current European Union, the real and the monetary, appear to be complementary if one bears in mind that the final objective is not, at least not exclusively, economic in nature. But neither can one attribute the desire to have a system of stable exchange rates to exclusively political motives, that is to say, motives

(2) This initiative came just in time: two years later, the United States ended its commitment to a convertible dollar. Four years later, in March 1973, the Bretton Woods system had given way to a system of floating rates.

which are indifferent to economic reasoning. The 1970s taught us that stable exchange rates have economic advantages: the volatility of exchange rates is an obstacle to business and international investment. The single market could be endangered if some countries believed that others were gaining a better position by devaluing their currencies. Furthermore, a system of fixed exchange rates centred around a highly stable currency may prove to be an effective instrument for anti-inflationary discipline.[3] It is not therefore necessary to refer to the experiences of the 1930s in order to give legitimacy to the preoccupation of European countries with the stability of exchange rates, a preoccupation which is the source of the European monetary system and, as a result, the single currency. But if what is wanted is a system of stable rates, why propose the extreme case of a single currency? Because of the usual combination of economic and political factors: of all the different conceivable alternatives for the creation of a system of stable exchange rates, the single currency is the one which leads most directly to some form of political union.

In 1987, the Padoa-Schioppa Report identified the potential conflicts resulting from the existence of an «inconsistent trio»: stable exchange rates, the freedom of capital movements and divergent macroeconomic policies cannot co-exist for long. The freedom of capital movements magnifies the effects of any inconsistency, be it real or perceived, between a country's economic policy and its exchange commitments, and the stricter the latter (narrow band as opposed to broad band for example) the more vulnerable the corresponding currency becomes. This «inconsistent trio» has resulted in the fact that, in practice, the stability of exchange rates is something which rarely happens. Of the medium or large economies with open capital markets, only five have maintained stable exchange rates for five years or more: Austria and Holland against the German mark, Luxembourg against the Belgian franc, Saudi Arabia and Thailand against the dollar.[4] There are various

(3) For a good recent summary, see Obstfeld (1995), especially p. 76.
(4) See Obstfeld (1995), p. 88.

ways of avoiding this «inconsistent trio», through the removal of one of its components: a return to floating rates, the imposition of restrictions on capital movements or the co-ordination of the economic policies of the participating countries. Of these, the Padoa-Schioppa Report came out in favour of the third method, which is the one being developed, being enormously reinforced by the Maastricht Treaty. The combination of a single currency and various strict convergence criteria goes much further than a mere voluntary co-ordination (which had not produced any results between 1987 and 1992), in that it establishes such small margins of action as regards these policies that they are compelled to be almost identical. As a result, at least at first sight, Monetary Union can be presented in purely economic terms as the only mechanism capable of guaranteeing the stability of the least disputed aim of European co-operation: the single market.

However, a great amount of literature, coming above all from North America and the United Kingdom, points out the weakness of a defence of the single currency based exclusively on economic arguments. In essence, if there are serious disruptions between members of the EMU, the single currency will not resolve them on its own. In the absence of such disruptions, which are at the source of the volatility of exchange rates, monetary union will not add much to the single market. It is the political argument which swings the balance in favour of the single currency. Although there are precedents for stable integrated economic areas with different currencies, there has been no experience of politically independent countries possessing a single currency in a stable form. The mechanisms which would allow for the compensation of the great differences existing between the member states of the European Union in the absence of adjustable exchange rates – the mobility of labour and the possibility of significant budget transfers from one state to another – are hardly conceivable at current levels of political integration within the Union. As a result, the adoption of the single currency will force the participants to move in the direction of political union because the economic problems which arise will require more and more instruments, the existence of which presupposes a single political will. Once again, the political objective is a necessary complement to the economic argument.[5]

If one bears in mind this constant interaction between economic and political factors, it is easier to guess what the immediate future of the single currency project may be. The economic debate, almost always centred on what may happen in 1999, has produced more resignation than enthusiasm among European citizens. If to this sentiment one adds the determined will on the part of the heads of government of the central countries in the Union to complete monetary union on the proposed date, one could think it probable that the single currency will be born according to the terms of the Treaty, unless the economic situation gets significantly worse in any of these countries. From that point, it will be necessary to trust the economic environment not to produce any big surprises, because the newly created monetary union will be little prepared to deal with them. The possible alternatives to political union are several, they are badly defined and they will all meet with resistance. As a result, the pace of political integration may be much slower than may be required for the solution of urgent economic problems. During the first years of monetary union, tension between economic and political aspects could become more acute, and this constitutes a factor of potential instability in the European sphere.

The political component of the European project is something in which each member state participates. On the one hand, European construction is to a great extent the result of national interests; on the other, political objectives and economic advantage are to a degree interchangeable.[6] Finally, the Spanish contribution to the European project

(5) «If Monetary Union is not to fail, it must be followed by political unification. If this is not desired, it is not worth taking the risks which monetary union entails.» (Schmierer, 1996, p. 61).

(6) Regarding this point, it is worth observing that the strategy followed by Spain at the Edinburgh Council could turn out badly in the long term. It seemed to be saying «yes to the Treaty in exchange for cohesion funds». Although this is not strictly true (among other reasons, it will be Ireland and not Spain which will be most favoured by the cohesion funds in proportional terms) it is true that our application has placed us in a position of inferiority which may possibly not be compensated by any funds received.

should perhaps be measured more in political than economic terms. For a state to have political influence within the European Union, economic weight is not the most important factor. It is rather that of having a well-defined and realistic strategy. The Danish «No» to ratification of the Treaty and the Norwegian rejection of entry to the Union have shown that this strategy cannot only come from the government. It must be a collective project which is generally accepted. At present, it seems that we have no other objective than that of entering monetary union as soon as possible. It is worth asking whether we have our own ideas about Europe and whether there are any ideas which the Spanish people can make their own. If this is not the case, we cannot claim to be anything more than an auxiliary, allied with one side or another according to convenience, in the process of European construction. Any response is linked with our ability to formulate and carry out projects involving the broad community with a certain scope, something which I will need to return to later.

3. Risks and the ability to adapt

Knowing that monetary union will not be prepared for dealing with economic tensions between its participating members, it is worth asking here whether it is probable that these tensions might occur and how they might affect a country such as Spain. This examination does not amount to putting the appropriateness of Spain's entry in the Union in doubt: although the weakness of the Spanish economy may be accentuated during the coming years, it seems reasonable to state that, on the whole, the consequences would be worse if Spain were to remain excluded.

One must therefore ask if it is likely that, following the creation of the Monetary Union, the member States will continue to be subject to unanticipated disturbances affecting different countries in different ways. The reply to this is that it is likely. Firstly, there will continue to be unforeseen disturbances, secondly their effects will not be the same in every country.

As a general rule it can be said that the more different the economic structures of the individual member states, the more different these effects will be.(7) A moment's reflection leads one to conclude that any disturbance which arises will have very similar effects in Germany and the countries of the German mark bloc – «the centre» – and quite different effects in Italy, Portugal and Spain – «the periphery». This means that the benefit of a single currency will be at its greatest in «the centre» and in «the periphery» it will be the reverse.(8) We can attempt to consolidate this intuitive thought with three examples of «disturbances»: those occurring on the supply side, those which may spring from persistently high rates of unemployment and, finally, those which result from the entry to international markets of large manufacturers with low costs. The consequences of the first and second types of disturbance depend on the behaviour of the different agents. The consequences of the third also depend on our production structure.

The first type, «supply shocks», such as a rise in energy or raw material prices, have been the most analyzed.(9) As is well known, with a «strong» single currency as the euro will certainly be, the effects of these disturbances will depend on the ability of each country to absorb them. Those countries which translate them into increases in domestic costs and prices will pay the price through lower growth and higher unemployment. From this point of view, Spain is still in a comparatively unfavourable position. In spite of the progress made in recent years, the Spanish economy seems to be less flexible than the others and a reaction against inflationary disturbances is the greatest risk which could be entailed, in the short term, by a renunciation of management of the exchange rate, as membership of the Monetary Union involves.

A second risk may arise on the employment side. A significant reduction in rates of unemployment is not foreseen within the European

(7) And the more differently they behave though this is more difficult to measure.
(8) See Alberola (1996).
(9) A short while ago it was usual to talk about an excessive increase in real wages as an example of a «supply shock». This now seems to me to be less likely.

Union in the near future. Any solutions offered to the unemployment problem are tentative and partial. The limited reforms in the labour market implemented by the different countries have an extremely restricted scope and their application is encountering a great level of resistance.[10] For this reason, one can legitimately ask whether the persistence of high levels of unemployment is compatible with the implicit «social contract» on which the stability of advanced societies relies. If the answer is that these two elements are not compatible – if the bad temper which seems to have permeated French society is not an exception – and it finally turns out that there is a need, however irrational one might think it, for the different governments to take more spectacular measures,[11] Spain will once more find itself in a relatively unfavourable position because of its poor starting position: unemployment rates at double the European average and a public deficit at the upper limit of permitted levels.

The third disturbance which we can consider by way of example requires a certain amount of explanation. During the past twenty-five years, in part due to the economic success of countries such as Japan, Taiwan or South Korea and in part due to what has been perceived as a decline in the western economies, much has been written about the effects of the entry of the «emerging economies» into world markets. If we consider the European economy as a whole, we can suppose that these effects will be marginal but beneficial. The European Union is, like the North American economy, an extremely self-sufficient economy and it acts as a complement to economies such as those of China or India because of their factor endowments: a high level of capital and a highly-qualified workforce as opposed to a low-qualified workforce and little capital. One can therefore

(10) This resistance is undoubtedly increased because the recipe being used for the unemployment problem – «deregulation» of the labour markets – is complemented with another, almost unique remedy for the reduction of deficit: the «downsizing» of the «Welfare State». These are both partial remedies, the effects of which tend to be concentrated on the less fortunate. It must be said that one remedy or the other may contribute to solving the respective problems, but a global solution will need other elements.
(11) It is not easy to guess what these measures might be, although they would probably involve increases in public spending. One can suppose, however, that if they were adopted in isolation by an economy such as Spain, this would only represent an extremely short-term solution.

imagine an exchange which is beneficial for both parties. Europe exports goods which are capital and highly-qualified worker intensive («machinery») and the emerging countries export goods which are low-qualified labour intensive («clothing»). But what is good for the European Union as a whole is not good for all of its members in equal measure. Spain does not enjoy the same combination of factors as Germany or Sweden and thus the amount of «machinery» that it exports to the rest of the European Union is lower and its exports of «clothing» much higher. As a result, it is conceivable that the entry of large emerging economies in world markets, while benefitting the Union as a whole, will worsen the relative position of countries such as Spain and make real convergence between the member States even more difficult.(12) In the absence of mobility in the workforce and an adequate system of transfers, this lack of symmetry in reaction to international competition is a potential cause of instability within the Union.

The above examples are sufficient to illustrate an idea which is not very original: the future holds risks for the Spanish economy! These risks originate from a combination of a lack of flexibility in our economy, making it vulnerable to external shocks, and the weakness of our productive structure, which places us in sectors of the market in which international competition could become particularly intense during the coming decades.(13) Our ability to adapt will be the factor which allows us to face up to these risks with success and if this is the case one can be moderately optimistic. Without forgetting how much remains to be done, it is true that the Spanish economy and its society have undergone deep transformations over the course of one generation assimilating these with a surprising degree of success. However, after reviewing the prospects for the next few years, one is left with the impression that the best that could happen, if we adapt ourselves to changes in our surroundings without offering too much

(12) In particular because one has to predict that the countries in «the centre» will suggest a fall in wages in Spain as the only solution to the «southern problem».

(13) It is this combination of inflexibility and weakness which is the source of these risks. With an economy which is more flexible (and certainly poorer, like that of Portugal) or more solid and less flexible (like that of Germany) such risks would be reduced.

resistance, is that our relative position does not get any worse. This is a partial view. There are also opportunities. But in order to see them, one must place oneself in a different context, one which is more familiar to the businessman than the economist. And to take advantage of these opportunities, something more than the ability to adapt is needed.

4. Opportunities and level of cohesion

Perhaps the best form of introducing this different context is to think once again of the world markets. On describing the risks which the entry of the large emerging economies may hold for us we began with one of the reasons for commercial exchange – comparative advantage. According to this principle, countries trade with each other because their productive structures are different. The abundance of sunshine in Portugal and coal in the United Kingdom confer a comparative advantage in the production of wine in the former and steel in the latter. With the opening-up of international trade, Portugal will export wine and import steel. The United Kingdom will do the reverse. This is the same reasoning which permits one to predict that Europe will export «machinery» and China «clothing», and that Spain may stop exporting «clothing» before it is able to export «machinery».

But not all international trade can be explained on the basis of comparative advantage. The greater part of the commercial trade between developed countries comes from productive structures which are very similar and it is explained by the advantages of specialization. We might imagine a situation in which Japan and the United States agree to specialize, one in the production of cars and the other in the production of airplanes (in fact, this is what seems to be happening, without any agreement having been reached). Does Japan have a natural advantage in the production of cars and the United States in the production of airplanes, similar to those offered to Portugal and the United Kingdom by sun and coal in the previous example? One can see that this is not so. In fact, with a little additional effort, the opposite agreement could be made: Japan could specialize in the production of airplanes and the United States in the production of cars. After a certain period of adjustment, either of the two agreements would be advantageous for both countries. The reason is that the presence of economies of scale in the manufacture of airplanes and cars (less frequent in other products) would allow each one to supply the world market at lower unit cost than would be the case if each one were to structure its industry for its own domestic market. If Ricardo and Mill give shape to the principle of comparative advantage, it is Adam Smith who pronounces the principle of specialization in modern terms: *the division of labour is limited by the extent of the market*.[14]

Specialization as a principle for international trade does not replace that of comparative advantage, it complements it. It does not explain all the trade which can be observed but it does explain a good part of it. And though it has received less attention in the literature on the subject it is nevertheless very familiar in the business world. The instinct of the businessman which leads him to increase and broaden his markets is based on the conviction that a larger market will allow him to reduce his unit costs in manufacture and sales, thus gaining ground over his competitors. In the real world, economies of scale or increasing returns which are the basis of the advantage of specialization seem to appear more often than the other theories which are more common in textbooks on the subject.[15]

An explanation of international trade based on the advantage of specialization provides different answers from those offered by concentrating on comparative advantage. Among the many differences, I should like to point out one: the way in which the pattern of trade is determined, that is to say, the composition of exports and imports for each country. In the case of Portugal and England, it was very clear. It was the factor endowments: sun

(14) This argument is, as will be appreciated from the quote, very old. For a recent treatment, see Krugman (1989 and 1996). Regarding Smith's proposition, see Stigler (1951).
(15) At least according to the way in which the majority of companies operate.

in one and coal in the other. But as the example of cars and aeroplanes illustrates, if the important factor is scale of production, the advantage is held by the first who succeeds in supplying a market which permits him to have a greater size than that of his competitors. Who is first may depend on circumstances which at first sight seem accidental. If we can imagine that, in the case of comparative advantage, the commercial model can be determined prior to the existence of effective trade relations, in the case of specialization, the margin of arbitrariness is much greater. Nobody would be capable of predicting that the Netherlands, and not Belgium, ought to specialise in the manufacture of gearboxes and not brakes. But the first one which has an efficient manufacturing plant will end up supplying the whole market.

All of this has a practical interest and is of immediate relevance to opportunities available for the Spanish economy in the foreseeable future. The progressive removal of barriers to international trade, the reduction of transport costs and improvement in communications has resulted in a broadening of the markets. As a result, in all those activities in which economies of scale are significant, we are seeing a process of concentration along with this broadening of the markets. This is common currency. In areas such as the pharmaceutical, automotive or business equipment industries, in services such as air transport or banking, to name but a few, the coming years will see a reduction in the number of participants, an increase in the scale of operations of those who remain and a reduction of the number of industrial installations. At the same time, it is probable that the suppliers of these industries, who form the lower level of the industrial structure, will tend to gravitate towards these installations. Spain, because of the structure of its industrial fabric and, in particular, because of the absence of groups of companies of a size sufficient for these markets, cannot aspire to head any of these processes of concentration. It can, however, participate in the ongoing distribution of these industrial installations aimed at supplying the European market or the world market, according to the particular case.

The margin of arbitrariness which exists as regards the placing of production plants with large economies of scale means that a choice cannot be made in advance and, as a result, Spain can opt to be a centre for one of these industries. For this it must compete with other countries. And in order to compete efficiently, the first condition is to know how to choose. We cannot aspire to be a European centre for the pharmaceutical industry, the automotive industry, banking and business equipment in just the same way that it is unlikely that five Spanish cities might provide the headquarters for five community institutions. As can be seen in cases such as this latter example, presenting various candidates is the best way of ensuring that none of them wins. A process of concentration is necessarily discriminatory: it does not give a little to everyone, but rather a great deal to a few and nothing to the rest.

If we look beyond the moment at which Monetary Union is created, we come to the conclusion that the principal advantage which Spain may derive from its participation in the Union is precisely this possibility of taking advantage of the opportunities offered by these processes of concentration. If Spain does not have access to the flow of information allowing it to anticipate events, if it is not as close as possible, both through private lobbying and from the community administration, to the big decisions which are to influence Europe's future, it will sooner or later return to a marginal position where it will not even be able to rely on the cohesion funds which it should perhaps not have requested.[16] But it is not enough to be there to take advantage of these opportunities. One must be know, in each negotiation, what can be achieved and above all what one wants to achieve. As the anecdote regarding the headquarters for community institutions illustrates, each member state will maximize its possibilities by offering the Union a unique position. This requirement has one difficulty: the central administration representing this country in the Union must each time decide

(16) It is worth pointing out here the small advantage that the Spanish administration draws from its community officers. In this regard we are even, to our own detriment, a long way behind countries as little in favour of Europe as the United Kingdom.

which of the different possibilities it should make its own, renouncing any claim on the others. As this involves requests which come from different sectors and different regions, any choice made by the administration will be the source of grievances and will therefore have a cost in political terms. If this cost appears to be very high, the government may choose to present various options, knowing that it will not obtain any of them.[17]

The element which determines whether this political cost is higher or lower is what, for want of a better phrase, we might call the *level of cohesion* in a country. If a given sector (or city, or region) in a country considers itself better off if a given benefit is conferred on another sector (city or region) in the same country than if it goes to another country, then the political cost of decisions which only favour one sector or one area (that is to say, which discriminate) will tend to be low and one would say that the country has a high level of cohesion. If, on the other hand, someone in a sector or area is indifferent to the benefit which may result for someone else in the same country, or even more if this is considered to be a source of grievance, then the political cost of these decisions tends to be high and one could talk of a country with little cohesion. In the latter case it is very difficult to join forces in a common cause which does not directly and immediately favour all the participants.

5. An opinion on the level of cohesion

By means of the above, I wish to illustrate that our ability to take advantage of the opportunities offered by our membership of the European project, at a time when the broadening of the markets will lead to a process of concentration,[18] will depend to a great extent on the level of

(17) One could counter this with the argument that the competition between countries for these production centres is above all competition between public subsidies. This is true, but it does not make the argument invalid. Given that aid comes from a limited budget, it is not possible to subsidize all of the possible alternatives. To choose means to discriminate.

(18) This does not mean that processes of concentration are going to be the only events happening in the future, in the same way that specialization will not be the only source of commercial exchange. It is merely that this is something to be borne in mind.

cohesion in our society, the capacity to undertake projects whose benefits, in terms of investment, employment, wage levels or technical progress, will be distributed unequally throughout the country, at least at first. If on reviewing the risks offered by our economic future we conclude that to face up to them successfully would depend above all on our ability to adapt, we might then conclude that taking advantage of the opportunities offered by specialization will depend to a great extent on our level of cohesion. And, if it seems reasonable to show a moderate degree of optimism when judging our ability to adapt, one might ask if the same could be said of our level of cohesion.

The reply, in my opinion, is that it could not. Although one might admire our capacity for adjustment, I think that we must admit to being a country with little cohesion in terms of the above definition. We only regard as beneficial that which corresponds to us or to our immediate environment and for this reason we seem always to expect some mechanism for redistribution to come into play with everyone tending to be treated equally. This requirement has marked the great debates and the grand economic projects of the last decade as regards industrial policy, public companies, privatization, public aid, to give just a few examples, without even beginning to discuss explicitly redistributive policies where one would expect a lower level of cohesion. Upon examining the real objectives (and not the official justifications) of public intervention during recent years, one is surprised to see that they are, in the great majority, redistributive. The main result of regional aid, public investment or industrial policy has been to contribute to the redistribution of income, much more than increasing production capacity or improving the efficiency of those who benefit. The importance assumed by the objective of redistribution in some of the decisions taken by politicians who are sensitive to the desires of their electorate, indicates that these politicians perceive that the political cost of discriminatory decisions (however efficient they may be), is very high. That is to say, the level of cohesion is low. Apart from this, I believe that anyone who has been a close observer or a direct participant in these grand projects will share this view.[19] It would perhaps be a good thing to take this weakness as one piece of information, or at least as a working hypothesis, when we evaluate our prospects for taking advantage of the opportunities offered by European integration. We will have to make a great effort in order to participate in activities with a more promising future, activities which require continuing action and, therefore, a firm agreement between participants with very different characteristics.

6. Final speculations

The above reflections are based on a consideration of the nature of the process of European integration; and if they stray from what would be a strictly economic analysis, this is because the process itself is going that way. They are aimed, not at suggesting routes or solutions which are alternative to the norm, but rather at complementing them. If conventional solutions are necessary, if it is necessary to maintain and improve our capacity to adjust to an extremely uncertain environment, they are also notoriously inadequate. Great opportunities require collective efforts which go beyond, rather than against, the «liberal trio» formed by current consensus: stabilize, liberalize, privatize.

Ability to adapt and lack of cohesion could, in our case, be two sides of the same coin, both having the same origins: indifference, sometimes aversion, to our past, which we perhaps see as a legacy which we would prefer not to have received. This would not be strange. And, if this feeling is true, it would have something to do, not so much with a hypothetical national character, as with the way in which we have created our own history. It is difficult to think of any episode in this history which has not, at

(19) In an earlier version of this essay, I had intended to give some specific examples of this lack of cohesion. I prefer, however, to omit them here, so that I am not appearing to blame anyone. The weakness to which I refer appears to me to belong to the country in general.

a later point, been considered an aberration or of any feature of our culture that has not at some time been interpreted as an anachronism or, alternatively, of any element among those which normally offer a form of national identity which has not been used by one regime in order to be vilified by a later one. This is particularly true as regards collective ventures and projects. Things being as they are, we should not be surprised that we are willing to adapt ourselves to whatever is convenient, on the one hand, while being, on the other, incapable of carrying out common projects of any particular range. We seem to have lost any feeling of common identity as regards the rest of Europe, like the children of immigrants who refuse to speak the language of their country of origin until they have found their place in their adopted country.

The above is, of course, nothing more than personal speculation. But it does perhaps serve to complete the economic debate by using elements from another discipline which are equally indispensable if we are to be capable of thinking about anything more than the most immediate problems. The usual recommendations of the economist can assist us only over part of the road. What I have intended to suggest here is that in order to travel the remainder of the way it will perhaps be necessary to be aware of and regain other elements which have, for the moment, been lost.

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