Europe after Maastricht – Have the Monetary Questions been Settled?

The decisions taken at Maastricht seem to have finally removed the obstacles to European monetary union. So have the monetary questions really been settled? Is the process of monetary convergence irreversible?

According to the decisions of the Intergovernmental Conference in Maastricht, it will not be determined until the end of 1996 which member states of the European Community meet the requirements for entry to a European monetary union, which relate to the permitted rate of inflation, net new government borrowing and the level of public debt. Only if at least seven countries are ready and able to set up the monetary union will a European central bank be established in 1997. If that does not happen, the European monetary union will come into force by the end of 1998 at the latest. Countries that then fulfil the criteria will automatically become members, unless they have secured an escape clause, as in the case of the United Kingdom.

Hence, it appears there can be no going back on the road to European monetary union, that the process of monetary convergence is irreversible. It remains to be seen whether this is really true, however. Europe has already witnessed many stage-by-stage plans that were not implemented, despite precise timetables. Even if this path is followed to the very end, the monetary decisions taken at Maastricht have not made the economic problems themselves disappear. Only if we come to grips with these problems dare we even hope that the European monetary union will be successful. It is therefore undoubtedly true that “There is an aura of unreality about the decisions taken in Maastricht”, as one commentator wrote on the day after the conference.

This view of things may be incomplete, given the narrow perception of the economist. It may even be too pessimistic from the point of view of economics, because certain aspects have been ignored. A satisfactory answer to this is more likely to be found if one considers at least three questions:

- Why are the countries of the European Community striving for a monetary union in any case?
- What obstacles must be overcome on the road to an efficient monetary union in Europe?
- Where must one begin, in order truly to remove these obstacles?

A monetary union in Europe will always make sense if it helps reduce the cost of financial transactions. These include in particular the cost of exchanging one currency for another or the costs caused by fluctuating nominal exchange rates or by inflation. Since the level of transaction costs depends very heavily on the degree of financial market integration and the efficiency of macro-political action (monetary and fiscal measures), the success of a monetary union in which exchange-rate induced transaction costs no longer play a role depends on the extent to which regulatory state intervention in the financial markets can be reduced and monetary and fiscal policy action disciplined so that inflationary problems are avoided.

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The success of a monetary union can also be judged by whether it makes it easier to apply scarce resources to productive uses. Allocation improves if it is possible to reduce the many changes in data (adjustment burdens) and to assimilate efficiently those changes that do occur in economic conditions (adjustment capacity). There would certainly be something to be said for a European monetary union if it not only succeeded in reducing the adjustment costs due to inefficient macro-political activities in member states but also increased the adjustment capacity of the often "sclerotic" European economies by making relative prices more flexible and factors of production more mobile.

Whether a European monetary union is ultimately successful therefore depends crucially on the extent to which it succeeds in disciplining the monetary and fiscal policy behaviour of monetary and governmental institutions and makes it possible to assimilate changes in parameters as efficiently as possible.

There are at least two obstacles that must be removed if a European monetary union is to be really successful. First, macro-political activities must be disciplined, and secondly country-specific shocks must be assimilated efficiently. With regard to macro-political activities, the question immediately arises whether it can make sense for individual members of a monetary union to support a monetary policy that is inconsistent with stability. The European economies differ not only in the economic objectives preferred by their policy-makers but also in the degree of imperfection of their markets in goods and factors of production. They therefore differ quite markedly in the extent to which they can exploit the trade-off between unemployment and inflation in the short term. The political decision-makers (politicians and bureaucrats) in countries with relatively high unemployment and a fairly low aversion to inflation therefore have an interest in pursuing a less stability-oriented, discretionary monetary policy.

These incentives are reinforced if there are differences in the cost of taxation, in terms of the waste of resources, and if countries bear markedly different burdens of debt. In such an imperfect world, inflation becomes a rational component of a "second best" tax structure, because it not only distorts resource allocation but also increases government revenue and reduces the real value of the public debt. The more taxation contributes to the waste of scarce resources and the higher a country's debt ratio, the higher the optimum national inflation rate will be.

Since optimum national inflation rates in European countries are not identical, owing to structural differences and preferences for particular economic objectives, the members of a European monetary union will have to agree on a common inflation rate. It is probable they will settle for an average rate above the rate in the country with the lowest inflation.

**Inflationary Dangers**

One monetary obstacle clearly lies in the fact that inflation problems are probable in a monetary union if it consists of economies whose preferences regarding economic objectives differ primarily in accordance with the degree of imperfection of their markets in goods and factors of production.

Even if countries could agree on a policy of price stabilisation, there is still a danger that such a policy would not be really credible. In that case, monetary policy would lack time consistency and the inflation rate in the monetary union would be sub-optimally high. This hypothesis becomes understandable if one considers a country that wants to reduce inflation from a relatively high level and consequently announces that monetary policy will be more restrictive in future. Such a change of stance may not be credible, because the government has an incentive to revert to an inflationary policy once wage negotiators have agreed nominal wage increases based on faith in a policy of price stabilisation and capital market operators have set nominal interest rates at particular levels.

By so doing, the government could try to exploit the short-term Phillips curve trade-off for economic policy purposes by triggering a surprise surge in inflation, thereby also increasing revenue from "seigniorage". If economic agents correctly anticipate this behaviour on the part of the government and take due account of it in their plans, they will not give credence to the announced monetary policy activities and will continue with their previous wage, interest rate and price behaviour. The inflation rate therefore remains sub-optimally high.

A second monetary obstacle to EMU therefore arises if monetary macro-policy is not really credible. This problem only arises, however, if monetary policy-makers aim to achieve real as well as monetary objectives, since they have only one weapon in their monetary armoury, a conflict of economic objectives is unavoidable if they attempt to

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