Monetary Union: Danger, Opportunity, or Utopia

1. Anxiety Reigns

It is actually quite amazing how often something that is very well known all of sudden becomes a hot topic and is treated as though it were new. Today, it is the European monetary union that is making waves, especially with our northern neighbor. Concern, fear, and virtual panic describe the basic tenor of the comments one hears. Some are recommending the allocation of entire fortunes, others predict that traditionally hard currencies will be devalued while heretofore soft currencies will strengthen, and warnings abound against the acquisition of long-term DM obligations. "Act, before the markets do", "Will the Deutschmark become the Euro-Dinar?", "A massive capital exodus into Francs?" - such are the titles in the business journals.

The treaty on European unification was signed on February 7, 1992 in Maastricht and became effective November 11, 1993. Since then there have not been many new developments. This raises the question of why the European monetary union took so long to become a topic of concern, only to then become the focus of such intense scrutiny. We believe there are two reasons: First, the date set in the treaty as the latest date for establishing the monetary union is coming upon us. So even the most notorious short-run thinkers in the financial markets have to start considering it. Secondly - and probably more importantly - one of the major players in the event, Germany, recently, through the experience of reunification, gained several important insights into monetary processes. Insights that got under its skin.

Monetary union has become such an important topic that even the president of the National Bank of Switzerland, Dr. Markus Lusser, has taken a position on it. Giving up the characteristic of a central bank representative for once, he unmistakably pointed to several weaknesses in the current conception of the anticipated monetary union and reaffirmed that it remains, without question, in Switzerland's interest to pursue an independent national monetary policy.

Both the development of the discussion and the fact that leaders in monetary policy are speaking out in this manner, point to the growing anxiety over the European monetary union. The anxiety is born of the many unanswered questions and unknowns left by the Maastricht treaty. Uncertainties markets. In an effort to help provide bearings in this uncertain terrain, we will try to lay out what is definite, provide parameters for what remains unclear, and establish the likelihood of the emergence of several scenarios.

2. The Point of Departure

The legal foundations of monetary union are to be found, as we said, in the final accords of Maastricht. These are divided into the "new treaty of the European Union" and a number of additional documents and declarations. The crucial difference between the Maastricht treaty and the 1957 treaties of Rome lies in the former's expanded unification objectives. The current European economic community is slated to become an economic and monetary union. Eight new policy areas are designated to be collectively determined, among them transportation, the environment, health care, and education. The monetary union is to be, so to speak, the embodiment of this harmonized togetherness, or perhaps, more precisely, a means to its end.

For as evident as it is from the documents that monetary unification is viewed as only one of many elements necessary for creating a European Union, it is clearly held to be of central importance in achieving the various harmonization objectives. Without a unified currency, there can be no community tax-, finance-, social-, and competition policies. This point requires further elaboration. What is causing what? Will a commonly shared currency emerge as a consequence of EU policies in the various areas, or will it be the other way around?

According to the Maastricht treaty, the creation of a unified currency is to occur in three steps:

- In the first step, capital transactions are to be liberalized. All restrictions on the free movement of capital between member states, as well as between member states and third party states, are prohibited. This policy became effective when the Maastricht treaty came into force in November of 1993.
- Step two calls for the creation of a European central bank. The bank would complete a kind of preparatory training period before ultimately becoming a fully independent central bank. The national banks would have a role similar to that of the individual member banks of the Federal Reserve Board. Step two is currently in process.
- In step three, the unified currency is created and the individual national currencies are replaced.

Maastricht establishes a timeline for this process with several target dates. By the end of 1996, at the latest, the European Council is to have decided, by qualified majority opinion, whether a majority of member nations have met the prerequisites for the creation of a standard currency and whether it makes sense to initiate step three. If such a decision has not been made by the end of 1997, then step three is initiated on January 1, 1999 with those countries, as determined by qualified majority opinion, that have met the prerequisites.

The prerequisites are the four famous convergence criteria:

- the achievement of a high degree of price stability
- the ongoing acceptability of the public sector's financialstate
- the maintenance of a particular level of currency stability with respect to the European monetary system
- a sufficient convergence with respect to long-term interest rates

The EU Commission has since developed a "Greenbook" detailing the practical details involved in the creation of a unified currency. In June of this year, the EU government leaders fully endorsed this document. The Greenbook divides the actual transition into three phases:

- Phase A specifies the decision-making procedure of the European Council with respect to initiating step 3 of the Maastricht agreement.
- Phase B marks the beginning of the monetary union through the irreversible fixing of the individual national currencies to the newly established European currency.
- In phase C, the national bills and coinage are replaced by European money.

3. The Weak Points

At first glance, all this may seem complicated but plausible and clear. However, once held to the light, there appear several uncertainties with the established process for creating a unified currency.

For instance, the convergence criteria are only apparently unambiguous. In a appendix to the Maasatricht treaty, continuing price stability for a country is said to be achieved when the previous year's inflation rate was no more than 1.5% above the best three countries' rates. There is no mention of whether the calculation is based on the average of the three best countries' rates or whether, for instance, the upper margin is instead 1.5% above the level of the worst of the three top countries. This is not just shadow boxing.

The restrictions placed on national deficit levels appear to be less ambiguous. According to the treaty, an unacceptable deficit level exists when the deficit quota (with respect to GDP) is significantly above 3%. In addition, the health of a nation's financial condition is considered insufficiently secured if the debt quota (national debt/GDP) is more than 60%. The problem with this convergence criterion has less to do with definitions than with the statistics employed. How reliable are the numbers on national budgets and the national economic calculations? What is to be taken into account and what not? What about the states' contingent liabilities? And what of mixed economy enterprise? To what extent are the municipalities taken into consideration?

The monetary stability requirement also only seems clear at first glance. For example, competitive devaluations undertaken "at one's own suggestion" are to be punished. But how can we, in the aftermath of currency turbulences, determine who actually started the ball rolling? There will be far too much room for interpretation.

Even the initially sensible seeming interest rate convergence criterion shows weaknesses. If a country succeeds in creating the appearance that it is likely to meet participation requirements, then the market will automatically reconcile interest rate differences. As the moment of membership draws closer, this balancing dynamic will only intensify. Thus, the interest rate convergence criterion is of little utility in measuring a country's fiscal policy orientation.

One frequently sees lay-outs in financial journals detailing the degree to which individual EU countries have met the convergence criteria. To be meaningful, these pieces would have to include an additional component in which the chosen definitions of "convergence" are described in more careful detail. Obviously, the financial markets find little pleasure in such imprecise definitions. Anxiety reigns.

The anxiety grows more intense as we do a closer analysis of the implementation procedure, or at least of that part of it which is known. From a political perspective, the time pressure created by the Maastricht treaty is understandable. They did not want implementation to be pushed off into the unforeseeable future. However, these restraints on behavior are problematic from an economic perspective. The decision, Go or No-Go, rests only on the achievement of the convergence criteria and not on other preconditions that might be more significant for monetary unification. Swiss National Bank President Lusser has rightly lamented, for example, the complete absence of a convergent tax- and financial transfer policy.

A host of practical problems also emerge from the omission of details from the implementation procedure. So, for example, it remains entirely unclear how the fixing of exchange rates at the beginning of phase B is to occur. Will the spotrate dictate the level at which currencies are fixed? If so, were the date to become know, even in a very restricted circle, it would have unpredictable consequences for the currency and interest rate markets. Will the member nations be known ahead of time? The financial markets would adjust in anticipation, in particular in the realm of long-term interest rates. Is it possible that countries that have only partially met the convergence criteria (i.e. the majority) but are nonetheless likely to be included for political reasons, would receive a currency windfall through the fixing of the exchange rates? In that case, those who are currently advising their investors to put money in traditionally soft European currencies would be bitterly disappointed.

These - and many more - weaknesses in the concept are having their effects long before the final hour. They are leading to anticipatory adjustments in the highly efficient financial markets, adjustments which are largely responsible for the events of today. The strengthening Franc of the last two years is not an accident. And the unusually steep interest rate curve in the DM region suggests that markets have added a risk premium to long term investments in order to compensate for the increased danger of future expropriation.

Thus, when the EU government conference is held next year, expect every change in the situation to affect the financial markets, whether that change be the further clarification of unclear procedures, the further politicization of what is in essence primarily an economic issue, or even the postponement of the entire affair. Premature conclusions, or misinformation, spawned by rumour could cause extremely unpleasant disturbances. Anxiety reigns.

4. Scenario A: The Monetary Union as Opportunity

Let us assume that the EU is able, in the next months and years, to deal with the worst weaknesses in the convergence criteria and to sufficiently specify the implementation process so as to avoid any false expectations within the market. Further, let us assume that the EU manages to formulate the bases for common (and realizable) tax and financial transfer policies and that it succeeds in giving the European Central Bank a credible structure. Then, but only then, can one conceive of a relatively smooth transition into a European monetary union.

However, only a few countries would be a part of the union: Germany, Holland, Luxemburg, perhaps Austria, probably not France. The rest of Europe would remain in the old European Monetary System (EMS). In other words, the monetary union would be little more than an extension of the DM dominated region and would not encompass the whole of Europe. Setting aside the questionable political implications of such a solution for a moment, it is perhaps the only economically sensible route to take. It would be a monetary union that does not significantly dilute the achievements of a hard German currency, that does not create any false stimuli for less disciplined regions of Europe, and that brings together that which is already convergent.

In principle it is entirely possible that over time one European state after another would strive for and achieve the qualifications for membership in the union. And the idea that a Europe with less monetary diversity would have its advantages should not be dismissed out of hand. Up until the last century, every city in Switzerland had its own currency. Today, a retreat from the single currency, the

Swiss Franc, is unimaginable. Furthermore, it emerged despite the fact that there are more than a few structural differences between the alpine villages and the cities in the flatlands.

5. Scenario B: Politics Has the Upper Hand

Economic reason - production based on what is unambiguous, confinement to what is doable - is often in conflict with political calculation. Maastricht was conceived with German reunification in mind and was thus viewed as a way to bind the reemergent central European heavy-weight into Europe-wide tructures. From this perspective, a "Europe at two speeds" is dangerous. A union reduced to a core of Germany and its close neighbors is unacceptable. At least France and the entire Benelux (that means Belgium too!), but possibly a part of Scandinavia as well, would have to be on board. The division into a northern and a southern half would remain more than enough of a problem. A monetary union pieced together in this manner would have stability problems from the outset. Furthermore, regardless of how you twist or turn the details, the Germans would, within a short time, face a second currency dilution. The consequences would be higher interest rates and inflationary pressure created by a devaluational tendency with respect to the U.S. $, the Yen, and the Swiss Franc. The benefactors would be those weaker European countries brought on board under favorable conditions. As long as political calculus has the upper hand, it should be assumed that freedom of action will be preserved for as long as possible. This simply means that the weak points in the convergence criteria and in the conceptualization of the transition procedures will remain unresolved. That is poisonous to the financial markets, for they work with probabilities. The result will be risk premiums, for example in the form of higher interest rates.

6. Scenario C: Monetary Union Remains a Utopian Ideal

The Maastricht treaty is, like any other piece of writing, in some respects just a piece of paper. It could, if necessary, be consigned to history without being implemented. The EU politicians are faced with a decision between proceeding according to the politically impossible scenario A, or risking the economic stability of Europe with the economically questionable scenario B. The possibility of simply doing without a monetary union (of course, they would say "temporarily") may not appear as the worst way out of this relatively hopeless situation.

In that case, Europe would be set back in its integrationist vision. But it could then, within the realm of what is doable and perhaps in a more federalist manner, continue to develop along calmer paths. Giving up on the ambitious project of monetary unification would likely have a stabilizing effect, even if certain softer European currencies fell back a notch as their membership fantasies disappeared. The long-term interest rates in the DM region would gain some flexibility in the downward direction.

7. Working with Probabilities

What will ultimately occur is difficult to assess. Mixed forms of the above scenarios are certainly possible. The various interest groups will experience ups and downs in their clout over the course of the next months and years; and in response the financial markets will assess the probabilities as higher or lower.

Economic rationality is held up and promoted by the central banks of the most stable countries, in particular by the German Bundesbank. Presumably, the Bundesbank can count on the support of a large part of the German public - a phenomenon which is not all that common for central banks. But the memories of the results of reunification are still too fresh to expect rose colored glasses of the political class to produce an effect.

It is more difficult to map out the political interests at stake. The main reason is that the idea of European unity was never really based on a positive creative vision. It was instead conceived, first and foremost, as a means of domesticating Germany. Thus the central question of the political calculus has largely to do with whether tying Germany into Europe continues to be necessary. The question appears to us, following reunification, to have gained in saliency on two accounts:

- With the fall of the Iron Curtain, Europe acquired a "rear courtyard". Sooner or later, closer cooperation with that area will be necessary. Or to be more concrete, someone is going to have to assist in the development of that region. Or more concretely still, there will be a need for an ordering power that can create stability in the area. For historical reasons, Germany cannot be that power. Whether we like it or not, policy concerns over Eastern Europe make the European Union necessary.
- This consideration holds from Germany's perspective as well. The handicap of not being able to pursue authentic foreign policy - much less power politics - for the foreseeable future could be partially remedied if Germany is able to express itself indirectly through European foreign policy. The European political efforts of German statesman can only really be explained from this perspective.

"Power Politics" is one, the seemingly natural drive for expansion within the political class is another. And the tendency, under the guise of a free trade zone, to create a kind of supra-national cartel that sets measurement standards for the admission of pickles, is a last powerful motivation behind the continued dominance of political calculation.

As a result, at this moment each of the first two scenarios has about the same probability of occurring. This, however, suggests that the third, "delay/do without", scenario has now become more likely. There is, in fact, no sign that economic rationality and political calculus are likely to be on the same page within any useful period of time.

8. Conclusions

From our perspective, it is unquestionably inappropriate to be betting on one scenario, perhaps in the belief that profits from speculation will be a "sure thing". It is too early. Too much remains completely open. We consider the move away from the hard DM into softer European currencies, based on the notion that these will benefit from the coming dilution of the DM, to be a dangerous game with fire. What if the membership candidate turns out not to be one? What if the fixed exchange rate is below rather than at parity? Likewise, we think it is mistaken to designate long-term DM obligations as dangerous and to be avoided. The risk premium is there in the form of the interest rate structure. What more can the courageous person want?

In the end, a lot will depend on the skilfulness of Europe's leaders. It will be up to them to establish a credible plan for advancing the process by the end of 1996. The danger of a destabilization of the EMS in connection with next year's governing conference is palpable. The danger can only be met by investing outside the EMS. Concretely, this means going with Swiss Francs and accepting lower yields or taking a risk with the dollar (but at attractive interest rates). We are currently adjusting our investment strategy in this direction.

One last note. With respect to the monetary union, there is one thing that appears certain to this author: That today is not the last time he will write about this subject ...