SCHOOLS BRIEF

One Europe, one economy

The European Community aims to create not only a single market but an economic and monetary union (EMU). For Europe's producers and consumers, what exactly would EMU mean?

AT FIRST sight, Europe's commitment to Project 1992 and its enthusiasm for economic and monetary union (EMU) seem to involve separate goals. Project 1992 is intended to turn the EC into a genuine common market for goods and services by the end of 1992. EMU, in its most ambitious variant, would oblige all or part of the Community to adopt a single European currency.

Many people nevertheless now regard EMU as a natural counterpart to the single market. They argue that for Europe's countries to retain separate currencies would itself amount to a barrier to trade. Such orthodoxy is new. Five years ago advocates of a single European currency were widely dismissed as dreamers. Nowadays it is the doubters who are chided for opposing the inevitable. This change in thinking about economic integration in Western Europe is remarkable in itself.

In many ways, economies everywhere—not just in Europe—have been moving closer to each other since 1945. Successive rounds of trade talks lowered tariffs and other barriers to trade. At the same time advancing technology expanded the opportunities for trade—most obviously by reducing transport costs, but in other ways, too. As a result, trade has grown much more quickly than output throughout the postwar period. Through flows of finance, too, economies are much more interconnected than before. Markets for equities, as well as for corporate and government debt, have become truly global in the past 20 years.

The countries of Western Europe have come to depend especially heavily on trade with each other. In the 1960s West Germany's ratio of trade to output (taking the average of its exports and imports) was 16%; by the late 1980s the figure had risen to 25%. In the 1960s 45% of West Germany's trade was with the other 11 members of the present EC; by the late 1980s that proportion had increased to 62% (see chart 1).

How far different European countries depend on trade differs more than might be thought: Italy had a trade-to-output ratio of 17% in the late 1980s; Belgium's and Luxembourg's were 62%. Despite that, a general trend towards greater European dependence on trade, especially on trade with other Europeans, seems fairly clear.

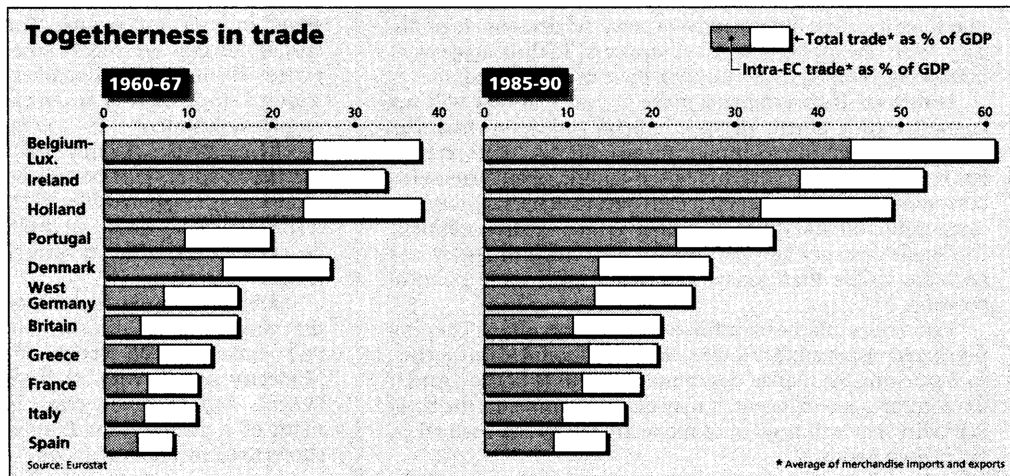
As might be expected, the intra-European trade shares of the Community's six original members (Belgium, France, Holland, Italy, Luxembourg and West Germany) are bigger than those of its six newer members (Britain, Denmark, Greece, Ireland, Portugal and Spain). But the difference has narrowed since the early 1970s, when the Community began to enlarge. This seems to confirm that membership of the Community has accelerated the trend towards integration.

But trade is not the only area where economic convergence in Europe is visible. Another is money and currencies. This is especially apparent since 1979, when the EC established the European monetary system (EMS).

The aim of the EMS was to create a European zone of exchange-rate stability. At the time, Europe felt unusually vulnerable: the collapse of the Bretton Woods fixed-currency system in the early 1970s and America's subsequent policy of "benign neglect" towards the dollar had made the international monetary system volatile. As a transatlantic remedy looked unlikely, the Community concluded that a regional one would have to do.

The designers of the EMS believed their new system would do two things: promote intra-European trade and help governments to fight inflation. The operation of the EMS is complicated: its exchange-rate mechanism (ERM) obliges governments to keep the movement of their currencies against each other within narrow limits. But the discipline it exerts is simple: countries with relatively high inflation are punished by a rapid decline in competitiveness that they cannot offset by devaluing the currency—not easily, anyway. As well as holding currencies steady, the mechanism tends to push inflation rates down towards the lowest in the system (as a rule, Germany's).

Until recently, the ERM was more flexible than this description makes it sound. Countries were able to devalue their currencies in occasional "realignments". Between 1979 and 1987 there were 11 of them (though since then just one). The system's blend of discipline and flexibility has worked well enough to convert doubters such as the British, who put sterling into the ERM in 1990. The average inflation rate of the eight countries that were members at the start fell from 12% in 1979 to less than 3% by the late 1980s; and the spread of inflation rates around that falling average narrowed appreciably (see chart 2).



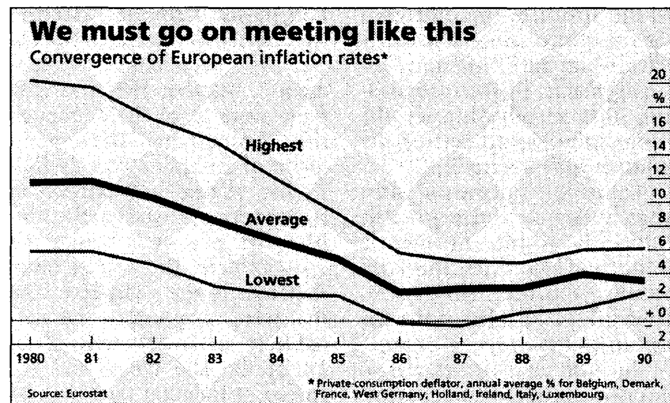
Now for 1992

By the beginning of the 1990s most members of the EC were, on almost any measure, highly integrated economies. What extra benefit, then, can the single-market programme bring? The European Commission has devoted much time and effort to this question. Its answer is, a lot.

The changes that the 1992 programme aims to bring about fall under four headings:

- **Frontier controls.** By removing these, the aim is to abolish delays at customs posts and reduce the resources tied up in coping with the trade bureaucracy.
- **Public procurement.** By opening this up to non-national suppliers, the idea is to reduce costs directly, by letting cheaper supplies into national economies and, indirectly, by forcing national suppliers to compete.
- **Financial services.** Europe's retail-banking and insurance businesses are split into national markets. The aim is to lift barriers to competition, which should drive down the price of financial services, including the cost of borrowing, throughout the EC.
- **Supply-side effects.** Those first three things should all lower the costs of doing business in Europe. But the single-market programme is also expected to have more complicated effects, as firms in different industries adjust to a more competitive climate. To mention just two: monopoly profits are likely to come under new pressure and companies will find fresh opportunities to exploit economies of scale.

In the Cecchini report of 1988, the commission tried to estimate the effect of these changes on the Community's GDP. In that exercise, it assumed that the single-market programme would be carried out in full. (The next



brief in this series will examine how far the 12 have got.) The commission began by estimating the first-round effects on output under each of the four headings. Next, these changes were fed into an economic model designed to capture second-round effects. (Output always rises by more than any initial stimulus, for instance; models take such "multiplier" effects into account.)

The report concluded that the removal of frontier controls could add 0.4% to the EC's output; open public procurement, another 0.5%; freer financial services, 1.5%; and supply-side effects, 2.1%. (These are not long-run increases in growth rates but one-off gains, though spread over the several years it takes for these benefits to come through.) Altogether, the putative gains add up to 4.5% of GDP—with a margin of error of plus or minus 1.5 percentage points.

There are reasons for thinking these estimates too cautious. One likely effect the Cecchini report overlooked is that gains in output will call forth an increase in Europe's capital stock: capital will be more productive, yet cost no more than before, making firms want more of it. This is an extra source of benefit—worth, according to Richard Baldwin of Columbia University, perhaps half as much again as the benefits already identified.

Another possibility is that the single-market programme will not merely provide one-off gains, but permanently raise Europe's growth rate. One estimate (again, Mr Baldwin's) is that the EC's long-term growth rate might rise by half a percentage point.

One money?

The best reason for not stopping at the single market but moving on to a single currency is that the gains from integration would then be even greater.

- **Transactions costs**. A striking example illustrates the most visible cost of keeping 12 European currencies: a traveller visiting every European capital, with £1,000 at the start, and converting that cash into each local currency in turn would return home with less than £500, conversion charges having gobbled the rest.

Businesses pay much smaller charges than tourists when they convert their currencies—but they transact in larger volumes. The commission reckons that Europe's businesses convert roughly 6 trillion ecus ($7.7 trillion) from one EC currency to another each year—at a cost of about 10 billion ecus in conversion charges. A single currency would avoid those costs, and help companies in another way: they could devote fewer resources to accounting and treasury management. In all, the commission estimates that these gains from monetary union could be worth about 0.4% of the Community's GDP.

- **Risk**. Currency systems break down: the Bretton Woods system did, and so did the pre-1914 gold standard, the most recent grand experiment in "permanently" fixed exchange rates. Barring such a collapse, however, the move to a single currency in Europe would fix intra-European exchange rates, so to speak, once and for all.

This would remove a large source of economic risk from Europe's businesses. Some economists argue that the gain from this would be small because today's clever financial instruments (currency swaps, futures, options and so on) make it possible for firms to hedge their risks. But such hedges cost money. Also, they cannot provide anything like complete protection for businessesexcept in the short term. The currency risk that a company takes when it decides to build a factory abroad is largely unhedgeable.

So a single currency would reduce risk. The effect of a less risky environment is, in turn, to reduce the cost of capital. Investment and output would therefore rise. It is impossible to do more than guess the size of this benefit, but the gains might well be large—according to one study for the commission, on the order of 5-10% of GDP.

So much for the benefits of a single currency. What would be the drawbacks? One is that national authorities would no longer be able to "choose" their own inflation rate: there would be one monetary policy, and one inflation rate, for the EC.

That makes it crucial to ensure that the EC's monetary policy is well run. The draft treaty on monetary union proposes an independent central bank with a clear mandate to pursue price stability. For Germany, whose Bundesbank would most likely be the model for any new Bank of Europe and whose inflation rate has been consistently low over the years, this new regime would be a gamble. For most others, notably Britain, it could hardly be riskier than present arrangements: Britain's record on inflation is poor.

To devalue is human

A more powerful objection to the single currency is that, in giving up the right to devalue their currencies, governments throw away a vital tool of policy. Suppose one country is hit by an economic shock that drives up its costs relative to those of its EC partners. To adjust to that shock successfully, the country would have to reduce its costs again to the EC average. One way to do that would be to devalue its currency. Denied that choice, it would have to adjust through wage restraint or higher productivity—which might, in turn, require a recession.

Note, however, that devaluation has not worked well in practice. It lowers costs by reducing real wages. If workers resist that, as they often do, devaluation can lead to a worsening spiral of inflation and depreciation. Also, the argument for retaining separate currencies works best for economies that are not well integrated in trade and finance. For economies that are highly integrated—distinct regional markets within a single country are an example—adjustment to price shocks happens smoothly without devaluation. Europe will be more highly integrated after 1992. A single currency would, in itself, be a powerful spur to yet further integration.

Nobody seriously doubts that the single-market programme will make Europe better off. Monetary union, with its large benefits and uncertain costs, is more of a gamble. But Europe seems to be in a betting mood.

Fiscal federalism

MANY say that monetary union will require greater fiscal control from the centre. With movable exchange rates, they argue, fiscal policy is subject to discipline: a government that borrows too much risks a run on its currency. This, in turn, may force it to raise interest rates—a powerful deterrent to profligacy. With one money, the risk disappears. To discourage overborrowing, binding fiscal rules will therefore be needed.

Is this so? If governments make it clear that they will not guarantee each other's debts—a crucial condition—financial markets will continue to impose interest-rate discipline on reckless borrowers. When governments in Europe, or anywhere else, borrow in a currency other than their own (dollars, say), they pay rates of interest that differ according to their creditworthiness. In a single-currency Europe, these implicit credit-ratings would be more visible than today, and hence exert more political pressure.

Fiscal rules may be harmful as well as unnecessary. They imply shared responsibility for the debts of national governments, so weakening the market discipline they aim to bolster. And if the control is too stringent, it may deny governments the fiscal flexibility they will need once monetary policy has been taken out of their hands.