



Chapter 8

Economic and monetary union

An unfinished project

I want the whole of Europe to have one currency; it will make trading much easier.
Napoleon, in a letter to his brother, Louis, dated 6 May 1807



This chapter will help you understand:

- how and why the single currency came into existence;
- the nature of EMU and the risks and benefits associated with it;
- the conditions which EMU requires to work and why these require fundamental reforms by eurozone members;
- the impact of the eurozone on the European business environment;
- why the UK, Denmark and Sweden remain outside the eurozone;
- the status and strategy of the 2004 accession states in relation to EMU.

In January 2002, euro notes and coins entered circulation and the single currency became a reality. This event represented the final stage in a long journey and the realisation of one of the 'big ideas' of European integration. The journey has not been without incident. It got off to a false start via the thwarted plans of the 1970 Werner Report which had envisaged full EMU by 1980. Attempts to forge closer monetary links subsequently encountered severe difficulties in the early 1990s with the crises in the ERM, EMU's predecessor. Although its

launch has largely been successful, EMU and the single currency continue to face many challenges, including the need for eurozone members to undertake economic reforms to enable the currency to operate smoothly; the management of relations with EU members outside the eurozone and the absorption of new members, especially from 2004 accession states.

This chapter addresses the above challenges by first exploring the nature of EMU and the single currency and the conditions that need to be met for it to succeed. Second,

the chapter briefly sets out how the EU arrived at its advanced stage of monetary integration, followed by an explanation of why it embarked upon such an ambitious path and of the risks attached to such a course of action. This process also reveals how EMU and the single currency have changed the business environment. The chapter then discusses the challenges facing the single currency. It concludes by drawing together the various strands in a tentative outlook for the project.

WHAT IS EMU?

A key part of the Treaty of Rome was the creation of a common market but it contained no explicit commitment to the objective of economic and monetary union. However, EMU is the possible, albeit not inevitable, next stage of integration after a common or single market (see Chapter 2). Indeed, the existence of separate national currencies is regarded by some as one of the remaining barriers to the attainment of a barrier-free single market. Moreover, as interdependence increases with the free movement of goods, services, capital and labour so the logic of increased common rules in areas such as competition policy and greater economic coordination and cooperation increases to the extent that separate economies and markets are melded together. Furthermore, in a highly interdependent market, the logic for monetary union increases to ward off the possibility of divergent monetary policies distorting and undermining the benefits of interdependence or of competitive policies setting off inflationary pressure.

EMU, therefore, embraces the following characteristics:

- policy harmonisation to remove obstacles to factor mobility. This corresponds to the achievement of the four freedoms (mobility of capital, services, goods and labour) – the heart of the SEM and of Stage one of EMU (see below);
- a more marked and wider range of common policies, especially in relation to macro-economic policy;
- irrevocably fixed exchange rates or, as in the case of the EU, a single currency;
- a common monetary policy – that is, one interest rate and exchange rate policy determined by a single central bank;
- some pooling of foreign exchange reserves;
- possible inter-state transfers to offset economic distortions arising from EMU.

The above characteristics are essentially technocratic and economic in nature but EMU also has a highly controversial political dimension. At a minimum, EMU implies a surrendering, or pooling, of sovereignty in certain areas of policy making, namely the national determination of interest rates and of exchange rate policies and the acceptance of constraints in the exercise of macro-economic policy. It also requires politicians to undertake the frequently unpopular policies needed to qualify for membership of EMU and, in the longer term, to introduce the structural reforms needed to ensure that their economies can thrive within EMU and that EMU itself runs smoothly. Although many current eurozone members showed tremendous political commitment in meeting the eligibility criteria for eurozone membership by restraining public spending and other deflationary measures, for example, it is the reluctance of some of the larger member states, in particular, to embark upon more fundamental structural reforms in their

economies that is potentially building up serious problems for EMU (see below). Moreover, EMU inevitably gives rise to a broader political debate about how far economic and monetary union spills over into the need for greater political unity among its members, the future role and nature of the EU in general or, indeed, whether political union should precede monetary union for EMU to work. These questions underpin some of the British population's concerns about the euro – despite the efforts of pro-euro campaigners at least to keep it as an essentially economic issue (see Case Study 8.1, p. 180).

The above factors may characterise EMU but they do not in themselves determine whether the EU is a suitable grouping for launching EMU. The theory of optimum currency areas (OCAs) sets out the conditions that should prevail if two or more countries are to give up their separate currencies and replace them with a single currency. A high level of interdependence through trade and capital flows is clearly necessary but according to Robert Mundell, the originator of OCA theory, three further conditions must be satisfied for a common currency to be beneficial:

- 1 There should be an absence, as far as possible, of asymmetric shocks – that is, external economic shocks that affect individual members of the EMU in a differential manner. The greater the degree of economic convergence among participating states, so the likelihood of asymmetric shocks diminishes. Such shocks become a problem within EMU systems because of the centralisation of interest rate and exchange rate policies.
- 2 A high degree of labour mobility and wage flexibility is needed, so that when shocks do occur, individual economies within the union are able to adjust via labour migration or changes in wages

given they can no longer rely on changes in autonomous national monetary policy to correct for economic imbalances between countries.

- 3 A centralised fiscal policy which can redistribute resources to member countries performing poorly should be in place.

This raises the question of whether the eurozone meets the criteria of an OCA. The process of European integration prior to EMU has increased cultural, economic and political links among European countries but significant differences remain (see Chapter 1). There are strong regional sub-groupings within the EU: Finland, for example, has more in common and greater linkages with its Nordic and Baltic neighbours than with the countries of Southern Europe and vice versa. The 2004 generation of member states that are striving to meet the eligibility criteria of EMU may also find themselves in an asymmetric conundrum. Their long-term major economic objective is to ensure macro-economic convergence with older member states. In order to achieve this, their economies must grow substantially more quickly than those already in the eurozone. In order to meet the Maastricht convergence criteria (see below), deflationary measures may be necessary to contain their budgetary deficits and the inflation their buoyant economies may unleash but which is not necessarily a serious problem at their stage of development. Once in the eurozone, these constraints will persist. Despite this potential for asymmetries among EMU members, the more closely the countries integrate, through the SEM and other policies, including EMU, the greater the level of interdependence and synchronisation of business cycles which, although not totally removing the possibility of asymmetric shocks, significantly reduces their power to undermine EMU.

The eurozone scores less well in terms of labour mobility and wage flexibility. Although the SEM has played its part in reducing barriers, obstacles to the free movement of labour, including high cultural and language barriers, remain. Labour markets in some member states remain highly regulated and generally inhibit the ability of labour markets to adjust to compensate for the absence of differentiated monetary policy. Moreover, although OCA theory emphasises the need for labour market flexibility as an adjustment tool, the mobility of goods, service and capital plus the SEM also generally facilitate the workings of EMU. Capital is highly mobile throughout the EU and the single market in most goods and services, although far from perfect (see Chapter 4), has made significant progress in the 1990s.

The EU also lacks any strong central redistributive element to compensate for tensions within the eurozone. Its budget is tiny compared to those of member states and, although the Cohesion and Structural Funds are intended to bring about some degree of redistribution, member state resistance to increasing the EU budget and to its tax-raising powers means the prospect of the EU taking on this role in any meaningful way remains distant.

In short, on a theoretical level at least, the prospects for EMU within Europe do not appear bright. However, the political commitment of member states to launch EMU was underestimated by many and, having made that commitment, presumably the will to make it work should not be underestimated either. However, there are signs that some member states are shying away from the unpopular reforms needed in their economies to make EMU work, potentially causing problems for the project in the long term (see below).

THE ROAD TO EMU

The final realisation of the single currency in 2002 – when euro notes and coins came into circulation – was the third modern-day attempt at European monetary integration. The first began in 1969 when the Hague Summit strove to relaunch the process of European integration by, among other things, introducing EMU by 1980. This objective was reinforced by the Werner Report, adopted by the EU in 1971, and resulted, in 1972, in the ‘snake in the tunnel’ – an adjustable fixed exchange rate system in which member currencies fluctuated within a margin of ± 2.25 per cent against the US dollar in a system administered by the European Monetary Cooperation Fund (EMCF). The upheaval in international financial markets that led to the end of the post-war Bretton Woods financial agreement and to inflation and high unemployment in the industrial world dealt a fatal blow to any serious attempts to meet the 1980 EMU deadline.

The second attempt at European monetary integration was the EMS, which was established in 1979 and formed the backbone of European monetary arrangements until the creation of EMU. The EMS was not intended to lead to EMU but to create a ‘zone of monetary stability’ – that is, to act as an anti-inflationary anchor in a world increasingly beset by inflationary problems. The ERM was a key part of the EMS: participation in the ERM required members to maintain their currency within specified fluctuation margins of ± 2.25 per cent either side of the ecu central rates. Higher inflation countries such as Italy were permitted fluctuations of ± 15 per cent. The ecu, or European currency unit, was a basket of currencies participating in the ERM, with each currency weighted according to its role in intra-EU trade.

MILESTONES IN THE DEVELOPMENT OF THE SINGLE CURRENCY

1969	Hague Council calls for EMU by 1980
1970	Werner Report endorses the goal of EMU by 1980
Mar. 1972	Currency snake launched
April 1973	European Monetary Cooperation Fund (EMCF) established to provide financial support to maintain stable exchange rates
1979	EMS, including the ERM, founded to create a 'zone of monetary stability' within Europe
1989	Delors Report proposes a three-stage approach to EMU and is adopted by the Madrid Council in June
July 1990	Stage one of EMU begins
Oct. 1990	UK joins ERM
Dec. 1991	European Council approves the Maastricht Treaty which establishes a three-stage timetable to achieve EMU. The UK and Denmark secure an 'opt-out' from Stage three
Sept. 1992	'Black Wednesday' – UK sterling and the Italian lira suspend membership of the ERM following massive speculation
Aug. 1993	Normal fluctuation band widened from 2.25 per cent to 15 per cent either side of the central parity of currencies within the ERM
Jan. 1994	Stage two of EMU begins with the establishment of the European Monetary Institute (EMI) – successor to the EMCF and forerunner of the ECB
Dec. 1995	Madrid Council confirms 1 January 1999 as the start of Stage three of EMU
Dec. 1996	Dublin Council agrees the terms of the Stability and Growth Pact
Oct. 1997	UK Chancellor of the Exchequer, Gordon Brown, commits the UK 'in principle' to eurozone membership and sets out five economic tests that must be satisfied before Britain joins
May 1998	Brussels Council decides 11 member states (Belgium, Germany, Spain, France, Ireland, Italy, Luxembourg, the Netherlands, Austria, Portugal and Finland) are eligible for adoption of the euro
Jan. 1999	Stage three of EMU begins with the 'irrevocable fixing' of the conversion rates between participating currencies. The European System of Central Banks (ESCB) starts to conduct a single monetary and foreign exchange policy and electronic trading in euros begins
Sept. 2000	The Danish people vote against joining the euro by 53.1 to 46.9 per cent
Jan. 2001	Greece joins the euro
Jan. 2002	Euro notes and coins enter circulation in 12 member states. Initially in 'dual circulation' alongside national currencies, the euro becomes the sole currency by the end of February
June 2003	Gordon Brown announces that the UK only passes one of his five economic tests and rules out UK membership for the foreseeable future
Sept. 2003	Sweden votes in referendum against joining the euro by 56.2 per cent to 41.8 per cent

Nov. 2003	Effective suspension of the Stability and Growth Pact (SGP) following persistent breaches of the budget rules by France and Germany
June 2004	Estonia, Lithuania and Slovenia join ERM II
Mar. 2005	Terms of the revised SGP agreed
April 2005	Cyprus, Latvia and Malta join ERM II
Nov. 2005	Slovakia joins ERM II

Currency realignments were permitted to reduce tension in the system. In the ERM's initial phase, states persistently devalued within the system and its ability to act as a disciplinary device to promote convergence in terms of key monetary indicators (that is, inflation and interest rates) was severely curtailed. By the mid- to late 1980s, the ERM had become more credible as a means of delivering convergence as member states showed a greater commitment to its rules and procedures. Consequently, inflation and interest rates converged and membership of the ERM expanded to include all EU states bar Greece. However, as the ERM expanded, tensions within the system grew: as the effects of the early 1990s' recession and German reunification took hold, the policy requirements and preferences of states started to diverge. Typically, some states had unemployment problems whereas others had inflationary difficulties. Such differences could not be sustained within the ERM framework and, in September 1992, the UK and Italy left the ERM. Instability continued with the Spanish, Portuguese, Irish and French currencies proving particularly vulnerable and in August 1993, the fluctuation bands were widened to ± 15 per cent where they have remained.

The timing of the crisis was unfortunate as the EU had just committed itself in the Maastricht Treaty to a progressive move to EMU by the end of the decade. For the more

sceptical states, the crisis reinforced a belief that moves towards EMU were premature whereas, for the more Europhile states, the crisis confirmed their view that, in a world of free capital movements, a single currency was the best way to achieve the desired currency stability. Economic problems were compounded by political uncertainty arising from the rejection of the treaty by the Danish referendum and the unwillingness of the British to sign. The upshot was opt-out clauses for both the UK and Denmark which allowed both countries to refrain indefinitely from adoption of the single currency.

The Maastricht Treaty resulted from the resurgence of the integration begun by the SEM campaign. By 1988, a committee had been established under Commission President Jacques Delors to consider the issue of EMU and the steps needed to achieve it. The result was the 1989 Delors Report which fed directly into the Maastricht Treaty. The treaty, among other things, set out the timetable, the eligibility criteria for EMU membership and details of the institutions and framework of rules for EMU. The timetable comprised three stages:

- *Stage one*, which began on 1 July 1990, required the removal of all remaining obstacles to capital flows; the participation of all member states' currencies in the ERM and greater policy coordination and convergence of economic performance.

- *Stage two*, which began on 1 January 1994, involved the creation of the EMI, a transitional institution intended to prepare the EU for Stage three when it would be replaced by the ECB. During this stage, any central bank that was not already independent of its national government, was to become independent.
- *Stage three* (to begin either on 1 January 1997 or 1 January 1999) began with the irrevocable fixing of participating currencies. The ESCB, composed of the ECB and independent national banks, took over responsibility for monetary and exchange rate policy.

In practice, insufficient member states were adjudged to be ready for EMU by 1997. In May 1998, amid some degree of cynicism and accusations of creative accounting, the European Commission declared that 11 states met the necessary conditions to adopt the euro on 1 January 1999. It was clear that not all states would meet a strict interpretation of the nominal criteria outlined within the treaty. However, the Commission decided that as long as the criteria, especially those for public finances, were moving in the right direction, then membership could go ahead. Only Greece was excluded for economic reasons. The others – Denmark, the UK and Sweden – remained outside EMU, largely for political reasons.

The decision to maximise the number of states within the initial moves towards EMU, despite their apparent deviation from the Maastricht targets, derives largely from political expediency (notably so in the case of Italy) and recognition that the level of benefits from EMU are directly linked to the size of membership. In addition, an improving general economic environment would, according to the Commission, eventually

eliminate deviations from the targets. Moreover, Greece made strenuous efforts to reduce inflation and its budget deficit and joined the eurozone in 2001 – in time for the entry of notes and coins into circulation. Within three years, it became apparent that Greece's last-minute qualification for eurozone membership was due more to an imaginative interpretation of key economic statistics rather than a sudden conversion to monetary and fiscal discipline. This disclosure, although overshadowed by the SGP controversies (see below), could become an embarrassment when it comes to assessing the preparedness of the 2004 accession states for eurozone membership.

In addition to establishing a timetable for EMU, the Maastricht Treaty set out the conditions (generally known as the 'convergence criteria') with which member states must comply to be considered eligible for eurozone membership. The ultimate success of EMU depends upon convergence between member states in terms of economic development and performance. The endpoint of the convergence process is a state of 'cohesion' between states. This does not imply uniform economic development and performance – merely harmonious economic conditions. Convergence comprises three distinct, yet ultimately related, processes – nominal, real and institutional convergence:

1 *Nominal convergence*. This is convergence in terms of macro-economic performance as indicated by core fiscal and monetary variables and is the form of convergence referred to within the Maastricht Treaty. In practice, there is little economic rationale for the Maastricht criteria other than to prove that states can live with, and are committed to, what are essentially criteria for sustaining price stability. Thus entry into EMU requires states to meet the following criteria:

- budget deficits must be no more than 3 per cent of GDP;
- government debt must be no more than 60 per cent of GDP;
- interest rates must be no more than two percentage points above the average of the three 'best' performing states;
- inflation rates must be no more than 1.5 percentage points above the average of the three best performing states;
- states must demonstrate exchange rate stability by maintaining their currency within the normal band of the ERM for at least two years prior to entry.

Although Stage three has been launched, these convergence criteria remain important for two reasons. First, the budget and debt criteria remain at the heart of the SGP which is intended to provide the framework for continued fiscal discipline once EMU is operational. Second, EU members outside the eurozone wishing to become members of the eurozone must also meet the convergence criteria. Given that the first incarnation of the ERM effectively disappeared upon the launch of Stage three, ERM II was set up as an exchange rate waiting room for prospective EMU entrants. Within one year of accession, six out of the ten new member states had become members of ERM II, raising the possibility of adoption of the euro by 2007 by some of them at least.

2 *Real convergence.* Eligibility for EMU membership rests entirely on compliance with the conditions for nominal convergence. However, in the longer term, it is the degree of real convergence that will determine the success of the eurozone. Real convergence implies that levels of unemployment and industrial and economic development between states should broadly approximate. While there are no set criteria, certain core indicators need to converge to ensure that

harmony can be established within the management of a single currency. For example, vast differences in unemployment between states could imply differing policy priorities between constituent parts of EMU. The EU sought to strengthen real convergence by including provisions for a Cohesion Fund within the Treaty upon European Union but the burden for achieving real convergence falls mainly on the willingness of individual member states to undertake often unpopular structural reforms, particularly in the field of labour market flexibility.

3 *Institutional convergence.* The move towards EMU also implies increasing uniformity in terms of economic management. The most obvious form is to achieve a consensus between states around the priorities of economic policy (namely, low and stable inflation). As part of the commitment towards this policy objective, potential members also have to guarantee the independence of the national central bank.

Achieving nominal convergence by 1999 was a core political objective for many member states. The monetary criteria did not pose much of a problem as they had been provided for within the existing framework provided by the ERM. The fiscal policy criteria proved more problematic. In the short term, the fiscal retrenchment necessitated by efforts to meet the criteria magnified Europe's unemployment problem and created a fear that the nominal convergence criteria could lock Europe into permanent mass unemployment.

BENEFITS AND RISKS OF EMU

Given the difficulties involved in establishing eligibility for eurozone membership, it is pertinent to ask why 12 EU members went

ahead with the project and why the ten 2004 accession states are striving to follow suit. The potential benefits of eurozone membership and the potential costs/risks associated with the eurozone are set out in Box 8.2. Many of these are difficult to quantify. Where they have been assessed, the gains do not appear to be particularly great. In the case of transactions costs, for example, it is estimated that EMU saves some 0.5 per cent of the EU's GDP. These relatively small benefits are also unevenly spread: smaller states with a higher dependence upon intra-EU trade will benefit the most. In practice, many of the gains from EMU will only be realised over the medium to long term (for example, through greater price stability stimulating higher levels of investment).

These effects are also unevenly spread across businesses. The biggest beneficiaries are those enterprises that derive the highest proportion of their revenues from foreign markets. Thus, larger enterprises are expected to benefit more from EMU.

These benefits will extend to large non-EU companies with extensive investments throughout the EU. However, not all large companies will benefit. Enterprises with a strong domestic market (such as utilities) will seemingly gain little until their markets start to exhibit a greater degree of internationalisation. For SMEs, the impact is difficult to predict. Although many SMEs have a strong tendency to serve local markets, there are a number with a high export focus (such as IT companies) which can expect to benefit from the introduction of the euro.

Despite nearly a decade of the SEM, there still remain large price differentials for many products between states (see Chapter 4). For many businesses, EMU should speed up price convergence through enabling consumers to compare prices across member states more easily because of enhanced price transparency. This transparency will extend to wages and other labour costs which some trade unions hope will lead to EU-wide collective bargaining – a hope which, as yet, remains

BOX 8.2

THE COSTS AND BENEFITS OF EMU

Costs

- short-term deflation
- loss of the exchange rate as a tool of national economic policy
- potential problems related to a lack of 'real' convergence and potential policy conflicts
- the inappropriateness of one monetary policy for so many states

Benefits

- elimination of transaction costs in intra-EU trade
- lower interest rates
- removal of exchange rate uncertainty in intra-EMU trade
- aids development of a genuine SEM by increasing price transparency and promoting international specialisation
- removes the option of competitive devaluations between EU states
- creates a new international currency to represent the EU's combined economic weight

largely unfulfilled. Price transparency could also change supply patterns as the elimination of exchange risk and greater transparency within the euro area will make it easier for firms to optimise their sourcing. Price transparency should also lead to price convergence within sectors such as banking, financial services, cars, chemicals and pharmaceuticals. However, complete price convergence will not occur because of continuing differences in transport costs, spatial variations in tastes and preferences, the costs of cross-border shopping, local cost differences and different competitive situations. Overall, however, the EU market should exhibit less fragmentation with internationalisation of markets affecting an increasing number of enterprises (regardless of size) as each is more able to sell its goods to a more geographically dispersed market. This process will be enhanced as inter-state direct mail and e-commerce become more widespread.

In practice, many of the positive and negative aspects of EMU will only manifest themselves over the medium to long term. Advocates of the process play up the fact that the benefits of EMU are directly linked to its size. As EMU membership expands, so the benefits to European business will grow. Opponents regard EMU as primarily a political exercise with negligible economic benefits. However, the core concern has to come down to whether the states are sufficiently similar for them to co-exist with a common currency.

Further problems could limit the ability to sustain convergence, including the perception that not all EMU states are at the same stage of the trade cycle – a major reason given for the UK's delayed entry into the EMU (see Case Study 8.1). A classic example is Ireland. At the time of its accession in 1973, Ireland was the poorest of all Community members in per capita terms.

However, its dynamic growth in the 1990s and beyond has meant that its GDP per head is among the highest in Europe in the mid-2000s and, in the early years of the single currency, a more restrictive monetary policy and higher interest rates than those preferred by Italy and Germany, both struggling with disappointing growth and unemployment, would have been more suitable for Ireland. In short, it is a legitimate question to ask whether one monetary policy *can* fit all. The implication of a single monetary policy is that, unless economies are perfectly aligned (which does not happen within let alone between states) some countries will have an inappropriate interest rate. Thus, attention needs to be paid to how economies can boost their factor mobility to balance out such differences and to whether closer integration will help bring these cycles into closer alignment.

A lack of real convergence between states represents the most potentially serious problem facing the fledgling EMU. If there is insufficient real convergence, EMU will be subject to asymmetric shocks whereby different parts of the zone will be affected by external shocks in markedly different ways (for example, some states could see unemployment rise, others could see inflation increase). If this is the case, a single monetary and exchange rate policy becomes difficult, if not impossible, to sustain. Only if shocks are symmetric or if there is an adequate response mechanism (in terms of fiscal transfers or resource mobility and flexibility) to compensate for such effects will an EMU work. As none of these conditions exists in the EU, EMU should, in theory, be a non-starter for this group of states. Despite this being a theoretical extreme (all states are themselves subject to asymmetric shocks or have inadequate resource mobility or flexibility to compensate for such effects: for example,

most states have regional variations in unemployment), it does imply that EMU needs to be accompanied by structural reform of labour markets.

The move towards EMU highlighted new challenges for policy makers in complementing the competitiveness of indigenous enterprises. The option of a competitive devaluation to secure competitiveness in foreign markets is explicitly ruled out in terms of trade with other EU states. This places emphasis upon firms to alter costs and exhibit greater flexibility if they are to compete successfully in both European and global markets. Flexibility requires governments to free up market forces within the European economy in both factor and product markets (see Chapter 13).

THE EARLY YEARS OF EMU AND LOOMING CHALLENGES

The introduction of the euro went relatively smoothly. There were complaints

from consumers in some countries that businesses took advantage of the changeover to round up prices (see Chapter 15). Although this undoubtedly took place in some instances, there was no overall significant impact on inflation in the eurozone.

When the euro was introduced in January 1999, the trend was for a weakening of the currency against the dollar (see Figure 8.1) and other currencies. This gave some ammunition to Euro sceptics who dismissed the euro as a weak currency. However, this was missing the point. During the first three years of its existence, the euro did not have the full functionality of a currency, given that notes and coins did not come into circulation until January 2002, and was therefore unlikely to operate as a full-blown currency. Moreover, the euro is a floating currency and its value can be expected to fluctuate in line with underlying economic fundamentals. From the beginning of 2002, the euro steadily strengthened to reach levels against the dollar that were above those prevailing at the time of the euro’s launch. This pattern stemmed

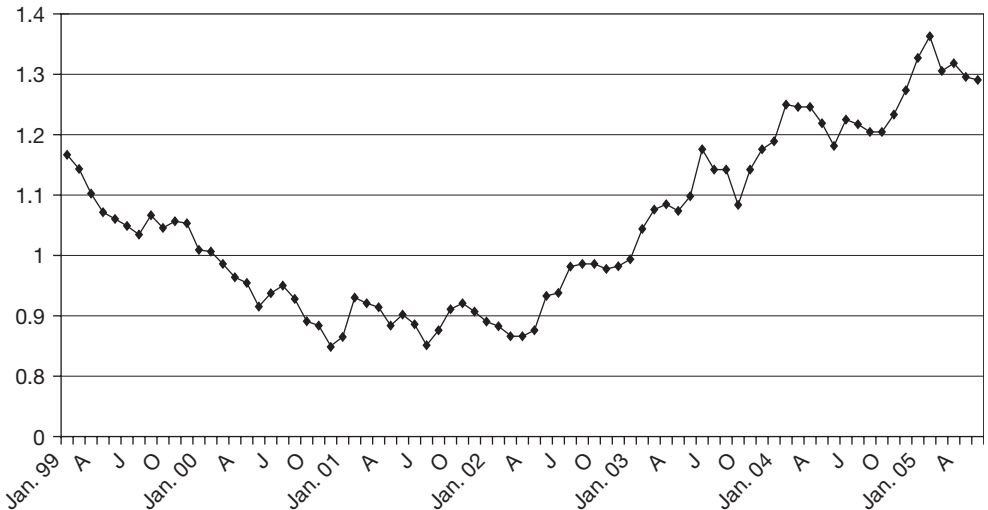


Figure 8.1 €/US\$ exchange rate, January 1999 to May 2005

Source: European Central Bank.

from an inherent weakness in the dollar. However, there is nothing inherently desirable about having either a weak or a strong currency: the former can foment inflation and the latter makes life more difficult for exporters. From the trade and investment perspective, the best that can be hoped for from a currency is that it is neither seriously over- nor under-valued and that it remains relatively stable. It is excessive volatility that creates unpredictability and uncertainty and inhibits trade and investment. This uncertainty has so far been removed in the eurozone and there is no evidence that the floating euro is any more volatile than the predecessor national currencies.

... within the Eurozone

In terms of the transition to the euro and the performance of the currency since its introduction, there is nothing untoward to worry about. However, fundamental problems are arising from two linked factors:

- 1 the ineffectiveness of the SGP as a bulwark against fiscal profligacy;
- 2 the unwillingness of some member states to take the necessary reform measures to ensure they can compensate for the loss of national monetary policy as the main policy instrument used to correct competitiveness problems. In other words, some key economies are putting off unpopular reforms that would help their markets operate more efficiently in line with the OCA criteria outlined above.

The Stability and Growth Pact (SGP)

The move to EMU was based around a consensus that low inflation is the primary goal of economic policy. To ensure this priority

is not diluted within EMU (and thus that states keep to pre-EMU commitments), in December 1996, upon the insistence of the German government, agreement was reached to sustain the Maastricht fiscal convergence criteria after the launch of EMU. That is, budget deficits should remain below 3 per cent of GDP and the national debt should be below 60 per cent of GDP after the launch of the single currency. Persistent failure to comply with the SGP could result in heavy financial penalties, including fines up to 0.5 per cent of GDP.

The SGP was considered necessary because if countries within a monetary union run large fiscal deficits, the single capital market means that financing of this debt will lead to higher interest rates for the whole union. Indeed, monetary union may even encourage expansionary fiscal policies if member states perceive that the cost of financing their debt is spread over more countries (this would, of course, only be a rational course of action, if other countries did not behave in a similar fashion). Moreover, large fiscal deficits can tempt politicians to place pressure on monetary authorities, even supposedly independent monetary authorities, to keep interest rates low – a strategy that would ultimately threaten the price stability goal of monetary union.

That fiscal discipline is needed in monetary union is uncontroversial. Some argued that the political capital locked up by respective member states in EMU would be sufficient to sustain convergence but experience and the dangers of free riders resulted in rejection of this option and adoption of the SGP. However, the SGP regime was regarded by many as too inflexible from the beginning. For example, the choice of 3 per cent and 60 per cent for the budget deficit and debt limits respectively was purely arbitrary. The SGP required member states

to keep their spending within limits at all times despite the strong case for allowing members to vary government borrowing as a percentage of GDP throughout the stages of the trade cycle. In EMU, fiscal policy is the one macro-economic weapon left to states to manage their economies. If constraints are imposed upon this, then the automatic stabilisers could be severely affected. That is, it is part of the normal corrective process for deficits to increase during economic slow-downs in line with decreasing tax revenue and increasing expenditure on unemployment and other social benefits, whereas budget deficits fall when economies prosper given rising tax revenues and falling social spending. In other words, to try to keep deficits below an arbitrary 3 per cent of GDP when the economy is in trouble will only increase deflationary pressure. The imposition of fines in such circumstances will also only exacerbate the problems. Such problems could be countered by a stronger central fiscal and redistributive policy but this is something that member states will clearly not countenance.

The above concerns about the potential for problems with the SGP were quickly borne out, even causing the then Commission President Romano Prodi to call the pact 'stupid'. Fiscal deficits in Portugal, France and, ironically, Germany, the architect of the SGP, rapidly breached the 3 per cent limit. The imposition of penalties on the two biggest countries in the eurozone was politically difficult and, indeed, the SGP was effectively suspended in November 2003 when sufficient members (excluding Spain, the Netherlands, Austria and Belgium) agreed not to proceed further against France and Germany. Despite the European Commission's victory in July 2004 in its subsequent case at the ECJ against the finance ministers, the SGP's shortcomings had been exposed.

The problems with the SGP undermined the general credibility of EMU. It created tension within the eurozone itself by emphasising the small–large country divide. The Netherlands and Austria, for example, were angry that they had taken difficult decisions in their attempts to comply with the terms of the SGP whereas France and Germany appeared to get away with ignoring it. It also sent contradictory signals to the new member states striving to comply with the Maastricht criteria ahead of adoption of the euro and who will thereafter be subject to the SGP.

In March 2005, the heads of government reached agreement on revisions to the SGP (see Box 8.3). In general, the changes result in greater flexibility in the system. The jury is out, however, on whether the relaxation has gone too far and undermined confidence in the fiscal framework of EMU and the sustainability of public finances in eurozone countries. It is the lack of clarity and the extensive range of 'relevant factors' that member states can invoke to avoid the excessive deficit procedure that brings in the greatest flexibility – or, in the view of its critics, significantly weakens the pact through its numerous exceptions, greater complexity and reduced transparency, all of which will make the pact harder to implement. In the short term, the agreement should reduce the embarrassing political rows surrounding the deficits of key EMU members like France and Germany but in the longer term, it remains unclear whether the revised SGP has become so 'flexible' that it has effectively become meaningless.

Economic reform within the eurozone

One of the conditions for a successful EMU is flexible labour and product markets. In the absence of the devaluation option as the,

THE REVISED STABILITY AND GROWTH PACT

The revisions in the SGP agreed by heads of government in March 2005 were intended to make the pact more flexible. The main conditions of the agreement were:

- *Thresholds*: the 3 per cent ceiling for the budget deficit and the 60 per cent limit for national debt remained unchanged.
- *'Relevant factors' enabling countries to avoid an excessive deficit procedure*: member states in danger of breaching the deficit will be able to invoke a range of 'relevant factors' to avoid the imposition of penalties. Such factors include potential growth, the economic cycle, structural reforms (for example, in social security and pensions), R&D policies, public investment etc. The agreement does not establish an exhaustive list of factors but rather sets out chapter headings that establish general principles around which member states will be able to argue their case.
- *Extension of deadlines*: instead of one year, countries will have two in which to correct an excessive deficit. This can be extended further in the case of 'unexpected and adverse economic events'.

albeit temporary, solution to competitive pressures, flexible markets should be able to take the burden of adjustment. However, the record of European countries in reducing structural rigidities in their economies is mixed. Unfortunately for EMU, its three biggest members – Italy, Germany and France – suffer from excessive labour and product market inflexibilities and costly, swollen pension, welfare and health systems which make it difficult to meet both the fiscal requirements of EMU and the need for freely functioning markets. In all three cases, political leaders have attempted to push through reforms to address these issues but the reforms have not gone far enough and/or have been amended in the face of their general unpopularity or looming local or national elections.

Each of the big three has its own problems. Italy, for example, depends disproportionately on small, specialist manufacturing firms in sectors such as textiles, furniture,

machine tools, food processing and white goods. These industries are relatively low tech and low skilled, need a low cost base to sustain their competitiveness and, as such, are particularly vulnerable to competition from CEE and Asia, notably China. Other competitiveness problems stem from poor infrastructure in the south, relatively high energy costs, low levels of R&D spending, a lack of large companies and a preponderance of small, family-owned companies with limited tendencies to merge. Italy traditionally maintained its competitiveness by devaluing the lira. Since 1999, this option has no longer been available and the need for structural reform was no longer hidden.

Political pressures have made reform difficult and they will not become any easier. Nevertheless, the government has made some reform efforts. In July 2004, parliament passed some pension reforms. Italy has a particularly acute problem in relation to its ageing population given its low fertility rates,

increasing life expectancy and low labour force participation (see Chapter 13). The 2004 reforms included an increase in the contribution period for entitlement to retire on full pension, incentives to workers to extend their working lives and measures to promote private pensions. In May 2005, competitiveness reforms, including incentives to encourage mergers among SMEs, bankruptcy reforms and some welfare streamlining, were pushed through parliament. Although welcome, these reforms need to be taken much further to achieve sustained competitiveness.

Indeed, Italy could become a test case for the revised SGP. The European Commission has also made known its intention to hold Italy to account for failure to meet the terms of the revised SGP. Such a move, important to the Commission to preserve any lingering credibility of the SGP, could bolster calls by Italy's Welfare Minister, Roberto Maroni, immediately after the French and Dutch referendum rejections of the constitutional treaty in May/June 2005 to reintroduce the lira. Although not a proposition to be taken seriously at the time it was made, particularly as the reintroduction of a depreciating lira would cause Italy's debt service payments to spiral, there remains the possibility that such calls could gain momentum if more substantial reforms are not taken to address Italy's deep-rooted economic problems and the eurozone becomes a scapegoat for these problems.

Germany, too, has its structural problems which, by exacerbating the country's unemployment problems also make its budgetary problems worse, and inhibit its ability to adjust to increased competitive pressures in the absence of national monetary policy. Germany's problems stem, in large part, from its high wage and non-wage costs (see Figure 16.7), high taxes and generous

welfare state (see Chapter 13). In 2003, the government brought forward Agenda 2010, a moderately ambitious set of proposals for structural reforms in public pensions, health-care and social benefits and the so-called Hartz labour market reforms which, among other things, were designed to end generous benefits for the long-term unemployed, to make it less easy for the unemployed to reject job offers, to put shorter limits on entitlements to unemployment benefit and to rein in the trend to earlier retirements.

Again, domestic political constraints and pressures caused a softening of the proposals and complaints by some that the reforms bring hardship without any benefits, whereas others say the reforms do not go far enough. The 2005 general election brought the more liberal-minded Angela Merkel to power. The full extent of her liberalism will not become clear until she has been in power for some time and she will have to work within the constraints imposed upon her by her coalition partners. Meanwhile, against the background of the threat of possible relocation abroad, several large German companies have negotiated deals with unions that have cut wage costs by forcing wages down, freezing wages or by persuading workers to work longer hours for the same pay.

France, one of the most enthusiastic proponents of the single currency, has also shown an unwillingness to free up its markets and generally deregulate its labour and products markets as implied by the logic of the single currency. Workers, for example, are protected by a high minimum wage, security from lay-offs and a short working week. Consequently, France has also been dogged by fiscal problems and stubbornly high rates of unemployment. The government has partially addressed some of the issues but overall there is an unwillingness to tackle the issues head on and raise the possibility of

social conflict. This became apparent in spring 2006 when government attempts to make it easier for employers to hire and fire younger workers met with fierce opposition including large-scale street demonstrations. Indeed, the negative result of the 2005 French referendum on the constitutional treaty has been interpreted by many commentators as a rejection by the French population of the deregulation and liberalisation that has marked the latest phase of European integration and a preference for more protectionism – or ‘economic nationalism’ – a preference that is at odds with the market integration ideology of the single currency (see Chapter 2).

That reform is possible has been shown by the UK and the Netherlands in the 1980s and by Denmark and Sweden in the 1990s. The short-term impact is frequently painful and consequently carries political risks for the political party introducing reform. However, reform does hold out the possibility for longer term gains. Without reform, the rigidities in the eurozone’s biggest economies will get worse, putting greater strain on the system. The danger is that the single currency gets the blame for these problems when, in fact, they have been building up for a number of years and would have come to the forefront even without the existence of the single currency, albeit probably not so quickly. Moreover, the absence of a single currency would not remove the need for reform in a world economy that is rapidly becoming more interdependent and globalised and nor would any attempt to insulate these economies from globalisation result in anything but deteriorating prosperity. In short, the eurozone is suffering from a political failure to implement the policies needed to make it work and needs national politicians with the courage to take these measures.

... within EU outsiders

Old outsiders

Three of the EU-15 – Denmark, Sweden and the UK – did not participate in the launch of the single currency. Denmark and the UK have a legal right to opt out of EMU under the TEU. Sweden, which acceded to the EU after the signing of the TEU and therefore was required to accept the *acquis communautaire* at the time, including a commitment to EMU, has no such right but was excluded from the euro on the technical grounds that it was not a member of the ERM. This was politically expedient as the Swedish government felt its population was not ready for EMU.

In all three cases, as Figure 8.2 demonstrates, levels of popular support for the euro are much lower than in the eurozone members. This helps to explain both why the countries were reluctant to join and why their adoption of the euro is not imminent. In September 2000, Denmark held a referendum in which 53 per cent voted against Denmark adopting the euro. In September 2003, 56 per cent of the votes in a Swedish referendum on the single currency were against membership. Consequently, euro membership is off the agenda in both countries for some time. Even though euro approval ratings in Denmark in particular have increased since the referendum, further efforts by the generally pro-euro political elites to take Denmark into the single currency are not likely for some time as the previous referendum itself showed that the possibility of gain was outweighed by the risk of failure.

Each country has its own reasons for not joining but, in general, public debate about the euro in these three countries has expressed concerns about loss of sovereignty,

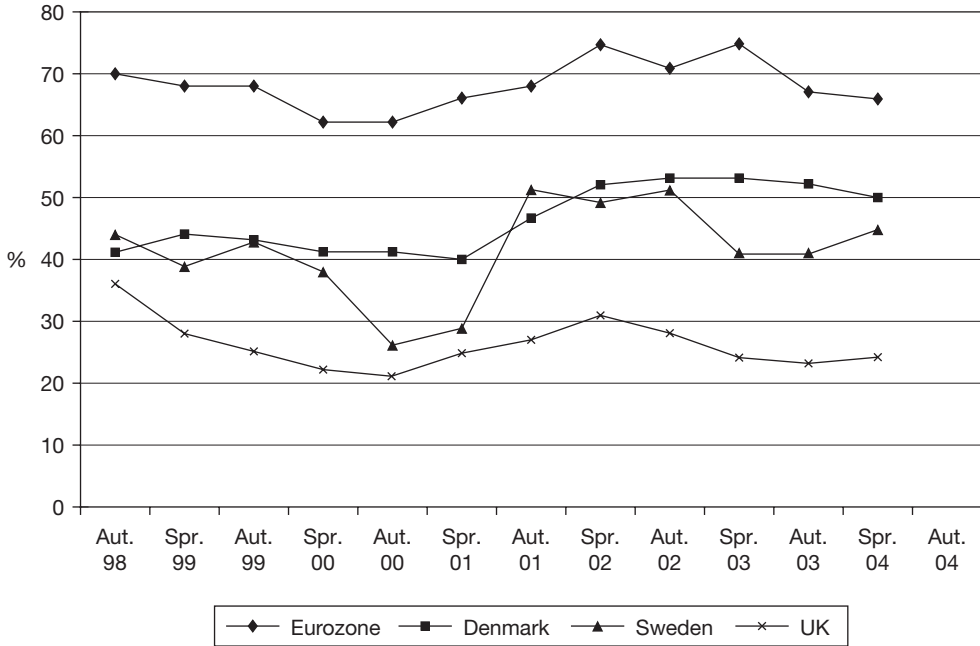


Figure 8.2 Support for the single currency, 1998–2004

Source: Eurobarometer.

especially in relation to the loss of monetary policy as a major economic policy instrument, loss of identity and doubts about whether it is possible for one interest rate to suit so many countries. On the other side, in addition to the usual general pro-euro arguments, the outsider countries also have to consider whether their continuing standing aside from the final stage of EMU will ultimately lead to their increasing marginalisation from core EU business.

However, even if the governments of Denmark, Sweden and the UK chose to try to take their countries into the eurozone, they would find it difficult to sell it to their respective populations given the poorer performance of the eurozone economies relative to their own. As the graphs in Figure 8.3 show, GDP growth in the outsider countries

has outstripped that of the eurozone; GDP per head in the outsider countries is above the average for most eurozone countries; the outsiders' unemployment performance is generally much better and inflation is below that of the eurozone. In these circumstances, especially given the tendency of the political elites in the outsider countries to talk up the economic side of the euro and downplay its political dimension, it would be difficult to convince the electorate that there is anything to gain by voting for the euro. There is a view that a sustained period of economic performance significantly below that of the eurozone countries is needed before euro referendums can be won in the outsider countries. Given the problems inherent in the eurozone area (see above), this scenario is unlikely in the short to medium term.

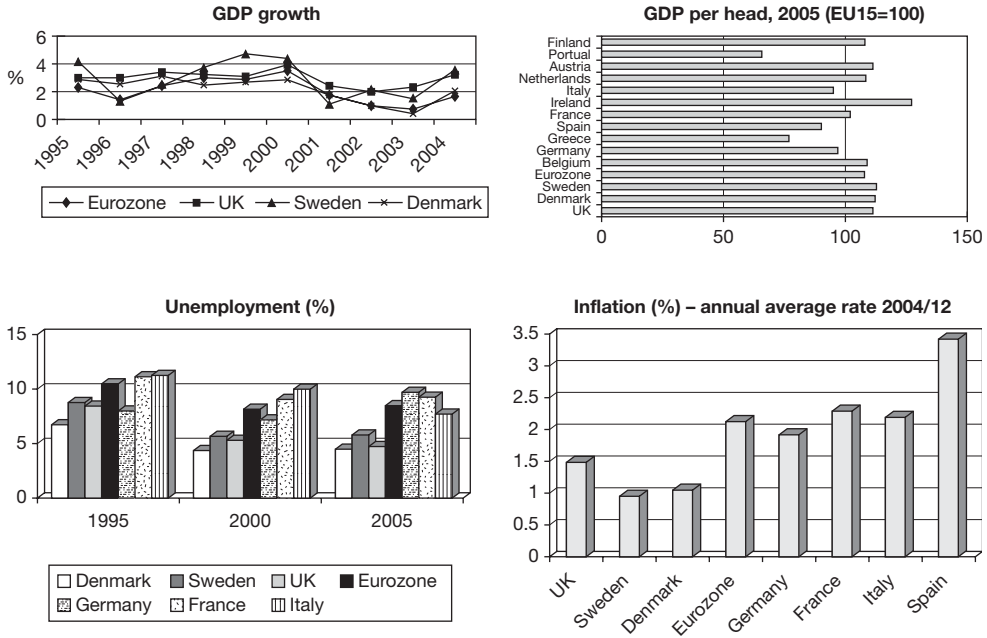


Figure 8.3 Comparative economic performance inside and outside the eurozone

Source: Eurostat.

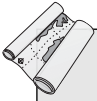
New outsiders

On 1 May 2004, ten countries joined the EU. All new members accepted the *acquis communautaire*, including participation in the third stage of EMU with a derogation regarding adoption of the single currency. Moreover, the populations of the new member states have implicitly given their consent to eurozone membership by virtue of their 'yes' votes in the 2003 accession referendums as commitment to join the single currency was part of the bargain for joining. Opinion polls confirmed this: as accession approached, according to Eurobarometer, 58 per cent of the population of the new member states were in favour of single currency membership, ranging from 46 per cent in Estonia to 81 per cent in Slovenia.

The new member states have announced their intention to join the single currency as

soon as possible. The key issue for them is not *if* they join but *when*. In order to join, the new members must meet the Maastricht convergence criteria, including a minimum of two years in ERM II. It is likely there will be two waves of eurozone entry. The first will involve the smaller new members: Estonia, Lithuania and Slovenia joined ERM II in June 2004 and Cyprus, Latvia and Malta followed suit in April 2005. Assuming the absence of any major currency upheavals in the two years following their ERM entry, the first new member states could adopt the euro by 2007.

The second wave of new country entrants will comprise the larger new member states – Poland, Hungary and the Czech and Slovak Republics. These countries are bedevilled by persistent fiscal problems and the associated social welfare costs and political problems arising from attempts to resolve these



Case Study 8.1

OPTING OUT OF EMU: THE CASE OF THE UK

The UK's decision to opt out of the initial moves to EMU is significant given that it is the world's fourth largest economy and the EU's second largest. Moreover, the UK is not only the headquarters and primary EU location for many major multinational companies but is also, through the City of London, Europe's major European financial centre. In addition to the standard arguments made against single currency membership (loss of sovereignty, one monetary policy cannot fit all, etc.), several arguments specific to the UK are often made against UK membership. These include:

- *Trade*: the UK has a lower level of intra-EU trade than other member states so is more vulnerable to external shocks. While it is certainly true that the UK has the lowest level of intra-EU trade in the EU, the majority of its trade (56 per cent) is still with other EU members, only three percentage points behind Italy and eight behind Germany. In short, this argument can be overstated.
- *Personal sector*: the UK has one of the highest percentages of home owners in the EU and British mortgage holders are more dependent on variable rate mortgages than in other EU countries, making UK interest rates much more responsive to housing markets than is the case elsewhere in the EU.
- *Oil*: the UK's position as an oil producer and exporter means the UK is affected differently by oil price movements, making asymmetric shocks more probable in a eurozone including the EU. The power of this argument is declining in line with the depletion of North Sea oil and the gradual transition of the UK from being a net energy exporter to a net energy importer.

That the UK opted out of EMU came as no surprise given the lack of public and political support for the project. The low level of public support is demonstrated in Figure 8.2. However, it is worth noting that for the majority of the British public, the single currency does not rank very highly as an important issue, raising questions about the depth of anti-euro feeling among the UK populace.

Business in the UK has tended to hold less polarised views. Foreign investors are the most 'pro-euro', especially if they view their investment as a platform for access to the SEM. Indeed, several foreign investors in the UK have warned that the UK's continuing absence from the eurozone will lead to mainland Europe rather than the UK being the first choice destination for future investment. Figure 8.4 shows the trend of inward investment in the EU since the early 1990s when the UK, along with France, was the main destination for inward FDI. The UK was even more dominant towards the end of the 1990s. Since then, the UK has been overtaken as a source of FDI by several EU countries. Although this is far from conclusive evidence that concerns about inward FDI if the UK stayed outside the eurozone were justified, the early indications are that the UK has lost its position as the major destination for inward investment in the EU, and it is likely that a major part of this loss is down to non-participation in the eurozone.

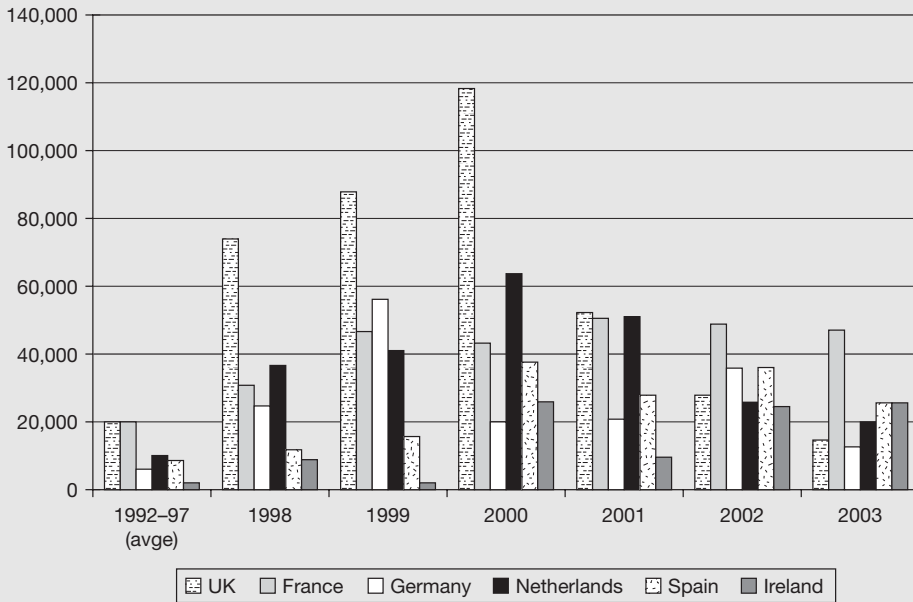


Figure 8.4 Inward FDI (US\$m)

Source: UNCTAD, *World Investment Report*.

Larger UK companies, on the whole, have tended to be pro- rather than anti-euro, although there are several high-profile contrary examples. Smaller UK companies have a greater tendency to be anti-euro but, again, there are many exceptions to this.

Even with the UK outside the single currency area, British business cannot ignore the euro. A number of big EU groups active in the UK, as well as major UK enterprises, shifted their accounting to the euro from 1999. Once multinationals alter their business processes to account for the euro so the pressures upon SMEs to alter their processes grow. Despite the fact that operating dual currency systems is expensive, this cost is more than outweighed by potential losses from ignoring the euro. Whatever their opinions upon EMU, UK businesses cannot ignore it as non-membership can act as a constraint upon their competitiveness within core EU markets.

Concerns have also been highlighted about the potential relative decline of the City of London as Europe's main financial centre if the UK decides to sustain its exclusion from the euro. The impact upon employment within the City depends upon its ability to capture a share of the market for euro securities. The fear is that new investment and the focus of banks could shift towards Frankfurt at the expense of London. Others doubt this, noting that the UK is a centre for international, not just European, business. Thus global, rather than intra-European, competition is more of a threat. Some feel that the presence of skilled workers and the ability of the City of London to be innovative and exist in 'unofficial markets' as well as global markets means that EMU may deliver more benefits than costs.

British political parties are also divided. The Liberal Democrats are the most enthusiastic Europeans and single currency supporters. The Conservative Party, torn apart by its divisions on Europe during its final years in government in the 1990s, contains a wide range of Euro sceptics, from a minority advocating total withdrawal to those arguing that integration should go as far as the SEM and no further. A small, but nonetheless deeply committed, minority support euro membership. The ruling Labour Party equally provides a home for all sides of the euro debate but European divisions have not inflicted fundamental damage on the party as is the case with the Conservatives. However, the overwhelming stance of Labour is supportive of Europe and the euro, a major turnaround from the early 1980s when the official policy was withdrawal. The official position of the government is that it is 'in principle' supportive of the idea of UK adoption of the euro but it will not entertain UK membership until the time is right economically. In order to determine when this will be, and in addition to the Maastricht criteria, the UK government has set out the following five economic tests or questions that must be satisfactorily answered before it takes the UK into the eurozone:

- 1 *Convergence*: are business cycles and economic structures compatible with European interest rates on a permanent basis?
- 2 *Flexibility*: if problems emerge, is there sufficient flexibility to deal with them?
- 3 *Investment*: would membership of the eurozone create better conditions for firms making long-term decisions to invest in the UK?
- 4 *Financial services*: what impact does joining the eurozone have on the UK's financial services industry?
- 5 *Growth, stability and employment*: will joining the euro promote higher growth, stability and a lasting increase in jobs?

In June 2003, Chancellor Gordon Brown concluded that, although progress had been made towards satisfying the five tests, only the test on financial services had been passed and therefore it was not in the economic interests for the UK to join at that point. During the 2005 election campaign, Prime Minister Tony Blair appeared to rule out UK adoption of the euro for the foreseeable future. Indeed, given the UK's better all-round economic performance than the eurozone (see Figure 8.3) and the problems in the eurozone, business pressure to join has eased off and in the mid-2000s, UK membership of the single currency appears much lower on the political agenda than it has been for some time. In short, for now at least, the euro has become a non-issue in Britain.

Case questions

- 1 In the mid-2000s, UK adoption of the euro is further away than ever. Why might this be the case?
- 2 How might UK business be damaged by continuing exclusion from the eurozone?
- 3 What benefits might continuing exclusion from the eurozone bring to UK business?
- 4 Discuss the political and economic role of the 'five tests' in determining whether the UK should join the eurozone.
- 5 To what extent does the 'distinctiveness' of the UK economy justify its continuing absence from the eurozone?

problems. Accordingly, their dates for potential euro membership have been retreating. In mid-May 2004, for example, Hungary announced postponement of the target date of euro entry from 2008 to 2010 as a result of its higher than forecast inflation and budget deficit. The Czech and Slovak Republics are looking at 2009–10 and 2008–10 respectively as their target entry dates, and Poland is unlikely to be ready before then.

In short, there will be a minimum of five to six years for the larger countries between EU accession and adoption of the single currency. This period could be longer if these countries shy away from difficult political decisions regarding fiscal reform. In the interim, there is sufficient time for any gap between expectations of EU membership and the reality to become apparent to the populace of these countries, thereby creating the conditions for a backlash against eurozone membership and a divergence between elite and popular support for eurozone membership. Moreover, the longer the gap between accession referendum and a serious attempt to join the single currency, the more the euro legitimacy of the accession referenda will fade, possibly leading to demands for a euro-specific poll.

In terms of the nominal Maastricht convergence criteria, the new member states are differentially placed. As stated above, the larger states have greater problems meeting the fiscal criteria and, in general, inflation accelerated somewhat in 2004, creating problems for some countries where previously there was none. However, the inflation problems were created by higher oil prices (which affect all European countries to a degree and thus do not necessarily represent a deterioration in the relative position of the new member states vis-à-vis current eurozone members) and by one-off

accession-related tax reforms and other price increases that will drop out of the inflation figures within a year.

With regard to real convergence, the new member states are growing significantly more quickly than the older member states (see Chapter 16) and, indeed, need to do so for many years before their economic levels are broadly comparable. Given the massive economic reform processes that the majority of new member states have gone through since 1989, several of them have better credentials regarding product market flexibility and liberalisation and deregulation generally than older member states. They do tend to suffer from labour market inflexibility and high levels of unemployment. The former have not been helped by the transition periods imposed on free movement by most old member states. By the mid-2000s, unemployment remained high in many cases despite rapid economic growth. This is because growth has taken place within a context of ongoing structural reform with the result that job creation was often offset by the loss of jobs in sectors undergoing reform. Moreover, growth has been accompanied by productivity improvements originating from restructuring. Although bad for employment in the short term, improved productivity performance is essential for the long-term competitiveness of these countries and will ultimately help them compete in the eurozone and beyond.

The entry of the new member states into the eurozone depends on their compliance with the convergence criteria but it may also be affected by factors such as how the existing eurozone members respond to their current challenges. For example, how meaningful will the revised SGP be? Will eurozone growth remain fitful and below that of its main economic competitors? If it does, will the attractiveness of the eurozone as a

way of boosting growth, trade and investment diminish and undermine efforts to take the countries into the area? Will the predominantly pro-European government coalitions in the new member states be replaced by governments with less enthusiasm for the European project? So, although the prospects for these countries to become eurozone members looked promising at the time of their accession, there are several factors that could derail euro adoption for at least some of them.

OUTLOOK

The early years of the single currency were largely successful. However, fiscal indiscipline, the persistent poor performance of the eurozone's biggest economies and their slowness/failure to undertake the necessary structural reforms to improve their competitiveness and to create the optimal environment for EMU coupled with the blow dealt to the whole European project by the French and Dutch rejection of the constitutional treaty in mid-2005 have raised a question mark, albeit as yet a small one, over the long-term health of the eurozone.

The ratification failure of the constitutional treaty should not, in itself, damage EMU. The business of the EU will continue as usual. The threat from the rejection of the treaty stems from doubts and differences

about the long-term future of the EU and from the interpretation of the treaty rebuff as a revolt, at least on the part of France, against the liberalising, open market approach of much EU policy to date. This links to the most urgent challenge to EMU – the resolution of the competitive problems of key eurozone economies via painful but needed micro-economic reform in terms of labour and product markets. Failure to do this will, eventually, put intolerable strains on the single currency area. Appropriate action by the member states concerned is certainly probable: they showed tremendous political commitment to get EMU off the ground in the first place and failure to carry the project through would carry extremely high costs as well.

In the shorter to more medium term, it is unlikely that the 'old' EMU outsiders – Denmark, Sweden and the UK – will take any significant steps to adopt the single currency. There is no immediate incentive for them to do so. In the longer term, if their relative economic positions vis-à-vis the current EMU members change, or if they find themselves increasingly marginalised from EU business, their single currency membership cannot be ruled out. The 'new' outsiders (that is, the ten 2004 accession states) have, without exception, expressed their intention to join the eurozone as soon as possible and their commitment remains strong.

KEY POINTS

- From a business perspective, EMU facilitates trade and investment and generally reinforces the market integration theme of earlier integration initiatives.
- Reform of the SGP has taken place but the jury is out on whether its credibility has been irreversibly undermined.
- Improvements in labour and product market flexibility are required in several euro members if EMU is to succeed. Some of the bigger states, in particular, are finding it politically difficult to introduce the needed reforms.
- In the mid-2000s, adoption of the single currency does not appear to be an option in the short to medium term for Denmark, Sweden and the UK.
- Adoption of the euro looks a real possibility within two to three years of accession for the smaller 2004 accession states whereas the larger new member states will have to wait longer.



ACTIVITIES

- 1 Choose one of the ten 2004 accession states and research their preparations for, and potential gains from, EMU membership. Also identify the risks that EU membership exposes them to.
- 2 In a classroom, organise a debate in which one side puts forward the case for UK adoption of the euro and the other puts the case against.
- 3 Choose France, Italy or Germany and research their efforts to pursue key economic reforms. Although it can be argued, the need for economic reforms existed before the euro and are needed for broader competitiveness reasons, consider how and why the reforms are also linked to the success of EMU.
- 4 Research a European company and consider how the existence of the euro might have an influence upon its strategy and operations. Companies ranging from global multinationals to SMEs based either in or outside the eurozone are suitable for this exercise as they will all be affected in some way, albeit differently. In a classroom context, individual students or groups of students can be allocated a different company and asked to present their findings to the class. Their findings can then be compared and contrasted to pull out the similarities and differences. Note: issues to look at include location in or out of the eurozone; location of suppliers and markets; characteristics of the sector; relative share of activities in the eurozone. For non-eurozone companies, to what extent do they utilise the euro? etc., etc.

QUESTIONS FOR DISCUSSION

- 1 'Present policies, institutional arrangements and political attitudes are incompatible with a sustainable economic and monetary union in the long run' (*FT* 8 June 2005, p. 17).
Explain and comment upon this statement in the light of the challenges currently facing the eurozone.
- 2 'The reform of the Stability and Growth Pact has rendered it useless as a mechanism for fiscal discipline within the single currency area.' Explain why this statement may have been made. Do you agree with it (make sure you justify your answer)? What do events since the 2005 reform tell us about its success or failure?
- 3 In what way has EMU changed Europe's business environment?
- 4 What are the main dangers to the long-term success of the single currency?
- 5 'EMU is as much a political as an economic project.' Do you agree? Explain your answer.

SUGGESTIONS FOR FURTHER READING

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Key websites

There are many sites on EMU – the following is merely a selection.

The Commission's EMU website: http://europa.eu.int/comm/economy_finance/index_en.htm

The European Central Bank's website: www.ecb.int

The website of the *Financial Times*: <http://specials.ft.com/euro/index.html>