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GERMANY AND THE EUROPEAN MONETARY UNION; A History of Western European Integration and Germany's Relationship, Both Then and Now.

Shannon E. Smith

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Shannon E. Smith
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List of Abbreviations

EC - European Community

ECB - European Central Bank

ECSC- European Coal and Steel Community

ECU - European Currency Union

EEC - European Economic Community

EMI - European Monetary Institute

EMS - European Monetary System

EMU - European Monetary Union

ESCB - European System of Central Banks

EU - European Union

GCB - German Central Bank

GDP - Gross Domestic Product

SPD - Sozialdemokratische Partei Deutschlands (Social Democrats)

US - United States

Introduction

On January 1, 1999 Western Europe took the next and long-awaited step towards complete political integration with the birth of the euro. This common currency combines the economies of eleven of the fifteen European Union nations into a single market called the European Monetary Union. Such a monumental action directly shows Western European leaders' commitment to a political union and their desire to create a better life for their citizens in the long-run, free of the wars and conflicts of the past.

This paper details the history of Western European integration as portrayed through the theory of functionalism, and analyzes Germany's roll both then and now. The discussion begins with a brief summary of how the European Monetary Union evolved and the dominant position Germany holds today. It then looks at what the future holds in store for Germans, in both the short and long-run, and how they feel about it. How is German monetary policy affected, now that the European Central Bank is in control? What kinds of fiscal policy tools are available to stimulate growth with the current recession? What changes should Germans expect in their everyday lives?

Western Europe's current state of integration is also questioned on the basis of the economic theory of an optimum currency area. Is Euroland an ideal fixed exchange rate area, or is it too soon? Lastly, the discussion ends with an analysis of what the euro means for the United States and looks at the possible changes in line for us.

Chapter 1: The History of the European Union (EU)

1.1 Functionalism

The first proposals for a political union began in 1929. After the destruction and terror of World War I, French Foreign Minister Aristide Briand asked for the participation of all European League of Nations members in creating a plan for unity. Although the 1920s were filled with much discussion over improving German-French relations, this was the first concrete measure. Many of these efforts were hindered in the following years, due to Briand's death in 1932 and the effects of the Great Depression on Europe. The greatest obstacles, however, were due to the continuity of strong nationalism among French and Germans and Adolf Hitler's growth in power in 1933, followed by World War II in 1939.[1]

After the end of World War II in 1945 the call for unity in Europe was stronger than ever before. World leaders recognized this necessity, but had also learned from Briand's trial that an alternative and much slower approach would have to be taken. This approach follows the theory of functionalism, first developed by David Mitrany in the 1930s and 1940s. According to Jenson and Miller's textbook Global Challenge; Change and Continuity in World Politics, *functionalism* is:

> A theory of international integration that asserts states should first develop cooperative ventures in "functional" areas of *low politics*, where political passions are not involved. As those ventures produce benefits to citizens in cooperating countries, they will support additional such actions. Eventually, the habit of cooperation may now produce a "spillover" effect so that integration may proceed at the level of *high politics*.[2]

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[1] Alfred Grosser, Geschichte Deutschlands seit 1945; Eine Bilanz (History of Germany since 1945; A Summary) (Munich: Deutscher Taschenbuch Verlag GmbH & Co. KG, 1978) 15-20.

[2] Lloyd Jenson and Lynn H. Miller, Global Challenge; Change and Continuity in World Politics (Fort Worth, TX: Harcourt Brace College Publishers, 1997) 428.

Mitrany understood the consequences of moving too quickly, emphasizing that governments need to begin with the area of economics or *low politics* before forcing integration on a more social level of *high politics* where people's cultures and belief systems are involved, or a political union. A brief analysis of the history of the European Union, beginning with the European Coal and Steel Community and continuing until the present day, will prove European leaders' reliance on functionalism from the early creation of a customs union, to a common market, to the economic union of today, the last stage before a full political union.

1.2 European Coal and Steel Community (ECSC)

The first new measure towards integration in Western Europe was taken on April 18, 1951 with the signing of the Treaty establishing the European Coal and Steel Community, also called the Treaty of Paris. The aim of this treaty, first proposed by French Foreign Minister Robert Schuhman in 1950, was to begin gently easing the turbulence between Germany and France in their struggle for power over Germany's coal deposits in the Saar and Ruhr regions and France's iron ore in the province of Lorraine.[3] The Germans first took this region from France in 1871, but never actually accepted its inhabitants as Germans. It was returned to France after WWI. A 1935 plebiscite returned the Saar region to Germany, however the French took it back again after WWII. In 1957 they allowed it to return to Germany, realizing that the Saar people were reluctant to become French.[4]

France and Germany, following the ideology of functionalism, designed the Treaty of Paris to first create a customs union. A customs union is a "free trade area in which the barriers to the

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[3]Lloyd Jenson and Lynn H Miller 334.

[4]Alfred Grosser 447.

free flow of goods are abolished and a common external tariff is established." An actual common market goes a step further to add the free flow of capital and labor, with a common external barrier.[5] A common external tariff, or barrier, means that all countries institute the same tariff and duty practices for non-member countries. The countries of Belgium, Luxembourg, Netherlands, and Italy, all having been affected by this Saar-Lorraine struggle in the past, quickly recognized the economic benefits of such a union and signed on as members of the ECSC, as well.

1.3 European Economic Community (EEC, EC)

A common market was created a few years later on March 25, 1957, with the Treaty establishing the European Community, also called the Treaty of Rome. According to the treaty a common market, originally referred to as the European Economic Community (EEC), would be established in 3 stages within a 12 year transitional period, allowing for alterations depending on the state of the Community. The second focus of the Treaty of Rome was to increasingly hand over more regulatory power to a set of governing institutions, also envisioned in Mitrany's theory. The institutions, each composed of an equal ratio of representatives and delegates from member states, exemplify the members' desire to create a united government to oversee Community treaties and policy making. Just as the European integration has grown in strength, members and responsibility throughout the years, so have each of these institutions.[6]

One of the first institutions created by the Treaty of Rome was the European Commission, whose major functions today are to initiate proposals for legislation, act as guardian of the Treaties,

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[5]Lloyd Jenson and Lynn H. Miller 426.

[6]Treaty establishing the European Community Page, Europa, the European Union's Server, 1999, <http://europa.eu.int/abc/obj/treaties/en/entr6b.htm>.

manage and execute Union policies and maintain international trade relationships. The European Parliament is symbolically located in Strasbourg, the capital of Alsace-Lorraine, the area that first led to the creation of the Coal and Steel Community. It controls the Union's budget and supervises the carrying out of policies. Its legislative power was originally limited to merely a consultative role, but has been expanded through subsequent treaties to amending and adopting legislation. It now shares decision making power with the Council of Ministers, also known as the Council of the European Union. The Ministers work to establish political objectives, coordinate their national policies and settle differences amongst themselves and other institutions.

The Court of Justice has in effect "made Community law a reality for the citizens of Europe," in that its decisions ensure the correct interpretation and application of the laws set forth in each of the Treaties.[7] Cases may be brought before the Court by Member States, other Union institutions, individuals and companies. The Economic and Social Committee advises the Commission, the Parliament and the Council on economic and social issues. The Court of Auditors is responsible for checking that all spending is properly carried out and within budgetary guidelines. The European Investment Bank provides the long-term loans necessary to raise the capital to finance each step of the integration. The Treaty of Rome also called for the establishment of the European System of Central Banks, composed of a European central bank and EU member national central banks. Since the start of the European Monetary Union (EMU) in January of 1999, this group controls monetary policy for EMU members.[8] The ESCB will be explained in more detail in a later section.

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[7]Treaty establishing the European Community Page, Europa, the European Union's Server, 1999, <http://europa.eu.int/abc/obj/treaties/en/entr6b.htm>.

[8]EU Institutions Page, Europa, the European Union's Server, 1999, <http://europa.eu.int/inst-en/htm>.

Throughout the next few years a number of major changes and additions to the Community framework were undertaken. The 1965 renaming of the European Economic Community to the European Community (EC) was a monumental breakthrough in the path to unity, signifying the step-up from a community based on merely economic advantages to include a much more social aspect. The Single European Act of 1986 amended the Treaty of Rome to call for the further progression of the common market into a monetary union after December 31, 1992. New additions to the European Community included Denmark, Iceland, and the United Kingdom in 1973 and Greece, Portugal, and Spain in 1986.

1.4 European Union

One of the most recent major agreements towards integration was the Treaty on European Union, or the Treaty of Maastricht, created on February 7, 1992. This Treaty was actually a series of revisions and amendments to the Treaty of Rome, in order to establish an economic union. This next level of unification included the harmonizing of economic policies, as called for in Mitrany's theory of functionalism.[9] Further important elements of this treaty called for the abolition of internal borders and a common foreign and security policy. The point most relevant to this paper was the official decision to establish an Economic and Monetary Union, including a single currency, by January 1, 1999.

The Committee of Regions was also created by the treaty. This committee, composed of elected officials from each state, acts as the guardian of subsidiarity. It is in direct contact with the

[9]Lloyd Jenson and Lynn H. Miller 427.

people of the Union and must be consulted on issues ranging from trans-European networks and public health to culture and economic and social cohesion.[10]

Recent additions to the Union include Austria, Finland, and Sweden in 1995. There has been considerable discussion over extending unity to a number of Eastern European and Baltic States. The Czech Republic, Hungary, Poland, Estonia, Cyprus and Slovenia are regarded today as those countries most likely to gain entrance in the next few years. Any country considering membership is expected to show considerable progress towards privatization and greater laissez-faire policies when it comes to government involvement in the economy. Further requirements include the dismantling of monopolies, the removal of trade restraints and the development of flexible labor markets.[11]

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[10]Treaty on the European Union Page. Europa, the European Union's Server. 1999. <http://europa.eu.int/abc/obj/treaties/en/entoc01.htm>

[11]John Green and Phillip L. Swagel, "The euro area and the world economy," International Monetary Fund Finance & Development No. 4, Vol. 35 Dec. 1998, online, Lexis-Nexis Academic Universe, 3 April 1999.

Chapter 2: European Monetary Union

Whereas the history of European integration does explain the main path followed up until the economic union of today, much more needs to be said about the creation of the actual Economic and Monetary Union at the root of this discussion. The signatories of the Treaty of Maastricht understood the difficulties associated with the harmonization of economic policies that would arise without a common currency. The history of its success can be broken down into three major attempts beginning in 1968 and planned to end in 2002, with the last stage of the introduction of the currency into the marketplace.

2.1 First Attempt

This first attempt began as a result of the growing turbulence between the French franc and the German mark in 1968, leading Raymond Barre, Vice-President of the European Commission, to propose the coordination of economic policies through a common currency. By 1970 Luxembourg Prime Minister Pierre Werner and his committee had devised a step-by-step plan to introduce the economic and monetary union by 1980. European Community members agreed to this plan in 1972. However, its success was quickly derailed in the following years as a result of its incompatibility with the existing regulations under the Bretton Woods system and due to the oil crisis of the early 1970s.[1] Yet, the biggest obstacle working against such a union at this time was the resistance by member nations themselves. The process needed to be taken more slowly.

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[1]The Bretton Woods system fixed member countries' currencies against the US dollar in 1944. It dissolved in 1973 after a series of US dollar devaluations and President Nixon's decision to break the dollar's reliance on the gold exchange standard. This standard refers the practice of selling US gold to foreign central banks in exchange for dollars, and the economic condition in which the dollar was linked to the price of gold.
Explanation taken from: Paul R. Krugman and Maurice Obstfeld, International Economics: Theory and Policy (New York: Addison-Wesley, 1997) 559-563.

2.2 Second Attempt: European Monetary System (EMS)

The increasing level of interdependence and trade between Germany and its neighbors in the late 1970s prompted German Chancellor Helmut Schmidt and French President Valery Giscard d'Estaing to propose the creation of the European Monetary System at the 1978 French/German Summit in Bremen. This plan officially came into action in 1979 with the initial inclusion of France, Germany, Italy, Belgium, Denmark, Ireland, Luxembourg and the Netherlands. This system of fixed exchange rates was designed to prepare member states for the common currency, then called the European Currency Unit (ECU), a fixed basket composed of all member currencies. Each currency was then assigned a fixed exchange rate against the ECU, and allowed a maximum fluctuation of 2.25%. Spain joined in 1989, Britain in 1990 and Portugal in 1992.

The EMS helped those nations with weak currencies to decrease their inflation by pegging them to stronger and more stable currencies, like the German mark. By the early 1990s these nations had indeed decreased their inflation rates, but not even close to that of Germany, prompting England and Italy to leave the EMS. Following this action, Community leaders agreed to widen the allowed exchange rate deviation to 15 %.

2.3 Third Attempt: Delors' Plan

The third attempt, under which the European Union is still operating today, began in 1986 with the signing of the Single European Act to create a single market, in which monetary policies are more strongly regimented and controlled. The responsibility of overseeing all of this regulation first came into discussion in 1988 when German Minister of Foreign Affairs Hans-Dietrich Genscher proposed the creation of a European central bank to be modeled after the German Central Bank. The bank would also be responsible for controlling price stability within the EMS. In June of 1988, at

the European Community Summit in Hannover, a committee under the direction of Commission President Jacques Delors was given the task of coming up with a step-by-step plan for the realization of a full economic and monetary union regulated by the European Central Bank (ECB) in Frankfurt.

Delors' plan, accepted by the Council in June of 1989, called for the creation of the European Monetary Union (EMU), with the euro (formally the ECU) as the common currency, in a 3- step process beginning on June 1, 1990. After the November 1989 "fall" of the Berlin Wall, concerns arose over whether Germany was willing to follow through with the necessary depreciation measures needed to better align member economies. In order to keep the project running as scheduled, Germany negotiated the carry over of German methods of political stability into the future Euroland (region of EMU member countries) and a guarantee to expand the coming political union.[2]

The Treaty of Maastricht established the European Union in 1992. Member states agreed to set January 1, 1999 as the starting date for the third stage of Delors' plan, the introduction of the euro. Step one of this plan had already been in effect since July 1, 1990, with the full liberalization of capital movements and closer cooperation on economic, fiscal and monetary issues. Step two began in 1994 as a preparatory phase for the monetary union, calling for the establishment of the European Monetary Institute (EMI), the forerunner of the ECB. Its main task was to prepare the groundwork for the European System of Central Banks (ESCB), consisting of the ECB and the national central banks of member States. The institute collected statistics on the euro, devised the ESCB's accounting rules, and prepared the euro banknotes.

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[2] All information regarding the history of the euro taken from:
"Wie der Euro entstand" (How the euro was built), DM Extra June 1998 No. 43: 62.

Step three of Delors' plan began January 1, 1999, with the introduction of euro into the marketplace, however merely as a "book" currency. On this day the Council of Economic and Finance Ministers fixed the exact conversion rates of member states' national currencies to the euro and transferred the responsibility for single monetary policy to the ESCB. The exchange rate is fixed at 1.96DM/euro for Germany. Today all "cashless" transactions throughout the EMU may be carried out in euros, but do not have to be, as the actual euro banknotes and coins will not be introduced until January 1, 2002. After a six month dual-currency adjustment period, all other national currencies in the EMU lose their status as legal tender on July 1, 2002.[3]

2.4 EMU Convergence Criteria

Which member countries ascend to and actually qualify for participation in the EMU was decided by the Council on May 2, 1998 in Amsterdam, based on the following convergence criteria:[4]

1. **Net fiscal deficit** - not to exceed 3% of Gross Domestic Product (GDP).
2. **National debt** - not to exceed 60% of GDP.
3. **Inflation rate** - not to exceed that of 3 most price stable lands by more than 1.5%.
4. **Interest rates** - not to exceed the 3 most stable rates by more than 2%.
5. **Exchange rate** - should hold to the normal range of the EMU's exchange rate mechanism for at least 2 years without depreciation.

These criteria were designed as a way to better align each of the economies with each other, in order to avoid many of the inflation and interest rate problems experienced with the EMS. The eleven out

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[3] Walter Norbert, European Monetary Union or Neotribalism in Europe? German Issues17, (Washington, D.C.: American Institute for Contemporary German Studies, 1997) 2.

[4] Catrin Bialeck, "Pressure from Brussel," DM Extra June 1998, No. 43: 60.

of fifteen EU members participating in the EMU include: Germany, France, Austria, Belgium, Finland, Ireland, Italy, Luxembourg, Netherlands, Portugal and Spain. Great Britain, Sweden and Denmark have chosen not to participate for the time being. Greece was not able to meet the requirements, but is expected to be ready by 2001.

2.5 European System of Central Banks (ESCB)

The institution responsible for controlling and managing such aspects of monetary policy after January 1, 1999 is the European System of Central Banks, divided into the ECB and the EU national central banks. Figure 1 shows the three divisions of the ESCB. The Governing Council consists of members of the Executive Board and the Governors of the national central banks. Its chief duty is the formulation of the EMU's monetary policy. The Executive Board implements this monetary policy. It consists of the President and the Vice-President of the ECB and four other members. The General Council is composed of the President, the Vice-President and the national central bank Governors. It has taken over the functions previously performed by the EMI, which is now in the process of being liquidated. In addition, it is responsible for making the necessary preparations needed in fixing the national currencies' exchange rates to the euro.[5]

[5]Organization of the European System of Central Banks (ESCB) Page, European Central Bank, 1999, <http://www.ecb.int>.

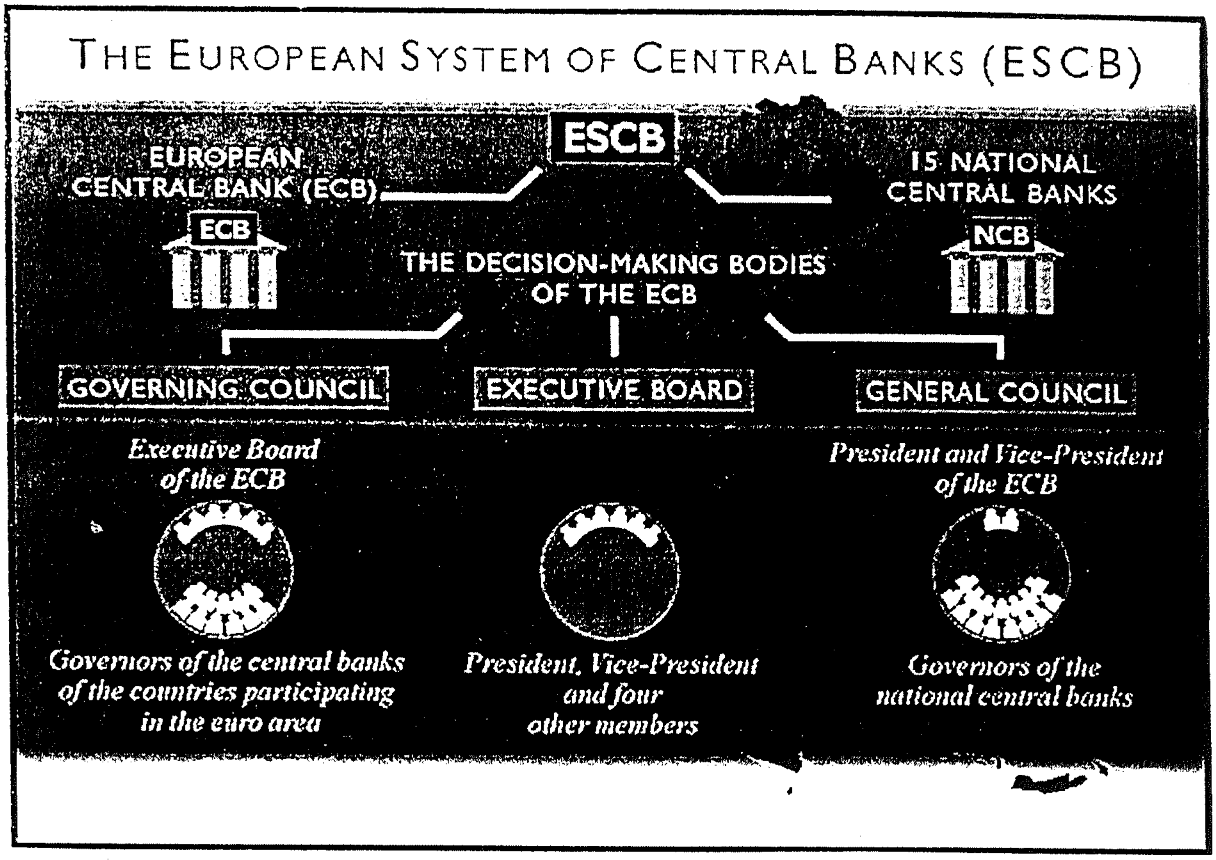

Figure 1: Organizational Chart of the ESCB

President of ECB - Willem F. Duisenberg
Vice-President of ECB - Christian Noyer

Source: Organization of the European System of Central Banks (ESCB) Page. European Central Bank. 1999 <http://www.ecb.int>.

Chapter 3: Germany and the EMU

3.1 Why focus on Germany?

At this point it is necessary to answer the question, "why focus on Germany?" In reality, ten other countries must also deal with this new way of life, yet Germany may be the most interesting. Before January 1, 1999, Germany was the world's third largest economy after the US and Japan. It generates 33% of Western Europe's output, compared with 22% for France and 18% for Italy.[1] More than 40% of its exports go to other Euroland nations alone.[3]

A second matter of interest that differentiates Germany from its neighbors is the recent election of Social Democrat Gerhard Schroeder, a liberal, in October of 1998 as Chancellor. It was former Chancellor Helmut Kohl, the Christian Democrat and conservative, who decided Germany would participate in the EMU in exchange for France's agreement on German reunification.[4] German citizens were not given a vote on this matter. It should be interesting to see how the new social and more liberal policies orchestrated by Schroeder's SPD/Greens party coincide with the conservative policies, as listed in the convergence criteria, needed to make Germany's participation in the EMU work.

3.2 Monetary Policy in Germany

In coordination with the birth of the euro in January of 1999, the German Central Bank (GCB) ceded its authority to institute monetary policy to the ESCB. The GCB has always remained

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[1]Christopher Rhoades, "German GDP Rose 0.9% in 3rd Period, But Slowdown Seen," The Wall Street Journal 4 Dec. 1998: A17.

[3]"Weg Ohne Umkehr" (Path without Turning Back), DMExtra June 1998: 10.

[4]Greg Steinmetz and Thomas Kamm, "Euro Could Drive Unemployment Even Higher," The Wall Street Journal 5 Jan. 1999: A15.

independent of the government, much like the Federal Reserve in the United States. Although European Union countries were historically tied to the ECU under the EMS system, exchange rates were still allowed to fluctuate up to 15%. This left the GCB at least some room to use monetary policy to influence the economy. [5]

If a country were facing high unemployment, like many of the European nations are experiencing today, the central bank has the freedom to increase the money supply to create jobs. Such an increase leads to a reduction in interest rates and a subsequent depreciation of the exchange rate. Lowered interest rates spur investment and expansion at home. The weaker exchange rate makes exports cheaper to foreigners, leading to a greater demand for German production, thus countering unemployment.

The lack of monetary policy to counter situations like this is precisely what has many in Germany worried, as unemployment numbers skyrocket and economic growth slows, due to increased consolidation in the world market and the recent economic crises in Asia and Latin America. In February of 1999, the unemployment rate reached 11.6% in Germany.[6] Many Germans, as do other nations in the EMU, fear the consequences of being left behind when it comes to ECB policy. However, Germany is Euroland's largest market and, therefore has a huge advantage over its neighbors in orchestrating the state of Western Europe's economy.

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[5]A country may expand or contract an economy using either monetary or fiscal policies. Monetary policy concerns central bank changes in the money supply, whereas fiscal policy concerns changes in government spending or taxes.
Explanation taken from: Paul R. Krugman and Maurice Obstfeld 456.

[6]"Unemployment Hits Seasonal High," This Weak in Germany 12 March 1999: 4.

3.3 Fiscal Policy in Germany

Because governments may only use either monetary or fiscal policy to influence the economy, Germany has just one avenue left. Fiscal policy allows a government to influence the economy through changes in expenditures or taxes. The following national income accounts equation for an open economy shows how each of these expenditures impact demand, and therefore output (GDP).[7]

Demand (or output) = C + I + G + NX

where: C = consumption = F(Y-T), or a function of income (Y) minus taxes (T)
I = investment
G = government expenditures
NX = net exports (i.e. exports-imports)

The positive relationship between G and demand shows that an increase in government expenditures leads to an increase in demand (or output). Equally, a decrease in taxes means people have more disposable income (after tax income) to consume goods. When people want to consume more, they demand more. This higher output level spurs expansion, counteracting unemployment. Using these simple remedies to strengthen the economy is more complex within the EMU. Recall that according to the convergence criteria government expenditure is limited, as the net fiscal deficit cannot exceed 3% of GDP. When government expenditures exceed the taxes collected, the country runs a fiscal deficit. A large fiscal deficit in Germany could lead to instability within Euroland, depreciating the euro and hurting investment in the region.

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[7]Assume output (GDP), equals aggregate demand for an open economy. An open economy means an economy that imports and exports goods and services, vs. a closed economy that does not partake in international trade.
Equation taken from: N. Gregory Mankiw, Macroeconomics 3rd ed. (New York: Worth Publishers, Inc., 1997) 25.

A decrease in taxes could be an effective expansionary tool, but only in a healthy economy. If a recession should occur output will decrease, thus causing a decrease in the amount of taxes already collected, prohibiting increased expenditures or any further tax reduction. This poses a particular problem for Germany, as fourth quarter growth statistics show it has fallen into a recession with negative growth of 0.4%.[8] An economy is said to be in recession if it experiences two negative quarters in a row.

This type of economic downturn could become alarming for Germans when it comes to the changes the euro brings to their everyday lives. The only answer to reviving an economy in recession, without the use of fiscal or monetary policy, is to turn to a true free market economy, in which labor mobility is absolutely unobstructed and no barriers to trade exist. If Germany wants to arm itself for the future and be prepared to make it through both good and bad economic times, it must take full advantage of this option.

Although the treaties say this situation is already in place within the European Union itself, different cultures, languages and compensation levels obstruct its progress. When this is the case, people cannot easily find work in neighboring countries like France, Spain or the Netherlands, nor do Germans necessarily want to move to other countries. Other measures the government may pursue to lower unemployment include decreasing the social benefits and convincing Germans to work for lower wages. When unemployment benefits or pensions are less generous than what people would receive at work, they are encouraged to shorten their job search or accept a position for lesser pay. Right now these social benefits are very generous in Germany. Furthermore, if

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[8]"EMU: Germany and Italy are Dragging Down European Growth," Societe Generale France: Monthly Economic Report 12 March 1999, Janet Matthews Information Services Quest Economics Database, online, Lexis-Nexis Academic Universe, 3 March 1999.

average German wages remain the highest in Euroland, calculated at 25.96 DM/hr in 1996, compared to 20.48 DM/hr in Finland or 13.17 DM/hr in Spain, workers will not be motivated to look for employment in neighboring markets.[9] The competition for jobs in Germany will also increase as more people from other EU countries will want to take advantage of these wages. This situation has already begun in a number of sectors.

Although this may be the textbook solution, Germans are not ready to easily accept such new conditions. In the real world, strong unions and political pressure impede cost-reduction policies. Germany, being a manufacturing-based economy, is heavily influenced by labor unions who want continued equal compensation for the high rate of productivity of German workers, compared to other nations where wages are lower.

3.4 Growing Support for the Euro

If these are the changes Germans are facing in the future, why are people increasingly deciding to support the euro now? In January of 1998, 58% of Germans were against the euro, whereas only 30% were for it. Less than a year later it was evident that the tables have turned in Germany. By December of 1998, 43% of the population spoke out for the euro, with only 41% against it. Yet, these numbers were a bit different in the former East Germany where those against the euro were still in the majority at almost 50%, and approximately 33% were for it.[10]

In my September 1998 interview with three East German Economics students from Magdeburg, I found an overwhelmingly negative opinion of the EMU. While Volker had had a

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[9]"Europa im Vergleich" (Europe in Comparison), DMExtra June 1998: 64-65.

[10]"Leicht überrundet" (Easily outstripped), Heute aktuell Dec. 1998, euro aktuell 25 Jan. 1999 <http://www.euro-aktuell.de/>

seminar at his university in Germany on the changes to come, Sandra and Sebastian felt extremely uninformed and did not know where to look for answers. All three students were weary about the idea of increased mobility for Germans, due to the cultural and language barriers as well as higher wages. Volker is convinced Gerhart Schroeder will never decrease social benefits or taxes, while Sebastian expects them to increase. Lastly, the students discussed their concern about the expected decrease in the German standard of living and how political unity is to be achieved without any concrete plan as of yet.[11]

An earlier July interview with West German Engineer Marc Ranzow of Wolfsburg gave a different view on the EMU. Marc was very confident in the EMU's future success in Germany. He expressed no concern about the amount of information available or where to find it. In his opinion, an economic and monetary union is long overdue. He does not expect to see wages decrease because he believes Germany will continue to effectively compete on product quality and modernity. However, he did mention this could be dependent on the amount of specialization required for his job in particular. For example, he alluded to the already increasing competition felt by German construction workers from firms in lower wage countries like Spain and Portugal. Concerning the needed increase in worker mobility, Marc sees it as just a sign of the times. He also pointed out that a decrease in social benefits would be accompanied by an equal decrease in taxes, which he would not mind.[12]

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[11]Interview with Volker Michael, Sebastian Sonntag and Sandra Anclam, Louisiana State University, Baton Rouge, LA, 28 Sept. 1998.

[12]Interview with Marc Ranzow. Volkswagen AG, Wolfsburg, Germany, 30 July 1998.

Former East Germans may still be under the shock of the currency conversion and economic instability resulting from reunification in 1989. Unemployment has grown in this area since then and is considerably higher than in the West German region. Perhaps they fear this may cause greater hardship for them. West Germany is more stable and more familiar with the idea of a common currency, being a driving force in the call for political unity since the early 1951 Treaty of Paris. They have been less affected by the reunification and have had longer to adjust to the idea of economic and monetary union.

Another important matter of concern for the former East Germany deals with the expected value of the euro itself, compared to the historically strong and stable German mark. Because Germany is now sharing the same currency with nations that had higher inflation rates and weaker currencies in the past, this instability may have a negative effect on the euro. With a weaker euro, Germany may lose some of its purchasing power in terms of foreign goods. This affects the former East German area because they are currently receiving a considerable amount of aid and support from the West. They fear a weaker currency may mean less money transferred to them. However a weaker currency may stimulate exports and consequently output, helping Germany's troubling economy.

3.5 Benefits of EMU Membership

The increasing support for the euro shown by Germans, especially those in the West, proves more people are beginning to understand that the long-term benefits associated with EMU outweigh the costs of learning to cope with the above mentioned lifestyle changes. For starters, increased currency stability throughout Euroland will pave the way for more outside investment. This spurs growth, leading to increased employment for Euroland citizens, including Germans. The latest

example of the disastrous effects felt as a result of exchange rate fluctuation occurred in 1995, with a 2% growth loss within the EU, costing 1.5 million jobs.[13]

Lowered exchange rate fluctuation affects taxes and interest rates as well. More people working and lower deficits (lower pubic spending) mean lower taxes for Germans. Authors Carsten Hefeker and Mathias Moersch suggest that less public borrowing may mean lowered long-term interest rates, due to decreased pressure on the capital market. This could bring more investment and growth for businesses, with lower borrowing costs for individuals as well.[14] Furthermore, the increased demand for euro-denominated bonds pushes up their price. Because bond prices and interest rates are inversely related, Europeans should expect to see a reduction in European interest rates.[15] Hefeker and Moersch also look at the flip side of the issue, a possible increase in long-term interest rates. They point out that the surge in cross-border investment due to increased economic and currency stability may actually drive up the cost of borrowing, raising interest rates.[16]

After 2002, the average citizen can also expect to see the benefit of the common currency when traveling and shopping. The absence of conversion costs saves tourists and businesses money. Increased price comparability between Euroland markets leads to increased competition on the supplier side. This benefits consumers in the form of lower prices.

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[13]Economic Impact Page, Office for Official Publications of the EC, 11 Nov. 1998, <http://eur-op.eu.int/en/opnews/198/r355.htm>.

[14]Carsten Hefeker and Mathias Moersch, "Possible Effects of EMU on German Long-Term Interest Rates," Intereconomics May/June 1997: 146.
Authors reference: R. Baldwin, "On the Microeconomics of the European Monetary Union," European Economy Special edition 1 1991: 21-35.

[15]Carsten Hefeker and Mathias Moersch: 147.

[16]Carsten Hefeker and Mathias Moersch: 146.

Many Europeans are also excited about the expected future roll of the euro in global markets as a reserve and vehicle currency, offering competition to the so often used US dollar.[17] The Office for Official Publications of the EC, in referencing the Euro papers, foresees three important advances in the euros international role:

> It will reinforce a shift away from the dollar. The size of EMU, the stability orientation of its policy framework and the integration of its financial markets imply that the euro will likely become a major world currency. First, the euro will be more widely used in international trade transactions. Second, portfolio shifts are expected to occur. Similarly, the use of the euro as an official reserve currency by third countries should develop.[18]

3.6 Consequences of Non-membership

Germans are also concerned about the economic consequences of not being a member of the EMU. Former German Chancellor Helmut Schmidt is quoted in DMExtra's article "Zurueck zu Neuer Groesse" (Back to New Greatness) as commenting:

> Each European state is too weak to survive against world powers such as the USA, China, Russia, and Japan (India in the near future) and to be able to successfully defend it interests in world trade, in the world financial markets or in the areas of atmospheric and oceanic protection.[19]

The situation in the four EU nations not currently participating in the EMU, Sweden, Denmark, Greece and Great Britain is a good example of these consequences. According to New

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[17]A reserve currency is a foreign currency held by central banks to promote stability in their own currencies. It is also held to ease the shock of a capital flight situation, in which citizens and investors trade in a local currency in the expectation of its devaluation. A vehicle currency is used in international contracts when both parties reside in countries that do not issue the currency used. Reserve currency defined: Paul R. Krugman and Maurice Obstfeld 513.
Capital flight defined: Paul R. Krugman and Maurice Obstfeld 733.
Vehicle currency defined: Paul R. Krugman and Maurice Obstfeld 338.

[18]Economic Impact Page, <http://eur-op.eu.int/en/opnews/198r355.htm>.

[19]"Zurück zu Neuer Grösse" (Back to New Greatness), DMExtra June 1998: 12. Translated by Shannon E. Smith.

York Times journalist Alan Cowell, these nations should expect higher interest rates and need to be able to handle the risk that foreign investors may shun nations outside the monetary union. Not surprisingly, sentiment in these countries is changing. In Scandinavia, recent poles show voters gradually approving of the EMU. Cowell explains some of the resistance in this area through his interview with J.P. Morgan & Company economist Katharina Hoyland. Hoyland feels membership is advantageous to those nations who benefit from EU transfer payments and lower interest rates. She further discusses Sweden and Denmark's concern over losing sovereignty to Brussels, the seat of the EU Council, the European Commission and committee meetings for the European Parliament. Nevertheless, these countries are expected to actually become members by 2002. Greece did not make the convergence criteria but is projected to have its economy in line and be ready for membership by 2001.

British Prime Minister Tony Blair is considering moving towards EMU membership after 2002, despite the continued strong resistance in his country. Since the early stages of integration after World War II, Britains have been concerned about losing their sovereignty to a higher supranational power. [20] They are also worried about having to share a common interest rate that may not suit them and the threat to their competitive advantage of low corporate and other taxes, after the institution of possible tax alignment measures sought by France and Germany.[21] Former Chancellor of the Exchequer from the British Labor Party, Lord Healy, is quoted in the March 1999 New York Times article "Anti-Euro Bloc Formed in Britain" as commenting, "I myself believe that

[20]Frank McDonald and Stephen Dearden, European Economic Integration, 2nd ed., (New York: Longman, 1994) 8.

[21]Alan Cowell, "Outlook 1999: International; Steps Get Tricker for 4 Countries Still Dancing Alone," New York Times 4 Jan. 1999, late ed.: C13, online, Lexis-Nexis Academic

E.M.U. will probably break down before Blair is called on to take a decision whether or not Britain should join."[22] Lord Healy recently formed a group aimed at stopping Britain's possible adoption of the euro.

3.7 German Firms and the EMU

The positive view Germans have over EMU membership is not quite as consistent when considering the opinions of small and medium-sized firms to that of the larger, international corporations. Based on the overall greater competition and integration between markets promised by the EMU, it is not surprising to see how the multinationals are behaving these days. Although the European Union has had free movement of labor, since the abolition of internal borders called for in the Treaty of Maastricht, large firms are *now* increasingly more eager to take advantage of cheaper labor and production prices, due to the promised economic stability and projected strong currency. With the foreseen higher competition based on greater comparability between markets, multinationals are using every opportunity to cut costs and remain lean.

Some Germans actually view the euro as simply a benefit for large companies who trade continent-wide, whereas it only creates havoc and headaches for smaller domestic businesses who must equally convert all of their operations to the euro.[23] The greatest advantages to larger, global firms, are the transaction cost savings when converting currencies. Throughout Euroland this means approximately 40 billion marks saved in the export market.[24] Furthermore, Germany exports 12.3

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[22]"Anti-Euro Bloc Formed in Britain," New York Times 1 March 1999, late ed.: C2, AP, online, Lexis-Nexis Academic Universe, 6 March 1999.

[23]Greg Steinmetz and Thomas Kamm A15.

[24]"Die Vorteile des Euro" (The Advantages of the Euro), EU Informationen Speziell; Tips zum Euro June 1998: 3.

percent of its GDP, more than 40 percent of its entire exports, within the European Union.[25] Actually, the overall GDP within the EU is expected to rise by 4.5-6.5 percent, after the alleviation of these costs.[26]

Transacting in euros also means a complete conversion of accounting systems. Many large firms' so-called "euro-teams," had been researching and making conversion plans for over a year in order to be ready for 1999. This includes details ranging from computer software to informing suppliers and employees about the coming changes and benefits. However, firms can only transact deals in euros if both parties are ready. This means either accounting ready or having a separate euro denominated bank account. When not ready, it could mean lost revenue.

The amount of time and money spent on preparation is less costly for these multinationals than for the smaller domestic firms, especially those who rarely transact across borders. This clearly explains the frustration that many of Germany's medium-sized and small companies are feeling. According to DM Extra's article "Die Grossen, die Kleinen" (The Big, the Little) many of these firms feel themselves badly informed and not sure where to turn for advice. In the magazine's interview with Arnold Willemsen, the Federation of German Industries' representative for questions about medium-size firms, he remarks that these firms are at the end of the EU-scale on preparations. A survey conducted by the Instituts für Demoskopie Allensbach found that only 28% of German small and medium-size firms had concrete plans for the euro.[27]

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[25]Twelve and three tenths percent taken from: "Europa im Vergleich" (Europe in Comparison) 65. Forty percent taken from: "Weg ohne Umkehr," (Path without Turning Back) 6.

[26]"Die Vorteile des Euro" (The Advantages of the Euro) 3.

[27]"Die Grossen; Die Kleinen" (The Big, The Little), DMExtra June 1998: 116.

The conversion is especially difficult and expensive for retailers, who by January 1, 2002 must be prepared to display prices and collect in both currencies for 6 months. Consequently, many retailers are hoping that the ECB may reform this dual-currency period for a sort of "big-bang" approach.[28] In Steinmetz and Kamm's interview with Olaf Schlueter, German department store Karstadt AG's head of the company's euro conversion, he expresses that they are " neutral about the euro," because more of the advantages will go to the global firms.[29]

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[28]"Die Grossen; Die Kleinen" (The Big, The Little) 117.

[29]Greg Steinmetz and Thomas Kamm A15.

Chapter 4: The Optimum Currency Area Theory and Euroland

After considering the pros and cons of joining the EMU, the idea of a fixed exchange rate area in Europe should also be analyzed on a scientific basis using the economic theory of an optimum currency area. This theory concludes that fixed exchange rates are most successful for areas which are closely integrated through international trade and factor movements. According to Paul R. Krugman and Maurice Obstfeld's text International Economics: Theory and Policy, "a country's costs and benefits from joining a fixed exchange rate area such as the EMS depend on how well-integrated its economy is with those of its potential partners."[1] At the time this text was written in 1997, the fixed exchange rate EMS was still the driving force in EU economic unity. Today, the EMS is functioning at a higher level of integration with the single currency EMU.

In order to fully evaluate this theory, the ideas of a monetary efficiency gain and an economic stability loss need to be defined. The monetary efficiency gain is the amount of time and money saved through avoiding the uncertainty, confusion, and calculation and transaction costs incurred with floating exchange rates.[2] This gain is higher when countries are more heavily integrated by trade and factor movements. For example, the EMU convergence criteria dictate that member nations must keep their inflation rates in close proximity to each other. A large variability in any member's price level would mean less integration, considerably offsetting this monetary efficiency gain. The expected Euroland price convergence will lead to higher gains.

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[1]Paul R. Krugman and Maurice Obstfeld 624.

[2]Exchange rates are either floating or fixed. A floating exchange rate has not been fixed, or tied, to another currency by its central bank.
Definition: Paul R. Krugman and Maurice Obstfeld 572.

The economic stability loss could be interpreted as a possible disadvantage of joining a fixed exchange rate area. It is the cost incurred when a country must give up its ability to use the exchange rate and monetary policy to stabilize internal problems like output and employment. If the gain equals or surpasses the loss, it is in a country's best interest to join a fixed exchange rate area.

The idea of the EMU is often compared to or regarded as the equivalent of creating a United States of Europe. A number of key differences exist, however, between the United States and Euroland. For example, most EU economies only export 10 to 20% of their output to other member nations, compared to figures of 30 to 40% for US interstate trade. Germany's statistics look much more promising with over 40% of its exports going to Euroland nations. Although free mobility of labor does technically exist within the European Union, it is not at the same caliber as in the US. Many unavoidable language and cultural differences hinder workers from easily seeking employment in neighboring countries. The US is not burdened with this problem. The US also practices greater use of fiscal federalism, or the transfer of economic resources from healthy economies to those performing more poorly. The EU does allow for some form of fiscal federalism, but current taxation powers limit its use.[3]

Authors Krugman and Obstfeld then take this discussion further to consider why, in view of such contradictory evidence, are Euroland leaders steadfastly hailing the benefits of EMU membership. They look at three crucial points. First, Euroland leaders believe the monetary efficiency gains from a single currency are greater than that from the simple EMS fixed exchange rate area, because it removes the problem of possible currency realignments and eliminates exchange

[3]Paul R. Krugman. and Maurice Obstfeld 631.

transaction costs. Second, some leaders, concerned about one-sided management of EMS monetary policy on Germany's part, feel the new independent ECB will be more considerate of all countries involved. Lastly, these leaders are driven by the importance of future political unity, which cannot be achieved without first ensuring complete economic integration. According to Krugman and Obstfeld, in reference to the euro, "the single currency was intended as a potent symbol of Europe's desire to place cooperation ahead of the national rivalries that often had led to war in the past."[4]

Based on the original optimum currency area criteria, the EMU is not yet functioning at an ideal level of integration. When compared to the United States, this stage is somewhat far away. However, the new common currency is expected to bring member economies closer together. Should they continue to progress at better aligning themselves and Euroland become a way of life in the future, generations to come may be able to take full advantage of these gains. Because of its dominant position and high Euroland export-level Germany is already one step ahead of its neighbors. Yet, EMU economists suggest that the euro does offer more benefits than the simpler fixed exchange rate model allows for. Of course, the greatest benefit of all is the long-awaited political integration.

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[4]Paul R. Krugman and Maurice Obstfeld 635-636.

Chapter 5: EMU Implications on the US

Many of the same EMU benefits felt by Euroland consumers and businesses will be seen here in the US as well. We will also be able to take advantage of the loss of currency conversion costs and the heightened price comparability between countries. This will make it easier and less-expensive for us to travel in and trade with Euroland. The stable ECB-backed market is expected to spur a large influx of investments in Euroland not only by US companies, but from those around the world, leading to strong economic growth.

As the demand for euros and euro-denominated investments rise, the currency will appreciate. Yet according to experts, the euro is not expected to reach this point of high demand for another three to five years. Expectations of this sort have led to extensive discussions in US financial markets about the possibility of a currency so strong and popular that it may break the US dollar's power as the leading world vehicle and reserve currency. The US dollar now accounts for approximately 60% of the global foreign currency reserves.[1]

US Treasury Secretary Robert Rubin was quoted in John Authers London Financial Times article with the optimistic opinion, "if it's good for Europe, that's good for the US. I have no doubt markets will fluctuate as they always do."[2] His Deputy Treasury Secretary Lawrence Summers was quoted in that same article as commenting, "As long as we keep our fundamentals strong, I think the dollar [and] US borrowing costs will do just fine."[3]

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[1]Richard W. Stevenson, "The Euro: for U.S., Gains and Losses," The New York Times 4 Jan. 1999, A6, online, Lexis-Nexis Academic Universe, 4 April 1999.

[2]John Authers, "US not fazed by early gains," Financial Times (London) 5 Jan. 1999, World News the Euro 2, online, Lexis-Nexis Academic Universe, 4 April 1999.

[3]John Authers.

Walter Russel Mead, a senior fellow at the Council on Foreign Relations in New York City, looks at the down side of a strong euro in his article entitled "Bet your bottom dollar, euro matters to Americans."[4] Mead explains that the dollar's popularity as a reserve currency is how the US has been able to manage large trade and government budget deficits throughout the last few decades. When a country spends more than it produces in a fiscal year, it runs a deficit. The US continually imports more than it exports, leading to our trade deficit. Budget deficits are the result of greater government spending than tax revenue collected. The US must borrow this money from foreign governments in order to consistently spend more than it generates itself. Use of the US dollar as a reserve currency can be compared to holding an IOU from the US. Mead uses the analogy of writing more checks than the amount of money you have in the bank, because no one would care to cash them in any time soon.[5] This luxury may become more difficult for the US in the future, making it more expensive for the government to borrow.[6]

Mead looks at a second unavoidable issue in his article, the consequences of a depreciating dollar. Should demand for the US dollar fall compared to the euro, the currency will depreciate. This will lead more people to sell their dollar-denominated holdings, depressing the currency even further against the euro.[7] However, it could in turn help the growing trade deficit, by making it cheaper for Europeans to buy our exports, but more expensive for Americans to import from them.

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[4]Walter Russell Mead, "Bet your bottom dollar, euro matter to Americans," The Houston Chronicle 5 Jan. 1999, A19, online, Lexis-Nexis Academic Universe, 4 April 1999.

[5]Walter Russell Mead.

[6]Richard W. Stevenson.

[7]Walter Russell Mead.

The euro is indeed important to Americans. First of all, its advantages could mean cost savings for US consumers and businesses alike. On the other hand, although it may be hard to admit or hurt our pride, the euro could finally offer an alternative to the dollar as a world currency. Consequences of this euro popularity include increased borrowing costs for the US government and a depreciating dollar. However, Americans do not need to start panicking just yet. In fact, the euro has continually fallen since its debut. A number of variables such as the lagging Western European economies, an economic shock or the war in Kosovo could play a future roll in the euro's stability. Because many these factors cannot be accurately predicted today, only time will tell.

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