The EU and the euro: an example to imitate? *

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At the origin of the European Union

At its inception what is now the EU had another name: the European Economic Community (EEC). Its birth act is the Treaty of Rome (1957), signed by Belgium, France, Germany (then West Germany), Italy, Luxembourg and the Netherlands. The objectives of the Treaty were eventually to promote the free circulation of goods, services, persons and capital assets, and in the short term to launch a European Common Market. In 1957 fixed exchange rates were the rule and no serious trouble to the international monetary system was expected. Consequently the Treaty of Rome did not address monetary problems.

Implementation milestones

We should therefore think of the EU as a stage during a process that was not thoroughly designed from the outset, except in the broad sense of envisaging the progressive economic and political integration of Western Europe. The widening of the initial Community took place in subsequent waves: Denmark, Ireland and the UK joined in

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1973, Greece in 1981, Spain and Portugal in 1986, Sweden, Finland and Austria in 1995. The Sixties saw the problems connected with the free trade of goods and services, and the free movement of workers come to the forefront. Monetary questions began to enter the concerns of the Community after the crisis of the Dollar Exchange Standard (1971). The aim of preserving quasi-fixed exchange rates among the country members gave rise to the 'monetary snake', which was not a very successful experiment, but paved the way to the subsequent European Monetary System. The EMS was established in 1979 by the EEC members and for the first time envisaged the adoption of a common currency among its objectives. In 1985 the governments of the member countries approved the program sketched out with the *White Paper on Accomplishment of the Domestic Market*. In the same year the Schengen Treaty virtually abolished borders and border controls between the member countries (initially between Benelux, Germany and France, subsequently by the others except Denmark). In 1986 with the Unique European Act the Rome Treaty was updated. The member countries adopted the important principle of the mutual recognition of product quality and sanitary standards whenever no specific common legislation existed. More recently, in 1992, the Maastricht Treaty again updated the Rome Treaty and gave rise to the European Monetary Union (along the lines of the Delors Report, first presented in 1989) and decided on a calendar for adoption of the common currency. The Maastricht Treaty also includes measures in the domain of common foreign and defence policies, thus contributing to give the EU increasing political content. In 1997 the Maastricht Treaty was strengthened by the Stability Pact, which binds the member countries to follow common principles in the conduct of fiscal policy. In the same year the Amsterdam Treaty took preliminary steps to give the EU political objectives, both domestic and external. At first sight, the progressive accumulation of treaties and agreements may look astonishing, but, as one may well understand, every time a new principle is forced into the national legislations, a number of adjustments have to follow and new principles are required that imply new agreements at the EU level, and so on. This means that a long process is still before us.

**Main achievements**

Among the main achievements of European construction I would like to stress the birth of a near continental goods and services market and the beginnings of an – again near – continental financial market. Whereas it took decades to build the real market (see Figure 1 that relates the evolution of intra-EU trade and the long sequence of simple convergences between Benelux, Germany and France, subsequently by the others except Denmark). In 1986 with the Unique European Act the Rome Treaty was updated. The member countries adopted the important principle of the mutual recognition of product quality and sanitary standards whenever no specific common legislation existed. More recently, in 1992, the Maastricht Treaty again updated the Rome Treaty and gave rise to the European Monetary Union (along the lines of the Delors Report, first presented in 1989) and decided on a calendar for adoption of the common currency. The Maastricht Treaty also includes measures in the domain of common foreign and defence policies, thus contributing to give the EU increasing political content. In 1997 the Maastricht Treaty was strengthened by the Stability Pact, which binds the member countries to follow common principles in the conduct of fiscal policy. In the same year the Amsterdam Treaty took preliminary steps to give the EU political objectives, both domestic and external. At first sight, the progressive accumulation of treaties and agreements may look astonishing, but, as one may well understand, every time a new principle is forced into the national legislations, a number of adjustments have to follow and new principles are required that imply new agreements at the EU level, and so on. This means that a long process is still before us.

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INTRA-TRADE 1950-98 (millions of US dollars)

25.3.1957 Treaty of Rome.
Italy, France, Germany, Belgium, the Netherlands, Luxembourg.

1.1.1975 Entry of Denmark, Ireland and U.K.

1.6.1968 Customs union.


1.1.1986 Entry of Spain and Portugal.

1.1.1995 Entry of Austria, Sweden and Finland.


1.6.1999 EMU.

7.2.1992 Maastricht.

FIGURE 1

SHORT-TERM INTEREST RATES

% of GDP

12
11
10
9
8
7
6
5
4
3
2
1
0


Italy
Germany
France
Spain
Belgium

The EU for fun: an example to follow.
the origin of the substantial interest rate differentials existing before 1999. Here is what happened. Before monetary union became effective, the member countries' financial situations (public debt and deficit burden) were remarkably different, with Italy and Spain in the weakest position (Figure 3), even though the weight of the weak countries with respect to the whole was relatively modest. The possibility that a weak country might break the Maastricht treaty, though unlikely, was not unthinkable (Buiter and Sibert 1997), and this was probably the major source of the country risk. But as soon as the ECB became the sole monetary authority, its credibility (associated with the average EU financial position) extended to all the (temporarily surviving) national currencies, with no further chance of any of the highly indebted member countries to opt to repay state securities by printing currency.

Another point worth noting here is that the Stability Pact of 1997, which binds every member country to aim at a balanced budget in the medium term, has introduced the important principle that every member country may play an active fiscal policy to compensate for asymmetric shocks (even though within the narrow limits of a 3% maximum yearly government deficit and zero mean deficit over the trade cycle).

Concluding the list of the main achievements it is probably worth stressing the fact that the current system of regulations practically rules out the possibility for the governments of the EU member countries to return to the once frequent practice of financing inefficient State Owned Enterprises (SOE) with public money or covering SOE loans with state warranty — a practice that, by removing the profitability imperative for the companies, did not favour growth in productivity.

Full satisfaction?

In some areas the new set-up does not look entirely satisfactory. Local prices and local markets survive, for example. According to some critics even the 'transparency' expected from the increasing practice of quoting prices in euro will be insufficient to challenge the survival
of the local markets. Actually, a number of distinctions are in order. There are price differences that may continue to show up due to national laws that still 'protect' specific markets and professions. Medicines, for instance, do not yet enjoy full circulation rights, so that the price of aspirin in Britain and in Italy may differ notably. The price of a pharmacy license may also differ from country to country, due not only to obvious location advantages (as also happens between districts in the same urban area), but also to the different categories of subjects, such as persons and companies, who the national laws recognises as entitled to own a pharmacy. Another striking example is that of automobile insurance rates, where the borderline between competition and collusion is still unclear. In the domain of telephone services progress in terms of competition is under way.

Access to various professions is subject to local licence legislation or the control of professional organisations, and the barriers are very rigid. A taxi ride in a province of northern Italy may cost several times as much as the same distance in Paris. Here of course higher competition can only be achieved in terms of licence liberalisation, since no spatial trade can occur.

Making the economic system more competitive also means reducing the area of SOEs whenever such a presence implies market power, indirect subsidies and possibly even the right to impose non-competitive prices. From this point of view the national situations differ widely. In France the state still owns a large proportion of the banking system (let alone Renault, the big automobile company). In Italy a good share of the companies belonging to IRI and ENI (the state conglomerates) and some big state owned banks have recently been privatized, but electricity production and distribution are still in public hands.

A special case is agriculture, where competition is not the rule. Contributions to the domestic producers are paid at EU expense and quotas are applied to a number of productions (for example milk). In general competition is not the rule in the field of regional transport or public utilities either, although a number of local authorities are working on privatisation programs. In other cases price differences are to be imputed to inefficiencies in the distribution system and insufficient consumer information. It is the case of many food and clothing items, where consumers cannot have direct access to different levels of wholesale distribution, but only to retail distribution.

The banking industry is at present subject to an intense process of restructuring and consolidation in spite of the fact that national rules on take-over bids and public offers in general are far from harmonised or satisfactory. The banks and the other financial institutions are probably aware of their excess capacity and are consequently prone to associate with the purpose of rationalising their organisation and growing stronger. The state authorities understand that the state owned banks must participate in the restructuring and are aware that the existence of nonfully responsible managers in the state owned banks may be dangerous for the stability of the system and even bring about financial crises (Dornbusch and Giavazzi 1999). But it must be pointed out that a number of mergers and acquisitions are not being conducted in a manner entirely favourable to the progress of an efficient capital market. Most of the EU banks that associate through friendly agreements or absorb other banks through hostile take-overs remain within the borders of the same member country, only few cross-border acquisitions taking place (see on this Table 1). Again, an important bank merger is now going ahead in Spain between two primary national banks, and only after an exhausting controversy has the Portuguese government been induced to consent to the acquisition of a Portuguese bank by a Spanish partner. There are various possible explanations for such behaviour. The European banks do not necessarily need to migrate in order to diversify their investments.

True, the European economic area exhibits remarkable cultural and institutional differences between the countries, but at the same time every single country is characterised by a good degree of industrial differentiation within its borders. In addition, integration at the national level is culturally easier. Moreover it seems that the member country governments strongly support integration at the national level (the case of the Banque Nationale de Paris (BNP) in France is emblematic). This strategy is open to criticism. One may understand that preserving some differentiation between the nationalities of the big actors on the EU banking scene may be fair in principle, but the criteria followed by the single governments should be clear, and efficiency must not be sacrificed to narrow, nationalistic views. The risk is that the banks stronger at the country level find it easier to protect themselves from competition and impose higher costs for capital,
especially on the small firms operating mainly on the local market (Danthine et al. 1999 and The Economist 1999b). If this were to happen, a certain degree of national segmentation might persist within the European capital market. On the other hand, some suggest that national aggregation is likely to be only a first (possibly inevitable) step on the way to future cross-border integration. In any event, when we consider the present set-up of the EU banking industry, the aim of at least avoiding national fragmentation of the final banking structure should surely be shared by all.

At the normative level, the other area still calling for improvement is harmonisation of the fiscal and social contribution systems. It must be recognised that significant steps have been made in added value taxation and, since 1997, in the taxation of financial rents and capital incomes, but very remarkable differences remain in indirect and direct taxation, as well as the weight of pension and health contributions on the cost of labour. The prevailing distribution of taxes in the UE countries between production factors also comes in for criticism. One of the EU commissioners, Mario Monti, has suggested that there is a tendency in Europe to concentrate an excess of taxation and indirect contributions on labour, thus increasing the pressure for labour-saving technologies and aggravating unemployment (EU Commission 1997).

It should also be stressed that the labour market has so far remained basically a collection of individual, national markets. The workers are obviously free to move at will within the EU, but apart from obstacles of language and education, many aspects of the national labour legislation differ considerably, as does the power of the trade unions in the various countries. As a consequence labour costs may remain somewhat diverse from member country to member country. Some progress has been made in the direction of mutual recognition of educational and professional qualifications.

Finalising the set-up

In the domain of the financial market the process of integration has been quicker, and transition to uniform rates of interest almost
complete. Nevertheless the integration process between the financial institutions (especially banks) must certainly develop in the course of time in order to exploit the available economies of scale fully. Both private and public initiatives are involved in the process, which does not simply consist of mergers and acquisitions but requires a clear privatisation strategy on the part of the government authorities, especially when property of the banking system is directly or indirectly in state hands.

The very design of monetary institutional construction also seems to need some significant additions to become complete. Note, first of all, that the European Central Bank has wisely been given a clear objective, i.e. price stability, and provided with a high degree of autonomy. Yet it is not clear who is in charge of stabilisation policy at the overall EU level. The Commission (i.e. the governing authority of the EU) obviously has general competence over economic policy, but once taken for granted that the fundamental concern of the ECB is price stability, it would seem reasonable to expect some institutional procedure (if not authority) to be devised in order to take systematic care of the stability of the real economy. The Maastricht Treaty and the Stability Pact, which set limits to both the annual and average government deficits, contribute greatly to the credibility of the euro, but the room that they open up to counter-cyclical fiscal policies is narrow and limited to the action of individual governments endeavouring to offset asymmetric shocks. The present form of the Stability Pact may consequently be too rigid and require improvement.

Other fundamental and connected aspects of the organisation of the monetary and financial sector concern the regulation and monitoring of both the securities market and the banking system, as well as the function of lender of last resort. Regulation and monitoring are almost entirely concentrated in the member countries former central banks or in other cases shared between the central banks (for the banking system) and securities market supervision commissions like the British FSA, the French CMF or the Italian CONSOB. The central banks and commissions retain their procedures and are expected to enhance their co-ordination. When banks with headquarters in one member country operate through branches in other EU countries, it has been agreed that the central bank of the country where the head-

1 See for example the recent ECB (1999).
seem a likely development. Informed people assure us that informal agreements exist within the European System of Central Banks regarding the provision of liquidity in case of need and that such agreements are likely to remain informal to discourage moral hazard. This is plausible, but prompt access to liquidity is only part of the problem, and it seems that in order to give the financial market the desirable degree of confidence, at least the basic principles should be declared.

How does the ECB operate on the foreign exchange market? Promoting domestic price stability as the first priority may not be inconsistent with exchange rate smoothing when exchange rate movements are expected to be transitory. But is anything to be done if the exchange rate tends to diverge systematically from its foreign trade based equilibrium level due to persistent capital movements? If monetary policy is the sole tool of economic policy, the most obvious answer is probably to drop the trade based equilibrium concept and let the foreign exchange rate fluctuate, according to the rules. However, such a response may prove destabilising in terms of output and employment, so it seems that additional strategies should supplement the monetary policy, possibly along the lines of international fiscal policy co-ordination.

With reference to business activity in general, I would also like to recall the traditional areas in which common norms would be welcome. In the domain of commercial legislation harmonised models of companies are expected, and in particular a new type of ‘individual’ Ltd company is probably due to come about quite soon. In addition, in order to encourage cross-border mergers common principles should be adopted to discipline corporate governance.

Further likely steps

Important progress remains to be done both in ‘deepening’ the existing frame and in ‘widening’ the extent of the EU. Besides the long and hard work of completing integration of the goods and services market together with the institutions required for the market to work properly, the EU must decide what it intends to become politically. There are fundamental issues at stake. Can the EU afford not to have a single foreign policy or, apart from the various other economic objectives, a common strategy reaching beyond the Schengen Treaty to face up to the pressures of migration from Africa, Central and Eastern Europe, Turkey, the Philippines, and so on? Most likely, the international treaties on which European construction has been developed since its inception should now be replaced with a European constitution. The Amsterdam Treaty (1999) represents some steps in this direction.

On the euro front it is expected that the UK, Denmark, Greece and Sweden will soon be joining, but it is in the sphere of EU membership that the most important enhancements are foreseen. Several groups of countries are waiting for admission, in particular Poland, Hungary, the Czech Republic, Slovenia plus the Baltic countries and possibly other countries in Eastern Europe, Malta and Cyprus. Switzerland will probably stay out. In the Mediterranean area Morocco and Turkey, despite a number of real problems, are likely candidates.

The tendency to associate and reduce the number of national currencies

How are we to judge the construction of Europe, and in particular the monetary union that has led to the euro? Is it to be seen basically as the result of a political process launched after the Second World War by a number of West European countries convinced of their common culture and civil values, and persuaded that two world conflicts had been tragic errors never to repeat? This issue has been extensively explored at the geopolitical level: I might mention contributions by Huntington (1996) or, recently, Beedham (1999). As an economist I hesitate to venture into such a field. At the risk of some oversimplification, I think that behind the construction of Europe, and of the euro too, there was the intuition of sound economic reasons to extend the national markets, create common institutions and ultimately employ a common currency. On the side of production and costs reduction it is probably what economists call the search for scale economies that accounts for the modern tendency
The conclusion is that if there is a pre-emptive decision not to use monetary policy for taxation purposes and if the financial position of a national economy is not excellent, as I have noted elsewhere (D’Adda 1999 and also Minton Beddoes 1999), preserving a national freely floating exchange rate may not prove too attractive, whereas joining a monetary union may be truly rewarding.

REFERENCES


