The Future of Transatlantic Relations

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In February 1992, European leaders signed the Treaty on European Union at Maastricht, creating the European Union and establishing both a timeline and criteria for the transition to a single European currency. Under the terms of the Treaty, EU Economic and Monetary Union (EMU) would begin at the earliest in January 1997 but not later than January 1999. In December 1995, the EU's Council of Ministers decided in Madrid that January 1, 1999, would be the starting date for the single currency. According to most political and economic analysts, EMU remains more or less on schedule. Nevertheless, many questions persist about which nations will qualify for EMU membership, the economic and political effects of the Euro within Europe, and most important for our purposes, the implications of the single currency for the United States and the transatlantic relationship.

The Road to EMU

A three-phase transition to EMU is envisaged by the European Union. The first phase is set to take place in 1998, during which participating member states will be determined (based on 1997 economic data), bilateral exchange rates locking together those countries joining the single currency will be announced, and the executive board of the European Central Bank (ECB) will be appointed.[1] The second phase will begin in January 1999 and last until early 2002. During this time, the Euro will become legal tender, the ECB will take control of monetary policy for all states participating in the EMU, and exchange rates will be fixed for those countries. National currencies will continue to exist but companies and individuals will be able to carry out transactions in money, interbank, capital and foreign exchange Euro markets. Furthermore, all new national government debt will be denominated in Euros and banks and financial institutions will transfer their operations from national currencies to the Euro.[2] The final phase, in which national currencies are gradally withdrawn and replaced with Euro banknotes and coins, will occur in 2002.[3]

Until recently, many Americans and Europeans doubted the viability of EMU and predicted a delay in the Euro's starting date. Citing the poor economic performance of many European countries, these skeptics questioned whether enough EU members would meet the Maastricht criteria for joining the single currency. Designed to ensure sustainable convergence of participants' national currencies, the Treaty outlines the following requirements: price stability (i.e., low inflation); low long-term interest rates; exchange-rate stability; and maintenance of a sustainable financial position, classified as a budget deficit no higher than a reference value of 3 percent of GDP and a ratio of public debt to gross domestic product (GDP) of no more than 60 percent.[4] Although the Treaty does provide some leeway in these requirements, German Chancellor Helmut Kohl and the Bundesbank long insisted on strict adherence to these standards to ensure the strength of the Euro and to guard against inflation. But by early 1997 (the year whose economic figures determine whether a country is allowed to enter EMU in 1999), Germany itself, along with France and others, was struggling to meet the budget deficit qualifications. In addition, disputes between France and Germany over various issues related to the proposed monetary union appeared to be increasing, especially following the June 1997 French election that swept Socialist Prime Minister Lionel Jospin to power on a platform of job creation and preservation of the social welfare system. In the immediate aftermath of his victory, Jospin began publicly criticizing a number of elements of the single currency package, objecting to the budget stability pact (designed by Germany to impose penalties on EMU members who fail to keep their budget deficits under the allotted percentage), lack of flexibility in interpreting the Maastricht criteria, and insufficient attention paid to job creation.

In the last several months, however, the mood regarding the likelihood of establishing EMU on schedule has changed, with the majority of commentators asserting that the single currency will debut as planned. Several factors account for this now prevalent belief. First is the fact that EU economies are beginning to revive. Although unemployment remains high throughout the Union, it is predicted that EU growth in GDP terms will reach 2.6 percent this year, 3 percent in 1998, and 3.1 percent in 1999.[5] Moreover, it is forecasted that EU exports will rise by 8.5 percent in 1997 and by 7.5 percent in each of the following two years. Greater growth, of course, will ultimately lead to reductions in budget deficits. Also, average inflation is at an all-time low level of 2.1 percent in the Union.[6] As a result of these improving economic conditions, it is now believed that with the exception of Greece, all EU members will fulfill or come close to fulfilling the Maastricht requirements.[7] Although it is believed that Britain, Denmark, and Sweden will not join the EMU at the outset, monetary union could "...start with as many as 11 [of 15] members, making it much more broadly based than experts were predicting a few months ago."[8]

Second, French rifts with Germany, caused primarily by Jospin's objections to the austerity measures necessary to meet the Euro budget deficit targets, have been papered over.[9] Although Jospin had threatened not to sign the budget stability pact prior to the Amsterdam Summit this past June, which capped the 18-month Intergovernmental Conference (IGC), he finally agreed to a resolution at the Summit calling for the promotion of growth and employment to accompany the renamed "Stability and Growth Pact." In July, much to Bonn's relief, Jospin's new government announced enough tax increases and cuts in government spending to bring France's 1997 deficit close to the 3 percent target.[10] In late August, Kohl and Jospin jointly reaffirmed their commitment to a "stable" single currency, their adherence to the deficit benchmarks, and to the 1999 EMU starting date.[11] And in October, Germany and France announced an agreement to create an informal council, composed of the finance ministers from each of the single currency countries, to ensure coordination of economic policies of single currency participants; it will deliberate on tax and spending matters, structural policies such as wage costs and labor market flexibility, and probably on trade relations.[12] France had been insisting for some time on the establishment of such a group to serve as a political counterweight to the ECB, which will function autonomously and have complete authority over monetary policy, like the Bundesbank does now.[13] For its part, France reaffirmed its respect for the ECB's independence.[14] Also, there is a growing conviction among European leaders that delaying the project would result in serious economic difficulties, threats to the single market, and increase the likelihood of EMU's complete collapse, thereby endangering continued progress toward European integration. According to a wide range of analysts, the most important indication that EMU will proceed as planned occurred in mid-October when the Bundesbank increased interest rates from 3.0 to 3.3 percent and the French, Dutch, Belgian, and Danish central banks followed suit immediately, raising their rates to the same level, despite high unemployment.[15] Journalist Wolfgang Münchau states that, "This sent an unmistakable signal that the process was more concerted in advance than anything that had gone on before. ... In short, central banks are starting to behave as though Emu were already in place...."[16] Münchau went on to note that although the Bundesbank's official explanation for its decision to raise rates was based on domestic concerns (i.e., the inflationary pressures building up inside Germany because of the fall in the value of the D-Mark against the dollar and pound over the last 12 months), "Inflationary pressures are much stronger in countries outside Germany, so it was certainly justified on European grounds. This is how financial markets saw the EU-wide rate rise."[17] Furthermore, many have observed that this coordinated rate increase by a number of key countries likely to participate in the monetary union represents another step toward the convergence of short-term interest rates, a prerequisite for currency stabilization and a smooth transition to the Euro.[18]

Nevertheless, uncertainties regarding the transition to EMU continue. The biggest question still remaining is which countries will join the single currency at its outset. Regardless of the progress of some European countries, such as Italy, to bring budget deficits under control, Germany remains wary of including Italy and the other "Club Med" countries in the monetary union in 1999. Despite Rome's belt-tightening, credited with drastically reducing Italy's 1996 deficit of 6.8 percent, many Germans are uncomfortable with Italy's recent history of lira devaluations and political instability (the latest example being the collapse and resurrection of the Prodi government in mid-October 1997).[19] Furthermore, they point out that Italy's public debt, although declining, is still more than 120 percent of its GDP.[20] France, however, continues to insist that Italy as well as Spain be brought into the EMU in January 1999.[21] Former EU Commissioner Peter Sutherland notes, "What is ultimately at stake is a political judgment. The final decision as to who will advance in the first wave of EMU will not be made on the basis of the economic numbers chalked up by the end of 1997. It will instead be a group judgment as to which member states can be counted on to meet the future obligations of monetary union...." [22]

Question 1: Will EMU go ahead in 1999?

Question 2: If so, which countries will be in the first wave?

ECONOMIC IMPLICATIONS OF EMU FOR EUROPE

As indicated above, the general consensus is that the Euro will be introduced in January 1999. Commentators are much more divided on the potential economic effects of monetary union on Europe.

Possible Disadvantages

Analysts point to a number of possible economic problems resulting from the single currency. First, some argue that Europe is not an "optimal currency area," with broadly homogeneous conditions.[23] Rather, the economies of the EU countries are diverse and currently at different stages of growth and recovery. The apparent convergence of inflation rates and budget deficits, emphasized as important conditions for the creation of a stable Euro, masks underlying economic differences both in structural rates of unemployment and cyclical levels of economic activity, with some EU countries more vulnerable to asymmetric shocks than others.[24] A number of experts note that while the United States is not an optimal currency area either, it is able to sustain a single monetary policy because of its extremely mobile labor markets and its system of federal fiscal transfers, through spending on unemployment and food stamps for example, that allocates money from prosperous regions to poorer ones.[25] In Europe, however, there is little labor mobility between countries, which are still separated by different cultures and languages, and there is no plan to institutionalize a distinct and systematic mechanism for fiscal transfers to countries and regions that might suffer from monetary union. Thus, it has been observed that, "Devising a one-size-fits-all monetary policy for such a diverse area might prove hideously difficult, and European economies are not flexible enough to cope with the potential problems," which could result in slow European growth and high unemployment in the long term, if not the break-up of the Euro.[26]

Second, some experts assert that the single currency will further worsen unemployment, raise interest rates, impede growth, and decrease Europe's economic flexibility because participating countries will be unable to use national nominal exchange rates to adjust for differences in competitiveness and relative prices between individual countries. Rudi Dornbusch states, "The overriding cost of an integrated monetary area is that nominal exchange rates disappear as an adjustment mechanism."[27] By instituting one single exchange rate, EMU will transfer to the labor market the task of adjusting for these differences. Dornbusch argues, "Exchange rates as an adjustment tool have a good history.... Forcing adjustment into the labor market, the European market with the poorest performance, is bound to fail. In backward regions unemployment will rise, as will social problems and complaints about integration."[28] He goes on to note that less rigid, more competitive labor markets would help ameliorate this situation but "...that is a dirty word in social-welfare Europe."[29]

In addition, critics worry about the ability of EMU participants to maintain flexible fiscal policies. Concerns among EU members, especially Germany, that profligate countries in the monetary union would run up debts and leave more responsible countries to pay the bill, led to the adoption this past June of the budget stability pact. Although designed to discourage countries from conducting irresponsible fiscal policies that would threaten the cohesion and stability of EMU, a number of analysts note that this constraint "...can also limit the scope for governments to engage in prudent stabilising fiscal policies," often necessary in light of the absence of an independent monetary policy, and thus result in an "...unnecessarily bumpy macroeconomic performance."[30] Some analysts also stress that instead of ending Europe's currency troubles or improving its prosperity, "...meeting the demanding Maastricht criteria for admission to EMU is adding to the burden of an already mismanaged Europe."[31]

Finally, many believe that banks and companies remain unprepared for the Euro. One recent survey for the European Commission found that only 12 percent of small companies across Europe had begun to think about EMU; another concluded that even most multinationals are not ready for the Euro.[32] Many estimate that the costs for national economies and businesses of converting to the Euro will likely be appreciably higher than the transaction savings expected from the single currency.[33] The logistics of getting the new currency into circulation are also proving daunting and, many assert, promise to be costly, especially for banks and retailers. At worst, it is estimated that the cost to retailers of the currency switch will be 1.8 percent of EU retail turnover, or almost double a year's average profits.[34] David Currie comments that, "For those who are sceptical of the benefits of EMU, these transitional costs are one more good reason for not proceeding."[35] He goes on to note, however, that they represent one-off costs. Therefore, if longer-term benefits from EMU exist, these costs are not a good reason for delaying or canceling the project.[36] Another danger of the EMU for businesses concerns the potential "Europeanising" of labor markets across the EMU zone, which could lead to more wage comparisons and leveling. If wages were leveled up, companies operating in low wage economies would experience an increase in their wage costs that would undermine their competitiveness.[37]

Question 3: Will monetary union negatively affect European economies? Which of the potential disadvantages are most likely and most dangerous?

Question 4: Is there a danger of a public revolt in some EU countries regarding negative economic consequences of EMU?

Potential Advantages

Other experts stress the likely economic benefits that will derive from the single currency. Perhaps the most obvious is the lowering of transaction costs over time that the Euro will bring, saving both money and time for individuals and businesses. Especially for small and medium-size companies, which operate across national boundaries in Europe and do not enjoy benefits of scale, the elimination of the costs of converting one national currency to another will be significant. A single currency will also simplify cash management across the Euro zone. Estimates of transaction savings range from 0.2 to 0.5 percent of members' GDP.[38] In addition, monetary union will eliminate exchange-rate volatility within the EMU zone, reducing the risks associated with intra-European trade, thereby boosting such trade and investment across the Continent. Clearly, companies whose trade is mainly in European markets will benefit more than those whose trade is dispersed internationally, as uncertainties associated with the dollar, yen, and other non-Euro currencies will continue to exist.[39] Another advantage of monetary union, as argued by its proponents, is the independence of the ECB, which many hope will guarantee low inflation for the Euro zone as a whole. This prospective disinflation benefit will be greatest for EMU countries that have not experienced stable low inflation in the past(namely, Ireland, Italy, Spain, and Portugal. The Economist recently wrote, "Over the past few decades many European countries have suffered from irresponsible monetary policies. Handing the monetary reins to an independent European Central Bank modeled on the German Bundesbank would ensure discipline, enabling Europe to entrench low inflation and create a climate conducive to faster economic growth."[40] Germans, who have enjoyed low inflation for decades, hope that the ECB will be able to perform as well as the Bundesbank.[41]

The single currency is also viewed by many as a logical extension of the EU's single market and as necessary to unleash its full potential.[42] Numerous European leaders are convinced that a hybrid of fixed and floating exchange rates is inconsistent with stability in the single market. As proof they point to the turmoil created when speculators attacked European exchange rates in September 1992, only seven months after the signing of the Maastricht Treaty, and derailed the European Monetary System (EMS), which for over a decade had produced a remarkable degree of currency stability in Europe.[43] Thus, supporters of the single currency claim that because of the liberalization of capital movements within the European Community in 1990, no exchange-rate regime short of full monetary union is viable. They argue that throughout the 1980s, capital controls had served to protect central banks' reserves from speculative attack, but these controls were deemed incompatible with the single market by 1990.[44] David Currie writes, "...it is arguable that quasi-fixed exchange-rate systems, such as Bretton Woods and the EMS, are by their very nature hopelessly vulnerable to speculative attack. Maintaining such a system in the face of today's potentially massive capital flows requires a high degree of coordination among the participating central banks. Inevitably, however, there are limits to the degree of cooperation that is feasible among independent monetary authorities, each with its own domestic pressures...."[45] Therefore, some maintain, the only way to guarantee exchange rates and prevent speculative runs is to pool monetary sovereignty.[46]

A number of Europeans and Americans also believe that the policies adopted by European governments to meet the Maastricht criteria have been largely beneficial, providing Europe with a "badly needed dose of fiscal discipline."[47] For years, European government revenues had lagged behind ever-growing expenditures on entitlements. Due to the imposition of more fiscally responsible measures, average European long-term interest rates have fallen and the differential between interest rates on 10-year government bonds has shrunk "...to the point that financial markets now judge most European economies as equally creditworthy." [48] Many assert that once the Euro comes on line, governments will further liberalize their economies by increasing the flexibility and competitiveness of their labor markets and restructuring their welfare systems(largely because they will have no other choice in countering differential shocks once the use of exchange rates for no other purposes is no longer possible.[49] And by forcing Europe to improve the flexibility of its labor markets, European economies will be able to react more quickly to changing conditions in global markets, increasing their potential rate of growth in output.[50] Some also predict that as Europe's economies become more integrated, a larger European economic space, better equipped to face external challenges and more impervious to adverse external shocks, will emerge. Lastly, it is argued that EMU is necessary to enhance Europe's competitiveness in the global economy. EMU advocates maintain that without the development of the single currency, European countries will remain divided and weak, unable to compete internationally with Asia's emerging, low-wage economies or with the United States' large, integrated economy.[51]

Question 5: What is your net assessment regarding the economic advantages and disadvantages of EMU?

Political Effects of EMU and Its Implications for EU Foreign and SECURITY Policies

Much debate exists on both sides of the Atlantic regarding the potential political effects of EMU and its implications on the Union's role in international affairs. While some believe that EMU will hinder further European integration and distract the EU from enlarging and devising a more coherent foreign and security policy, others insist that the formation of the monetary union will bring Europe closer together and heighten the EU's ability to exercise political and economic leadership both in Europe and beyond.
Problems Ahead?

Among the possible dangers associated with EMU, perhaps the most worrisome is the possibility that monetary union will result in the creation of a two-tier Europe, dividing the Continent between "ins" and "outs," thereby exacerbating regional disparities and animosities. Embodied in the Maastricht Treaty, EMU is the first EU project to envisage two tiers in two ways. First, the treaty allows two countries (Denmark and the United Kingdom) an explicit opt-out from the EMU.[52] Second, by outlining specific criteria for joining the monetary union, in theory it could indefinitely prevent certain countries from participation. Of the current 15 EU members, most experts predict that EMU will initially consist of somewhere between eight and eleven founding members. Although it seems certain that France, Germany, the three Benelux countries, Ireland, Austria, and Finland will join in January 1999, questions remain whether Italy, Spain, and Portugal will participate at that time. Given its poor economic performance, Greece is not expected to be approved for membership in 1999. Sweden, which meets most of the convergence criteria, prefers to remain outside the currency union in the beginning (and as it is not part of the EMS, it is unlikely that the other EU members will require Sweden to join the monetary union until Stockholm opts for inclusion in the EMS).[53] If the Union proceeds with its long-term plan to enlarge by bringing in East European countries, most of which continue to face economic challenges associated with their transformation to free market economies, the EU will then likely contain even a larger number of countries excluded from EMU in the future.[54]

A number of observers are concerned that the "ins" will become the focus of integration, with the development of the single market proceeding more rapidly among them than the "outs."[55] Consequently, EMU members will experience greater economic growth and prosperity than those outside the monetary union. Even if similar progress toward the single market is achieved in both EMU and non-EMU countries, many worry that those states not participating in the single currency regime will be significantly disadvantaged, especially because they might encounter difficulties maintaining a level exchange rate with the Euro. If these exchange rates decline or if non-EMU countries institute higher interest rates to prevent such a decrease, this would discourage business investments, stifle economic growth, and inhibit the relative international competitiveness of those not part of the single currency regime. Also, given the interdependent nature of the European economy, some analysts assert that international recessions will be more strongly felt in European countries not part of the monetary union (the closer cooperation of EMU economies and the elimination of competitive devaluations will help reduce the effect and length of recession for companies and individuals in those countries). [56] In short, it is argued that the economic benefits accruing to EMU countries, relative to those outside the Euro zone, will result in increasing regional inequalities, rising intra-European tensions, and growing bitterness between the "ins" and "outs." Indeed, rather than encouraging European integration, EMU would result in a weakened and divided Europe.

Critics also fear that EMU will distract the European Union from enlarging to Eastern Europe, viewed as essential to solidifying that region's democratic political structures and its burgeoning free markets. As one expert put it, "...by lending support to these countries through economic integration and demonstrating the willingness of the market economies of western Europe to help them, the EU would help to stabilise these countries politically and socially."[57] Therefore, many perceive enlargement as the Union's most important task in the years ahead and its most significant contribution to the promotion of peace and security on the Continent. However, at present, they claim that "The main focus of EU members and of the European Commission is inward, on the question of preparing for EMU. This could easily absorb their energies up to 2002 and beyond.... If so, the prospects for enlargement are dismal. And if the Emu process runs into trouble for any reason, EU energies will be devoted to fixing it, again pushing enlargement off the agenda."[58] As an indication of this primary preoccupation with the EMU at the expense of enlargement, some observers point to the inconclusive outcome of the Amsterdam Summit. Although the Summit intended to focus on reforming the Union's rules and procedures to make way for new members, most of it was spent defusing the French-German crisis over the EMU stability pact. [59] Moreover, there is some concern that countries such as Spain or Italy, if not admitted to EMU in January 1999, will block EU's enlargement to the east.[60]

Many commentators, particularly Americans, maintain that the Union's self-absorption with EMU is also distracting the EU from developing a common foreign and security policy and diverting resources from modernizing European defense capabilities. Bruce Stokes remarks that the Union's preoccupation with creating EMU, or with the consequences if the initiative fails, is complicating progress "...on a range of other issues

Washington regards as more important... [such as] a shoring up of NATO through the creation of common European foreign and defense policies."[61] In addition, a number of European defense budgets, already decreased to reflect the end of the Cold War, have also fallen victim to spending cuts undertaken to help national economies meet the convergence criteria. Defense News recently reported, "...most of the European Union's fifteen member states are squeezing their national budgets-(especially their defense budgets--to meet the Maastricht Treaty criteria for participation in the future so-called euro zone."[62] The recent actions in this respect taken by Jospin's government are a prime example. In order to meet the Maastricht criteria while preserving social programs, the new Socialist coalition has further slashed France's defense budget.[63] Jospin's 1998 budget, unveiled this past September, decreased 1997 defense spending levels (85 billion francs or $14 billion) by 10 percent.[64] Jospin also canceled 3.8 billion French francs ($608 million) of planned spending in its 1997 procurement budget.[65] Some experts worry that such defense reductions will worsen the growing gap in military and technological capabilities between the United States and Europe. In its latest Military Balance, the International Institute for Strategic Studies stated, "Continuing spending cuts by NATO's European member-states, particularly...by France and Germany, are evidence that governments' current priority is to meet single currency criteria, if necessary at the expense of equipment programmes."[66]

Finally, skeptics are wary of the effects of EMU on national sovereignty. They warn that not only will elected governments lose the ability to react autonomously to losses in their domestic economic competitiveness through currency devaluations, but also that monetary union could be an ill-advised step toward a European superstate, or at least a more closely bound and unwieldy European federation. Critics believe that such a federation would be hobbled by bureaucracy, command little public support, and impose a crushing regulatory burden on Europe's economies.[67] In addition, some fear that dormant European nationalism will be reawakened in reaction to the EMU's centralizing tendencies.[68] Others remark that if EMU fails, "forces of disunity long thought dead on the Continent," could be unleashed(dividing Europe, inhibiting growth, and indefinitely delaying the completion of the single market.[69]

Question 6: Is EU preoccupation with EMU distracting the Union from the enlargement challenge?

Future Benefits?

On the other hand, numerous policymakers and scholars view the opportunity provided by the EMU to create a stronger EU with greater economic, political, and social cohesion as a primary advantage of proceeding with monetary union. In a recent editorial, former French president, Valéry Giscard d'Estaing, and former West German chancellor, Helmut Schmidt, wrote, "One must never forget that monetary union, which the two of us were the first to propose more than a decade ago, is ultimately a political project. It aims to give a new impulse to the historic movement toward union of the European states."[70] Since the end of World War II, European integration has been seen as a way to mitigate competition and hold nationalisms in check, thereby serving as a guarantee against intra-

European conflicts. Some have noted that EMU is especially necessary in light of German unification because it offers a means of containing Germany's economic strength.[71] At the same time, a strengthened EU provides Germany with "political cover" for an active foreign policy, in which it prefers to keep a low profile for obvious historical reasons.[72] These factors have certainly contributed to Chancellor Kohl's deep commitment to the establishment of the single currency and his attempt to pursue the political dimensions of European integration in parallel with the EMU project. In short, according to David Currie, "Enthusiastic federalists...often see the move to a single currency as another important step towards a more united Europe."[73]

Proponents of EMU also argue that the contribution it will make to the creation of a closer and more dynamic political union offers the best hope for bringing the former Communist-bloc countries of Eastern Europe into the EU. Instead of hindering enlargement, greater integration among the current EU members will actually promote its prospects by enhancing the Union's ability to speak with one voice and formulate more coordinated and coherent policies. Furthermore, EMU is likely to lead to a shift in EU governance structures toward a core/periphery design over the long run. Currie remarks that, "As a result of the EMU process, we see the growth of EMU-"ins" institutions: the ECB is a prime example...."[74] The development of such institutions, to which only some EU members would belong, would create inner and outer divisions within the EU. Rather than being a negative effect of monetary union, advocates assert that this arrangement would "...help to resolve the major problem of EU governance which will otherwise arise from enlargement of the EU both to the east and south. The institutional structures of the EU, set up for six member states, have now been stretched, with some modifications, to encompass 15. Can the same structures continue to work for a Union of 20 or 25 members?"[75] Thus, a core of "ins" with greater power to influence the direction of the EU would decrease the decisionmaking difficulties associated with an expanded membership; at the same time, the existence of the peripheral "outs," who would not have to assume all the requirements of EU membership and have less decisionmaking power in consequence, would make it easier to integrate new members.[76]

Lastly, those who maintain that EMU will produce significant advantages for Europe assert that only a stronger and more integrated Europe will be able to exercise political and economic leadership on a global scale in the period ahead. Again, many view the division of the Union into EMU and non-EMU members as a positive development with respect to this goal. William Pfaff writes, "The future belongs to two Europes, related but separate. One will be small, far more integrated than today, able to take decisions, capable of playing a world role in political affairs as well as economics. The second will be large, more loosely associated...."[77] He goes on to note, "This is the solution that seems dictated by Europe's realities. It is not a bad solution. ... It creates one Europe that can act, and weigh in world affairs, together with a second associated Europe which is secure, cooperative, conscious of its community with the others, but whose members are free in what each chooses to take from the union, and in what each commits to it."[78]

Question 7: Will there be a two-tier European Union over the long term? If so, will that contribute to a more robust EU international role?

EMU, THE UNITED STATES, AND THE TRANSATLANTIC RELATIONSHIP

The European Union is the largest consumer of U.S. exports and the single most important region for American foreign investment.[79] Although extensive discussion in the United States on the international political and economic impact of the Euro has yet to occur, two overarching schools of thought on the potential consequences of EMU for the United States and the transatlantic relationship have emerged. Skeptics assert that the Euro will prove disruptive and harmful to U.S.-European relations, increasing economic rivalry and transatlantic political friction. Supporters of the monetary union opine that it will facilitate greater cooperation across the Atlantic.

Potential Negative Consequences of EMU for the United States and transatlantic Relations

Most economists and policymakers agree that the Euro will eventually play a more important global role than its constituent European currencies do today.[80] C. Fred Bergsten argues that a bipolar currency regime dominated by Europe and the United States, with Japan as a junior partner, will replace the dollar-centered system that has prevailed for most of this century.[81] Depending on the number of initial participants, Euro zone countries could collectively represent an economy at least two-thirds that of the United States, with a greater share of global trade.[82]

Many observers assert that the Euro will challenge the dollar as the currency of international commerce, thereby representing the first real competition for the dollar since it surpassed the pound sterling as the world's dominant money between the two World Wars.[83] Some predict that between $500 billion to $1 trillion of international investment may shift from dollars to Euros.[84] At present, the United States accounts for approximately 27 percent of global production and 18 percent of world trade. Given these figures, the dollar's 40 to 60 percent share of world finance far exceeds the economic weight of the United States.[85] Thus, the governments of Europe, China, Japan, Taiwan and other nations with large foreign exchange reserves are likely to diversify their holdings by acquiring more Euros.[86] Although there is some disagreement among economists regarding how quickly portfolio diversification will occur, and therefore, how rapidly the Euro will come to rival the dollar as a key international reserve currency, many say that this shift will have a significant, long-term effect on exchange rates(i.e., generating greater fluctuation and instability in the dollar-Euro exchange rate than that which the United States currently experiences with individual European currencies.[87] This, in turn, "...could cause prolonged misalignments that would not only have adverse effects in both Europe and the United States but also provoke protectionist pressures on the global trading system."[88] One reason increased exchange-rate volatility could result is because European policymakers will have less need to pay attention to such fluctuations because trade among EMU members will be transacted in a common currency, and "international" trade will be smaller as much of participants' current foreign trade will be reclassified as "domestic."[89] In addition, a more attractive alternative to the dollar might reduce the ability of the United States to finance its large external deficits.[90] A number of experts counter that whether one nation wants to hold another state's debt depends on the creditworthiness of the debtor and if the U.S. economy continues to be strong, there is no reason why other countries should not buy its debt.[91] There has also been some concern among financial analysts that the creation of the ECB will yield a surplus of dollar reserves among central banks participating in the monetary union and consequent dumping, which would reduce the value of the dollar. Following EMU, the need for participating countries to hold reserves will decline because member countries will need to pay for much less of their imports with foreign currency as trade between them will take place in Euros. Not only will Europe's reserves be much higher relative to its imports than the equivalent ratio in the United States, but upwards of 90 percent of those reserves could be in dollars (depending on how many countries join the single currency).[92] As such, some fear these excess dollars will be sold quickly on global currency markets, weakening the dollar against the Euro.[93] Others discount such worries about this so-called "dollar overhang." The European Commission itself has stated, "Although the absolute value of the amounts involved may indeed be substantial, they are not significant in view of the turnover in financial markets."[94] Some also point out that any attempts by central banks to reduce the dollar overhang would be gradual given the potential impact of such transactions on exchange rates.[95]

A number of experts believe that following monetary union, the influence of the United States over European economic policies will decrease. Since the end of World War II, America has been less dependent on trade and therefore, less vulnerable to fluctuations in exchange rates than the countries of Europe. Henning writes, "When clashing with European governments over macroeconomic policies or the balance of payments, American officials often took advantage of this asymmetry. In several instances, the threat of a precipitous exchange-rate movement pressed European governments to reflate or dampen their economies in accordance with American preferences."[96] However, according to Henning, monetary union will largely eliminate this asymmetry by insulating the EMU from fluctuations in the dollar, thereby reducing the costs of transatlantic monetary conflict for Europe and shielding European policymakers from U.S. pressure.[97] Consequently, he concludes, "The United States would confront a larger, more cohesive, and more self-confident and powerful partner in the monetary union than it has faced in the past."[98]

In addition, some propose that EMU could have a negative effect on transatlantic and international trade. Most obviously, if the Euro worsens unemployment and produces slow long-term growth, as some have predicted, Europeans will be unable to buy as many U.S. exports, subsequently harming American producers.[99] If, however, the Euro works as intended, skeptics worry that the decreased dependence of the European economy on exports (because intra-European trade will essentially become domestic commerce) will result in a change in perception of the importance of international free trade. Christopher Taylor of Britain's National Institute of Economic and Social Research comments, "I don't think we can be absolutely confident that the trend toward international liberalization [of trade] will [then] continue."[100] For example, such analysts question whether Europe will be willing to further expose its farmers or bankers to international competition.[101] A reduced European commitment to free trade, they maintain, would be detrimental not only to the United States but to the international trading system as a whole.

Question 8: Will the Euro challenge the dollar as the prime reserve currency? If so, what are the likely consequences?

Question 9: Will EMU make the Union more protectionist?

Potential Contributions of EMU to an Invigorated transatlantic Partnership

EMU advocates maintain that rather than fostering rivalry and competition in the transatlantic relationship, the single currency will promote greater cooperation and coordination between the European Union and the United States in economic, foreign policy, and security matters. For more than 50 years, America has supported the European integration process as a means to stabilize Europe, thereby preventing a repetition of the horrors of the first half of this century. Thus, EMU is viewed by many U.S. leaders and analysts as another step toward closer European political integration, which will further reduce the chances of return to bitter intra-European conflicts into which the United States could again be drawn. As U.S. Treasury Secretary Robert Rubin has stated regarding the Euro project, "All of this is a very positive development with respect to Europe, and what's good for Europe is good for all of us."[102] Besides the political advantages of further integration, many observers also stress that monetary union will yield numerous benefits to U.S. businesses. As EMU promotes economic growth and more dynamic markets, opportunities for transatlantic trade will increase. Deputy Treasury Secretary Lawrence Summers has commented, "American economic interests are well served when Europe prospers. A more rapidly growing European market is good for our exports...."[103] Moreover, U.S. companies operating in Europe will also benefit from the elimination of transaction costs in the same way as their European counterparts.[104]

Many supporters of EMU recognize the fact that the emergence of the single currency has the potential to produce greater economic rivalry and political friction between the two sides of the Atlantic. They maintain, however, that if the Euro is properly managed, such conflicts can be avoided. Therefore, it is precisely this requirement(to ensure that confrontations about the Euro do not arise(that will facilitate greater transatlantic collaboration and coordination. Bergsten comments that "a quantum leap in transatlantic cooperation" will be necessary to deal with both the transition to the new international currency regime that will result and its long-term effects.[105] In order to prevent volatile exchange-rate fluctuations, for example, Bergsten recommends that the United States and the EU develop a structured exchange rate regime to manage the future relationship between the dollar and the Euro.[106] Specifically, he suggests that the United States and the EU, along with Japan, negotiate a target zone system with broad currency bands to avoid large current account imbalances. According to Bergsten, without such an institutionalized exchange rate mechanism, "...both Europe and the United States will often be tempted to practice benign neglect. If left to market forces, the two currencies will likely experience increased volatility and misalignments. Both outcomes would be destabilizing for other countries and the world economy."[107] In addition, he opines that the United States and other non-EMU nations should resist any attempt by Europe to undervalue substantially the Euro's start-up rate, which would be a blatant effort by the EU to export its high unemployment and unilaterally strengthen the single currency.[108] Some Europeans also believe that because EMU will produce a Europe capable of speaking with a single voice, the United States will have no choice but to be more cooperative.[109]

Question 10: How likely are the United States and the European Union to develop a structured exchange rate regime to manage the international effects of the Euro?

Others stress that, "The United States and the rest of the world have a strong interest in the creation of a European Union that can form a common position with reasonable efficiency and bargain externally...."[110] They question, however, whether European policy will truly be better coordinated following EMU, noting the EU's fragmented decisionmaking processes, even in the ECB. Bruce Stokes writes, "For the moment, it is unclear who will have ultimate responsibility for setting the value of the Euro. On the face of it, the existence of a single central bank would seem to enhance U.S.-European cooperation in an exchange rate crisis. But the Maastricht Treaty gives the EU Council of Ministers, the European Commission and the European Parliament a new say in exchange rate matters, along with the European Central Bank."[111] To rectify this situation, C. Randall Henning proposes that the EU undertake institutional changes and stresses that the United States has a role to play in encouraging such a reform process. He states, "...American officials should waste no time in discreetly expressing concern that the machinery of European decisionmaking could impede international monetary cooperation..." nor should they hesitate in inquiring of their European colleagues how Article 109 of the Maastricht Treaty, which addresses the making of external policies for the monetary union, will be applied in practice.[112] Henning also proposes initiating more robust macroeconomic cooperation within the Group of Seven leading industrial countries (G-7) to ensure a smooth transition to EMU for both Europe and the United States. In the G-7 forum, policy issues of portfolio diversification and excess dollar reserves, which will arise during the transition, could be addressed.[113]

Numerous commentators emphasize that a more united and integrated Europe will constitute a better, more capable, and more efficient global partner for the United States. Many Americans often criticize European leaders for devoting so much attention to the problems associated with the European process, such as establishing EMU. However, Europeans assert that until the EU achieves further integration, Europe will be unable to effectively address security and economic concerns beyond its borders. As John Roper comments, "Greater European coherence can only make a working partnership [with the United States] easier to achieve."[114]

NOTES

[1]In late September 1997, European finance ministers meeting in Luxembourg accelerated the EMU timetable in practice when they decided to announce in May 1998, when participating states are selected, the level at which exchange rate parities among the Euro member countries will be fixed on January 1, 1999. This decision was taken in order to discourage financial speculation between May 1998 and January 1999. Exchange rates between the Euro and non-European countries will not be set until January 1999. See "The euro-creature," Financial Times, October 8, 1997, p. 13; "Ready or not, here comes EMU," The Economist, October 11, 1997, p. 21; and Anne Swardson, "Now You Can Bet Your Bottom Euro on a Currency Merger," Washington Post, October 13, 1997, p. A1.

[2]David Currie, The pros and cons of EMU (London: Economist Intelligence Unit, 1997), p. 28.

[3]Ibid.

[4]"A Survey of the European Union," The Economist, May 31, 1997, p. 7; Currie, The pros and cons of EMU, pp. 28, 30; and C. Randall Henning, "Europe's Monetary Union and the United States," Foreign Policy, no. 102 (Spring 1996), p. 85. Price stability is defined as a rate of inflation within 1.5 percentage points of the three "best-performing" EU countries (usually interpreted as the average of the three lowest-inflation countries); low long-term interest rates as within 2 percentage points of the long-term interest rates of the three countries with the lowest inflation; and exchange-rate stability as the ability of a government to keep its currency within the fluctuation margins of Europe's exchange-rate mechanism (ERM) for the two years prior to membership.

[5]Barry James, "A Rosy Forecast for EU Currency," International Herald Tribune, October 15, 1997, p. 1.

[6]Ibid.

[7]Ibid; Barry James, "Euro Calendar Advanced; Definitive Exchange Rates to Be Set in Spring," International Herald Tribune, September 15, 1997, p. 1; and Swardson, "Now You Can Bet Your Bottom Euro on a Currency Merger," p. A1.

[8]James, "A Rosy Forecast for EU Currency," p. 1.

[9]See James, "Euro Calendar Advanced," p. 1; and Swardson, "Now You Can Bet Your Bottom Euro on a Currency Merger," p. A1.

[10]Lara Marlowe, "The Relationship Between France and Germany Survives, But It Hasn't Been Easy," Irish Times, July 28, 1997, p. 12; and Swardson, "Now You Can Bet Your Bottom Euro on a Currency Merger," p. A1.

[11]John Schmid, "Jospin and Kohl Commit Themselves to `Stable' Euro," International Herald Tribune, August 29, 1997, p. 14.

[12]"EMU: Franco-German Deal to Coordinate Economic Policies," European Report, October 18, 1997. Electronic Version. Also see, Philip Stephens, "Moment of Fusion," Financial Times, October 17, 1997, p. 18.

[13]Journalist John Vinocur writes, "The former Gaullist prime minister, Alain Juppe, had pushed for a political counterweight to the European central bank, and the idea had found support in Paris, where wide bands of both sides of the political spectrum considered it senseless to turn over virtually all responsibility for Europe's money to independent bankers they may not be able to reach on the phone." John Vinocur,

"French-German Discord on a Eurobank Is Sure to Be Heard Again," International Herald Tribune, June 19, 1997, p. 6.
[14]James, "A Rosy Forecast for EU Currency," p. 1.
[15]Michael Elliott, "Monetary Union Has Always Been Mainly About Politics," International Herald Tribune, October 14, 1997, p. 8.
[16]Wolfgang Münchau, "Big Stride Towards Emu," Financial Times, October 11, 1997, p. 8.
[17]Ibid.
[18]Wolfgang Münchau, "Banks Try to Show United Front Ahead of Emu," Financial Times, October 10, 1997, p. 2.
[19]Christopher Balmer, "Clock Ticking for Italy in EMU Race Against Time," Reuters, March 11, 1997.
[20]Roger Cohen, "The Cries of Welfare States Under the Knife," New York Times, September 19, 1997, p. A1.
[21]"French Left Sweeps into Power in Second Round of Elections; Socialist Party's Jospin Named Premier," Facts on File World News Digest, June 5, 1997, p. 386.
[22]Peter Sutherland, "The Case for EMU: More than Money," Foreign Affairs, vol. 76, no. 1 (January/February 1997), p. 12.
[23]"A Survey of the European Union," p. 6.
[24]Ibid; and "The euro-creature," p. 13.
[25]Walter Russell Mead writes, "In America, when one part of the country is in recession, we get in our cars and follow the jobs-(17% of Americans move every year, and almost half of them move to a new state. ... That isn't going to happen in Europe. The French won't move to Finland no matter how many Kinkos open in Helsinki. In Europe, the welfare system is national; if French unemployment goes up, Germany doesn't help pay the welfare bill." See Walter Russell Mead, "Economic Union: Will All Europeans Have the `Right' to Live in Paris?," Los Angeles Times, June 22, 1997, p. M1.
[26]Ibid.; "A Survey of the European Union," p. 6. Also see, "Ready or not, here comes EMU," The Economist, October 11, 1997, p. 22.
[27]Rudi Dornbusch, "Euro Fantasies," Foreign Affairs, vol. 75, no. 3 (September/October 1996), p. 120.
[28]Ibid.
[29]Ibid.
[30]Currie, The pros and cons of EMU, p. 14. Also see, "Ready or not, here comes EMU," p. 23.
[31]Dornbusch, "Euro Fantasies," p. 113.
[32]"Ready or not, here comes EMU," pp. 21-22.
[33]Currie, The pros and cons of EMU, p. 38.
[34]"Coining it: the euro," The Economist, September 20, 1997, p. 88.
[35]Currie, The pros and cons of EMU, p. 34.
[36]Ibid.
[37]Ibid., p. 58.
[38]Ibid., pp. 38, 55.
[39]Ibid.; "A Survey of the European Union," p. 6.
[40]"A Survey of the European Union," pp. 5-6.
[41]Currie, The pros and cons of EMU, pp. 38-39.

[42]"A Survey of the European Union," p. 5.
[43]Currie, The pros and cons of EMU, pp. 20-22. Also see, Bruce Stokes, "Bank On It," National Journal, vol. 10, no. 1 (January 4, 1997), p. 23.
[44]Barry Eichengreen notes that, "It was hardly feasible to restrict the freedom of Frenchmen to open bank accounts in Germany, for example, while eliminating all controls on intra-EC movements of portfolio capital and direct foreign investment, not to mention labor and commodities." Hence, controls were a casualty of the single market program. See Barry Eichengreen, Should the Maastricht Treaty Be Saved?, Princeton Studies in International Finance, no. 74 (Princeton, NJ: Department of Economics, Princeton University, 1992), p. 8.
[45]Currie, The pros and cons of EMU, p. 25.
[46]Ibid., pp. 25-26.
[47]"A Survey of the European Union," p. 6.
[48]Stokes, "Bank On It," p. 23.
[49]Currie, The pros and cons of EMU, p. 86. Also see, "Ready or not," The Economist, October 11, 1997, p. 18.
[50]Michel Camdessus, "Europe's Coming of Age," The Banker, vol. 147, no. 855 (May 1997), p. 12.
[51]Currie, The pros and cons of EMU, p. 1.
[52]Except for Britain and Denmark, the Maastricht Treaty requires all member states that meet the convergence criteria to join EMU. See Henning, "Europe's Monetary Union and the United States," p. 87.
[53]"Euro: Sweden Shuns First Wave," European Report, October 11, 1997. Electronic Version. The Report states, "Sweden has met most of the budget criteria, but the national currency is not part of the European Monetary System, and the majority of Member States believe such participation is mandatory for countries wishing to join the single currency."
[54]Robin Niblett remarks, "For their part, Central and East European states will be permitted to set up camp inside the ramparts of the EU, but outside its new citadel. They will continue to pay the price of the cold war even after its demise." See Robin Niblett, "The European Disunion: Competing Visions of Integration," Washington Quarterly, vol. 20, no. 1 (Winter 1997), p. 107. Regarding enlargement, the European Commission is likely to invite Poland, Hungary, the Czech Republic, Cyprus, Estonia, and Slovenia to join the EU in its next round of expansion. At the earliest, it is believed that new members will accede to the Union in 2002. See Sarah Helm Brussels and Andrew Marshall, "EU Prepares to Expand By Six States," The Independent (London), July 11, 1997, p. 16.
[55]Currie, The pros and cons of EMU, p. 84.
[56]Giovanni Bucci and Carl James, "The Implications of Being In or Out of the Single European Currency," Management Accounting, vol. 75, no. 2 (February 1997), p. 49.
[57]Currie, The pros and cons of EMU, p. 84.
[58]Ibid., pp. 84-85.
[59]See John-Thor Dahlburg, "EU Settles Fight Over Jobs, Keeps Euro on Track," Los Angeles Times, June 17, 1997, p. A1.

[60]Lionel Barber and Anthony Robinson, "Uncertain Map of the Future," Financial Times, March 12, 1997, p. 17. Also see, Henning, "Europe's Monetary Union and the United States," p. 91.
[61]Stokes, "Bank On It," p. 22.
[62]Brooks Tigner, "AGS Is Next Challenge to Trans-Atlantic Amity," Defense News, July 28, 1997, p. 1.
[63]This past July, in order to reduce France's projected 1997 budget deficit of roughly 3.6 percent, France announced a 15 percent increase in taxes on large corporations and an increase in corporate capital gains taxes. These measures were expected to decrease the deficit by about two-thirds. The remaining third of the deficit would be reduced "...through spending cuts, particularly in the military budget..." as well as through a special contribution from the state-owned electric utility company. See Roger Cohen, "France Raises Business Taxes, and Anxiety Over Euro," New York Times, July 22, 1997, p. A3.
[64]"French Budget Cuts Defence, Boosts Jobs," Agence France Presse, September 24, 1997. Electronic Version.
[65]Giovanni de Briganti, "Unlikely Allies Aim to Avert French Budget Cuts," Defense News, August 25, 1997, p. 3.
[66]International Institute for Strategic Studies, The Military Balance 1996/97 (London: Oxford University Press, 1996), p. 41.
[67]Currie, The pros and cons of EMU, p. 1.
[68]Ibid.
[69]Stokes, "Bank On It," p. 22.
[70]Valéry Giscard d'Estaing and Helmut Schmidt, "Along With the Euro, a Fresh Political Agenda," International Herald Tribune, October 14, 1997, p. 8.
[71]Niblett, "The European Disunion," p. 98.
[72]Henning, "Europe's Monetary Union and the United States," p. 89.
[73]Currie, The pros and cons of EMU, p. 4.
[74]Ibid., p. 82.
[75]Ibid., pp. 82-83.
[76]Ibid., pp. 82, 85.
[77]William Pfaff, "There Will Be Two Europes(And This Is Not Bad," Chicago Tribune, July 22, 1997, p. 11.
[78]Ibid.
[79]Stokes, "Bank On It," p. 24. In July 1997, Deputy U.S. Trade Representative Jeffrey Lang testified before Congress that, "The combined economic weight of trade and investment between the United States and the 15 member states of the EU exceeds $1 trillion. The EU collectively is the U.S.'s largest market for goods and services and vice versa. In 1996, two way trade in goods and services amounted to nearly $400 billion. In 1996, U.S. merchandise exports to the EU were $127.5 billion.... Imports from the EU in 1996 were $142.7 billion. ... The stock of U.S. foreign direct investment into the EU in 1996 was $315.4 billion." See Prepared Statement of Ambassador Jeffrey M. Lang, Federal News Service, July 23, 1997. Electronic Version.
[80]"Why non-Europeans should care about EMU," The Economist, March 29, 1997, p. 86.

[81]C. Fred Bergsten, "The Dollar and the Euro," Foreign Affairs, vol. 76, no. 4 (July/August 1997), p. 83.
[82]Ibid., p. 84.
[83]Ibid., p. 83; and Stokes, "Bank On It," p. 25.
[84]Bergsten, "The Dollar and the Euro," p. 84.
[85]Ibid., pp. 83-84.
[86]Stokes, "Bank On It," p. 25.
[87]Bergsten comments, "Many analysts agree that the euro will rival the dollar as the world's leading currency. Most believe, however, that such a shift will take considerable time, since any redistribution of international portfolios occurs incrementally. But there is evidence from the history of major currencies that major shocks can produce rapid changes in portfolio composition." See Bergsten, "The Dollar and the Euro," pp. 84, 91. Deputy Treasury Secretary Lawrence Summers summarizes the majority viewpoint succinctly: "The revolution in European financial markets which many expect to follow EMU will not happen overnight. The dollar will remain the primary reserve currency for the foreseeable future, and any further erosion in its relative position in the system is likely to happen, if it happens, only slowly." As quoted in Martin Walker, "The Euro: The View from America," Europe, September 1997, p. ESR14. Also see Larry Summers, "American Eyes on Emu," Financial Times, October 22, 1997, p. 14.
[88]Bergsten, "The Dollar and the Euro," p. 84.
[89]"Why non-Europeans should care about EMU," p. 86.
[90]Bergsten, "The Dollar and the Euro," p. 93.
[91]Michael Elliott, "Hey, Can You Spare a `Euro'?," Newsweek, February 17, 1997, p. 48.
[92]Henry Engler, "Euro Set to Rival Dollar on Global Stage," Reuters Financial Service, April 23, 1997. Electronic Version.
[93]Ibid.; Also see, "The euro and the dollar: strut your stuff," The Economist, October 19, 1996, p. 75.
[94]Engler, "Euro Set to Rival Dollar on Global Stage."
[95]Ibid.
[96]Henning, "Europe's Monetary Union and the United States," p. 94.
[97]Ibid.
[98]Ibid.
[99]Mead, "Economic Union: Will All Europeans Have the `Right' to Live in Paris?" p. M1.
[100]As quoted in Stokes, "Bank On It," p. 25.
[101]Ibid.
[102]As quoted in Walker, "The Euro: The View from America," p. ESR14.
[103]Lawrence H. Summers, "An American View of Europe," The Reuter European Community Report, May 22, 1997. Electronic Version.
[104]"An Interview with Yves-Thibault de Silguy," Europe, September 1997, p. ESR10.
[105]Bergsten, "The Dollar and the Euro," p. 83.
[106]Ibid., p. 94.
[107]Ibid., pp. 93-94.
[108]Ibid., p. 92.
[109]Ibid., p. 94.

[110]Henning, "Europe's Monetary Union and the United States," p. 96.
[111]Stokes, "Bank On It," p. 25.
[112]Henning, "Europe's Monetary Union and the United States," p. 96.
[113]Ibid., p. 97.
[114]John Roper, "A European comment," in America and Europe: A Partnership for a New Era, ed. David C. Gompert and F. Stephen Larrabee (New York: Cambridge University Press, 1997), p. 230.