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An Essay on the Political and Institutional Deficits of the Euro

The Unanticipated Fallout of the European Monetary Union

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Abstract

The Euro is an unprecedented innovation, which can only very partially be analysed with the theory of optimal monetary zones, nor most conventional approaches. It calls for an analysis integrating three domains and levels: the change in the rules of the game at the European level, the impact upon the national institutional architecture and "régulation" modes and the transformations of domestic political arena. It is argued that various interpretations can be given to the Amsterdam Treaty and its implementations, the more so since the new institutional architecture is far from coherent, but quite on the contrary, political conflict and economic unbalance prone. The survey of the literature then deliver a method for generating a whole spectrum of scenario by combining three major hypotheses: the ex-post objectives pursued by the European Central Bank, the existence and extension of budgetary and political innovation in reaction to the Euro and finally the unequal ability of different societies to be reformed in line with the constraints and opportunities generated by the EMU. The very political and institutional deficits of the Amsterdam Treaty gives a low probability to totally rosy as well as to quite gloomy scenarios, but opens a quite uncertain process of trials and errors with possibly radical innovations which would complement the Euro. This essay concludes by suggesting some agenda for future negotiations about the European institutions.

Un essai sur les déficits politique et institutionnel de l'Euro :
Les surprises de l'Union Monétaire Européenne.

Robert BOYER

Résumé

L'Euro est une innovation sans précédent qui appelle des analyses originales, au-delà de la référence à la théorie des zones monétaires optimales et autres théories usuellement mobilisées. Il est proposé d'intégrer trois niveaux d'analyse : le changement des règles du jeu au niveau européen, leur impact sur l'architecture institutionnelle et les modes de régulation nationaux , enfin et surtout la formation de la politique au niveau national. Dans ce contexte, des interprétations très contrastées peuvent être données du Traité d'Amsterdam, donc de sa mise en œuvre, d'autant plus qu'il est loin de définir une architecture institutionnelles cohérente et que bien au contraire, il sera sujet à d'importants et récurrents conflits politiques et déséquilibres économiques. Une revue de littérature livre une méthode pour engendrer une série de scénarios grâce à la combinaison de trois hypothèses : les objectifs finalement poursuivis par la Banque Centrale Européenne, l'existence et l'étendue d'éventuelles innovations budgétaires et politiques, suscitées par l'Euro, finalement la capacité fort inégale des différentes sociétés à être réformées en réponse aux exigences et opportinités ouvertes par l'intégration monétaire. L'ampleur même des déficits politique et institutionnel du traité d'Amsterdam conduit à accorder une faible probabilité tant aux usuels scénarios optimistes que pessimistes. De fait se trouve ouverte une période d'essais et d'erreurs, avec potentiellement l'émergence d'innovations radicales. L'essai se conclut par la présentation de quelques points cruciaux dans la négociation à venir de nouvelles institutions européennes.

KEYWORDS : European Monetary Union – Euro – European Institutions Reform – Diversity of "régulation" modes, Hierarchy of Monetary Regimes and Wage Labour Nexus – Institutional Economics.

MOTS CLES : Union Monétaire Européenne – Euro – Réforme des Institutions Européennes – Diversité des modes de régulation – Hierarchie entre régime monétaire et rapport salarial – Economie Institutionnelle.

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Introduction

All along the Nineties, the discussions about EMU have focussed upon the rationale of the convergence criteria set by the Maastricht Treaty, the likelihood of each specific country to be part of the first wave of Euro, the opportunity to postpone its launching or the degree of flexibility in interpreting the convergence criteria. But since the European summit held on May 1998, all these issues are no more relevant and indeed analysts have began to raise the neglected but fundamental issue: *does the Amsterdam Treaty design a viable configuration for European integration and national policies?* This essay precisely proposes a *structural analysis* of the viability of the current phase of monetary integration.

The Euro : a misunderstood innovation

It is not a surprise if economists have tried to capture the consequences of the common monetary currency according to the tool box inherited from several decades of international economics. The theory of *optimum currency-area*, initially proposed by Mundell (1961) has been applied to the European case. A large bulk of the literature has dealt with the issue of symmetric and asymmetric shocks: if the former are more frequent than the later, then the common European currency might be viable. Under this respect, many econometric studies do conclude that only a limited group of countries (France, Germany, Austria, Belgium and Netherlands) could share monetary policy, whereas for most other countries the costs of such a loss autonomy are higher than the benefits (Melitz 1997, Jansson 1997).

Of course, alternative approaches have been investigated in order to check whether Europe is an optimum currency zone. Does external trade bring a synchronisation of economic activities for all member-states ? Is the mobility of capital and labour sufficiently high? Does nominal wage and price flexibility provide a tool for reacting to national idiosyncratic shocks? Does the current European budget warrant a fiscal solidarity across European regions and Nation-States? The answers to these questions are generally negative and therefore the logical conclusion would be that the Euro project is bound to fail, if the related features are not corrected by relevant and radical reforms during the process of European integration.

A comparison between the American monetary integration and the current launching of the Euro usually delivers the same message: labour mobility is quite inferior in Europe, fiscal federalism is absent, real wage flexibility is missing,…as well as a fully-fledged political integration which is clearly absent for Europe, since Brussels nowadays is not the equivalent of Washington a century ago. The core message of this essay is to challenge these two visions: the Euro is neither a mere complement to the Single Market integration, nor a carbon copy of the emergence of the dollar. Therefore, the EMU calls for a quite new analysis of this radical and structural innovation, which by definition has no equivalent.

Exploring the institutional and political deficits in the EMU project.

Actually, conventional economic theory is badly equipped to deal with such an innovation, mainly because it refers to a static world, with rational expectations and pure market mechanisms. Therefore, the very first development of this essay proposes an *integrated framework* mixing economic analysis and political science, and builds upon the main hypotheses put forward by “régulation” theory. This approach is then used in order to explore a series of consequences of the EMU. It is argued that this is not a marginal transformation but the confirmation of a *new hierarchy in the institutional forms* which define national “régulation” mode: the primacy of the monetary regime and the ideal of fair competition do challenge most components of the post-WW II capital - labour accord.

But precisely, these institutionalised compromises had taken contrasted forms according to the nature of the political process, economic specialisation and more generally the trajectory followed by interest formation and mediation. Therefore, it might well be that the same European Monetary Policy will have quite contrasted impacts over national economic systems, a pattern which may exacerbate some conflicts about the objectives and tools of the European Central Bank (ECB). This institutional argument goes beyond the frequent reference to the absence of synchronisation of the national business cycles, specially between the UK and continental Europe, or between core European countries and new member states. Actually, the difficulties associated to *the heterogeneity of national “régulation” modes* would persist even if, for instance, the adhesion of the UK to the Euro would finally synchronise all business cycles all over Europe.

Another side of the same issue is then the following: do Nation-State have a sufficient degree of manoeuvre left in order to pursuit their traditional objectives of macroeconomic stabilisation and reduction of unemployment? This issue is actually central to the long run legitimacy of the EMU. It is argued that new tools have to be implemented at the national level, specially if the Industrial Relations systems do not fit with the requirement of price stability and independence of the ECB. Basically, the dividing lines between *Europeanisation of economic policy and subsidiarity* have not been yet correctly drawn in order to deliver a viable configuration. This major weakness in the institutional architecture designed by the

Amsterdam Treaty is complemented by a *major political deficit*. Many strategic decisions are taken more and more at the European level, be in Brussels, Frankfurt, The Hague, whereas, the political arena remains essentially domestic, since the European parliament is not at all the equivalent of national democratic and representative bodies. Under this respect, the long run political viability is far from achieved by the current configuration of European/national institutions. In the first phase of Europeanisation, the more cosmopolitan interest groups may gain, but afterwards, populist and nationalistic movements may become very active and vocal, possibly halting or even reversing the advance of the European integration.

Even the more precisely defined component of the Amsterdam Treaty, i.e. the statute and objective(s) of the ECB, will experiment *a trial and error process* during the implementation of the new monetary policy. Will the Central bank adopt a low inflation rate as the unique objective, or will it consider that the Euro should be a hard currency, with more or less stable exchange rates with respect to the Dollar and the Yen? Or alternatively will the recurring financial crises and the deepening of internal trade within Europe remove the barriers put by a quasi-complete capital mobility upon the choices of the ECB? These options are the starting points for a *series of scenarios*. Similarly, the same clauses of the Maastricht and Amsterdam Treaties may recover *quite contrasted conceptions* about what should be decided at the European level and what should be left at the initiative of local governments, what form of coordination should prevail between national budgetary procedures and whether new structural policies should develop a principle of solidarity among European Nations and regions, and so on. Not to forget that the admission of new members may make more complex and shaky the process of decision by unanimity and consequently the institutional reform of European Union (EU). This is the second ingredient for various scenarios. A third component of these scenarios deals with the ability of each Nation-State to conduct the *structural reforms* which are required for the long run viability of their adhesion to the rules of EU. Thus, during possibly dramatic episodes, the different members States may struggle one against another and finally form new coalitions in order to implement new European institutions, that would be required by a major financial crisis, a surging unemployment or anti-Euro domestic political movements. Many possibilities are thus opened and the present essay proposes a method for generating as many scenarios as the reader may wish to analyse.

A short conclusion insists upon the fact that the current phase of European integration is largely opened upon a rich *series of futures* which will be drawn by the first major decisions made in response to the first economic disequilibria and/or European or national political conflicts. Simultaneously, it is shown how paradoxical is the EMU and how drastically reformed should be many national Industrial Relations, as well as the welfare systems. This essay would have fulfilled its role if it gave the reader some hints about the most *urgent reforms* of European institutions.

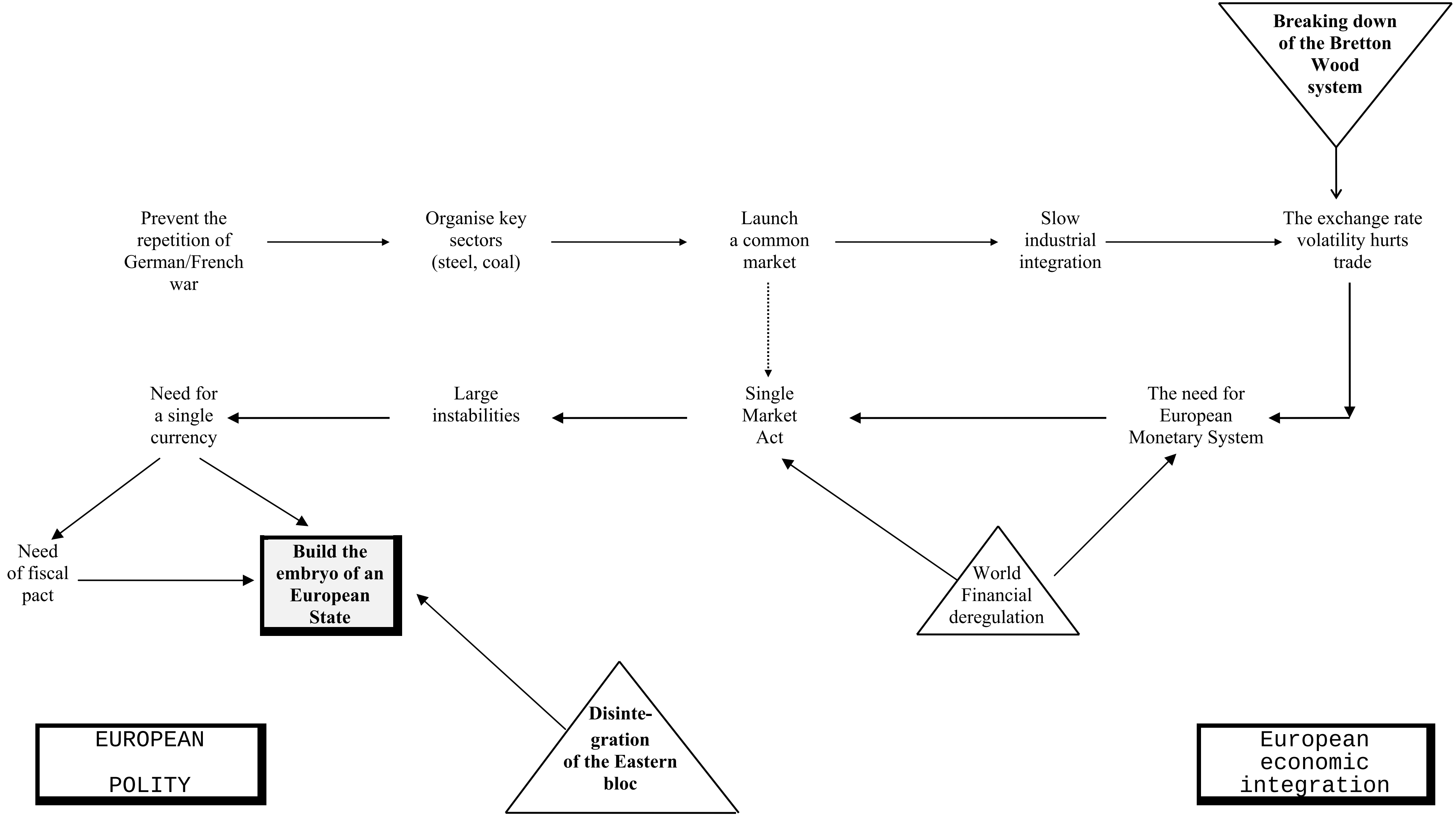
The seven paradoxes of European integration.

For the key actors promoting the EMU, the success is only related to the clarity of the objectives pursued and the steadiness in the commitment to the satisfaction of the convergence criteria (de Silguy 1998). "*On parvient toujours à ce que l'on veut quand on le veut avec persévérance pendant quarante ans*", that is the quotation borrowed to Marguerite Yourcenar in the front page of the book devoted to the EMU by the European Commissioner in charge of the Euro. Conversely, other analysts express a gloomy pessimism about this innovation and point out the lack of political will of national governments to abandon a large fraction of their sovereignty. A second distinctive feature of this essay is to deal simultaneously with this two opposite visions of EMU. Pointing out a series of paradoxes about the current integration process might be a convenient starting point..

A political project disguised into an economic one.

A brief historical retrospect suggests that the European project launched by Jean Monnet was clearly a political one. In order to prevent the repetition of the dramatic German/French conflicts, why not to organise and coordinate the economic activity of the key sectors such as coal and steel? Given the success of this first initiative, the project was extended by the creation of the Common Market by the Treaty of Rome, which in turn has been triggering a slow process of economic integration among the founding members (Figure 1). The breaking-down of the Bretton Woods system brought a lot of exchange rate instability among European currencies, hindering the on going process of economic specialisation across national borders. The European Monetary System (EMS) was precisely designed in order to remove this source of discrepancy, but the success was difficult to achieve in front of the huge move towards financial deregulation. The dramatic 1992 and 1993 episodes brought a confirmation about the project contemplated by the Maastricht Treaty: a single common currency would be a definite solution to the recurring instability among European currencies. This project was frequently presented as a purely economicist strategy, whereas it is clearly a political project, put forward by France and Germany after the collapse of the Soviet empire and specially the

FIGURE 1 : THE LONG MARCH OF EUROPEAN INTEGRATION : FROM POLITY TO ECONOMY.....AND BACK TO POLITY ?



German reunification (Vernet 1998). Here comes the first paradox: *the Euro is presented as a purely functional device reducing transaction costs and removing exchange rate uncertainty, whereas it is basically a political enterprise.* During the early years of the European project, economics was a means and political integration the objective, whereas nowadays the political will is assumed to be applied to purely economic, not to say monetarist, objectives…. Quite a paradox indeed !

A daring "Constructivism" at the epoch of free market beliefs.

A second paradox relates to the relations between States and markets. A priori, Euro is a quite exceptional process of monetary integration. Usually, a new currency is backed by an emerging leadership over a territory, with few countervailing power of private agents such as banks or financiers. After all, the American monetary unification was made possible by the victory of the North over the South, the emergence of a unified political power solving the previous conflicts of interests (Boyer and Coriat 1989). Under this respect, an opposite configuration prevails at the end of the Nineties: the Euro is the outcome of an intergovernmental treaty, without any clear hegemonic power, since quite on the contrary most governments expect thus to mitigate the initiative and power of the *«Bundesbank»* and the hegemony of the Deutsche-Mark. The potential conflict of interests among European countries are not solved but postponed until the implementation of the Amsterdam Treaty. Furthermore, financial markets have acquired such a power that they assess in real time, the credibility of any economic policy, and specially such a daring experiment as the Euro. Back in the Seventies, the Werner's plan had already proposed a monetary integration, without any success, but at a period when the limitations to capital mobility would have allowed such a creation. In the Nineties, governments do not have any more the full initiative of their policy, but they now wish to create a common currency. In other words, *governments could have created Euro when they were not convinced of its usefulness, but now they wish to do so…but do not necessarily have the power to implement it*, and "beat the market". Briefly stated, the Euro is an ambitious example of *Constructivism* – in the sense of Friedrich von Hayek – at the very time when a vast majority of agents operating on financial markets seem to adhere to a rather naïve *free market ideology*.

An euphoric presentation for a complex and contradictory project.

A third paradox opposes *the selling of a bright future and getting mediocre results*. Such a disappointment had already taken place with respect to the Single Market Act back to the mid-Eighties. The European Commission had taken this initiative in order to overcome the crisis of the European integration, and actually it changed a rather pessimistic mood into a much more optimistic one. But a series of economic studies were launched and used, showing that European growth would be 12 % higher, with job creation by millions. Nearly ten years later an ex-post assessment exhibits far more modest achievements of the Single Market Act: only 1,5 % of extra GDP growth could be attributed to this structural reform, of course largely partial and limited to some key industrial sectors (Monti 1996). The European Commission seems to have reiterated exactly the same process for the single currency: the early research were delivering a quite optimistic message (EC Commission 1990)… but as soon as the Euro has been agreed upon, a much more balanced view has been proposed, stressing the need for difficult structural reforms, without which the benefit of the EMU could not be reaped (EC Commission 1998). In the age of the rational expectations revolution, it might be risky to *over sell the merits of a quite complex and contradictory innovation*.

Integrating Europe… but exacerbating domestic social conflicts?

A fourth paradox derives from the previous one. On one side, the politicians and civil servants engaged into the European integration, along with the most privileged groups in each Nation-State tend to adopt a quite positive assessment of the consequences of the Euro. The official statements present this innovation as Pareto improving, i.e. benefiting to anybody, without hurting any single individual agent. For instance in a recently published book, the European representative Yves-Thibault de Silguy presents a very appealing picture of the consequences of the Euro: it will reinforce the Single Market, stimulate growth, alleviate public budget deficit, enhance innovation and the profitability of the European firms and last but not least, it will speed up job creation (de Silguy 1998: 74-118). Why should anybody be against such a wonderful scenario? The paradox is precisely that on the other side, many social groups perceive the EMU as a threat to their previous position or privilege. This is the case for small entrepreneurs, retailers, low skilled workers, retired people and more generally any group strongly related to the national welfare system (see Table 8 infra). The dilemma is therefore the following: *a project, which is supposed to be unanimously supported by the citizens, is actually generating strong and sometimes new divisions among most societies*. Incidentally the dividing line between pro and anti Euro frequently cross each party, be it leftist, conservative or even centrist. For instance, in France, both the Gaullist party (RPR) and the Union of conservatives (UDF) have a majority in favour of the Euro, but furthermore a vocal minority against the Amsterdam Treaty. Therefore, the very political architecture built

TABLE 1 : A HIDDEN PARADOX : THE COUNTRIES, EXPECTED TO SUFFER THE MORE FROM THE ADJUSTMENT, EXPERIENCE THE MOST FAVOURABLE PUBLIC APPRAISAL OF EMU.

european survey
Early 1997

A rather enthusiast Southern Europe		A sceptical Northern Europe	
France	70 % have a positive appraisal about Euro. 58 % consider that the benefits overcome the required sacrifices.	**Germany**	60 % fear Euro.
Spain	70 % have a positive appraisal about Euro.	**Great Britain**	58 % fear Euro...but 56 % of businessmen wish Britain to join.
Portugal	53 % are ready to financial sacrifices in order to have their country in the first wave of Euro.	**Netherlands**	A drastic breaking down of the acceptance of Euro. 1995 : 73 % 1996 : 46,3 % 1997 : 34 %
Italy	70 % have a positive appraisal about Euro.		

Source : Le Sondoscope n° 129, Avril 1997, p. 70-71-73.

after the second world war is challenged by the EMU. *Would the sharpening of domestic social and political divisions be the cost to be paid for unifying Europe?*

Enthusiast Southern Europe, reluctant Northern Europe.

A similar paradox can be observed when one compares the respective support of the Euro by various national public opinions (Table 1). Roughly speaking, Southern Europe is generally quite enthusiast about this new phase of European integration: in France, Spain or Italy for instance, in early 1997, 70 % of the citizens had a positive appraisal of the Euro, whereas in Portugal, 53 % of the individuals were ready to bear financial sacrifices in order that their country be part of the first wave of the EMU. Quite on the contrary, Northern Europe is rather reluctant with respect to the Euro and the fraction of the population rejecting it seems to have increased as the deadline set by the Maastricht Treaty, was approaching. Is it not surprising to note that *the very countries that require the more drastic structural reforms, experience the most support by the population for the Euro, whereas the already integrated countries are facing a quite sceptic, if not opposed, public opinion?* Italy is a good example of the first configuration, Germany and Netherlands of the second. The cases of Great Britain, Denmark or Sweden are still different, since the political leaders have followed their public opinions in not joining Europe, given the large costs to be born in order to adapt the national structures to the requirements of the Maastricht Treaty. Nevertheless, this fifth paradox opposes *the general political assessment about the desirability of the EMU to the economic costs of the transformations it requires for some countries*.

Unifying Europe… at the perils of balkanisation!

This leads to the next paradox. Clearly the Single Market Act, then the Maastricht Treaty and ultimately the Amsterdam agreement do aim to promote European integration and unification. But the conditions put to the adhesion to the EMU, as well as the challenging requirements for national autonomy in order to harmonise diplomacy, defence and security, are bound to restrict the number of countries able and willing to join such an ambitious and novel project. Therefore, *the very process intending to unify Europe would trigger a multiple tier Europe, with potentially diverging forces*. By enforcing strong criteria convergence, the Euro would actually split the previous integration process, either according to the opposition between core participants and new members, or by multiplying an “Europe à la carte”, i.e. separate agreements including a variable number countries for each domain of competence (CEPR 1995, Dehove 1997). For instance, after the European Summit of May 1998, the eleven countries elected for the Euro have to organise their monetary and financial relations with the *OUTs*…and this is not without arising new and difficult problems in the institutional architecture of the EU: should the *OUTs* be admitted to the Euro Council designed in order to coordinate national budget policies? Will some countries stay out of the Euro forever, or are they supposed to join as soon as their public opinion is ready for and/or satisfy the convergence criteria? Paradoxically enough, *for unity sake new divisions have been brought into EU*, and they will not be easy to overcome.

Democracy and market: trading places?

A final paradox has to be pointed out and is about the interpretation to be given to the current phase of European integration. For some politicians, the final objective is to recover a form or another of *collective control* over exchange rates, interest rates and more generally the ability to monitor a large continental economy at the epoch of globalisation. For other politicians or analysts, the objective is strictly the opposite: to unleash *the forces of the market* in order to redesign the institutional forms which are now outdated, confronted with the internationalisation of production, a large unemployment and the new technological paradigms. This opposition is an evidence for a still deeper paradox. Since a decade, *markets and democracy have been trading places*. During the Sixties, the governments used to make strategic decisions, whereas underdeveloped and highly regulated financial markets were playing a quite minor role, even in allocating capital to alternative sectors or individual firms. Taking in charge the long run was the task of the State, adjusting short run disturbances the role attributed to the markets. Nowadays, the highly sophisticated financial markets do scrutinise any government initiative, in order to check its long run viability and sustainability. Conversely, governments try to have an efficient short-run management in accordance with the criteria sets by the bond markets, which have built a large autonomy with respect to public authorities, including international organisations such as IMF, World Bank, WTO or OCDE. In a sense, the launching of the Euro does not dissipate this ambiguity: will a tentative control of the European currency be *a step in the direction of a victory of collective interventions over market forces…or conversely, will it be the hidden strategic device, invented in order to bring the forces of globalisation into the inner domestic space of each member State?*

Building an integrated framework, able to capture the complexity of "Europeanisation".

The current debate is polarised by strong opposition between the tenants of the Euro and its opponents, i.e. a black and white picture with few nuances. Analysts should recognise the complexity of the issues at stake and develop original frameworks able to en-light some of the major political choices, both at the European level and the domestic one. In order to do so, one has to recognise how contradictory the current phase of European integration is and how detrimental is the division of the academic research between economics, political science and law.

A challenge to conventional economic theory.

Actually, all these paradoxes boil down to a central feature present in all of the arguments in favour of the Euro. They derive from an economic theory which considers that markets are the more adequate mechanisms for managing modern economies. Thus, the role of public authorities is to reform the really existing institutions in order that they resemble more and more to the outcome of ideal of pure and perfect over markets. In this world, the polity per se is non existing, since its only function is to move the economy towards a pure market equilibrium, which is supposed to be a Pareto optimum. This vision is in line with the general trend of macroeconomic theorising, which consider that markets are self equilibrating and that the unique rational objective of the governments is to adopt pro-market reforms. This is at odds with the Keynesian vision, which had been adopted by most governments until the Seventies. During this period, it was quite common to assume that markets are unable to deal with uncertainty, externalities and even the simplest coordination problems. It is noticeable that this old framework is rarely used in order to assess the impact of the Euro, whereas its impact upon effective demand is far from absent.

More precisely, the conventional arguments in favour of the Euro run as follows (EC Commission 1990 ; de Silguy 1998). The irrevocable fixing of exchange rates among the participant countries removes the basic uncertainty which was hindering the deepening of the Common Market. Simultaneously, transaction costs are reduced which enhance both external trade among countries and the profitability of the firms (Table 2). The clause about excessive public deficit does benefit to the credibility of the Euro, still enhanced by the large

TABLE 2 : WHY EUROPEAN MONETARY INTEGRATION?
An underestimation of political and institutional factors

RATIONALE FOR EURO	ASSESSMENT BY CONVENTIONAL ECONOMIC THEORY	 INSTITUTIONAL/POLITICAL APPROACHES
1. It becomes a major player in the International Monetary Arena.	- Less reserves in $ for Central Banks. - Some « seigniorage » for Europe. - More control over exchange rate. - Euro becomes a strong currency.	- The building of credibility requires quite restrictive policies. - Long term inertia in the effective use of key currencies. - Major instabilities if three independent monetary policies (USA, Japan, Europe). - Conflicting views across national governments about the optimal exchange rate for Euro.
2. It removes intra European uncertainty about exchanges rates.	- Allows to deepen the benefits deriving from the single market. - More predictability enhances invest-ment by European firms.	- These gains have been small during the last phase (1,2% of European GDP in 1994). - The uncertainty about « Ins » and « Outs » is still present.
3. It reduces transaction costs associated to exchange from one money to another and completes the single market.	- Enhances welfare in Europe by 0,4% of GDP. - European consumers will be able to compare more easily prices : more cross border competition.	- The implementation of Euro is costly for banks, firms, governments. - The remaining obstacles to the single market are not removed (taxation, dealers networks, national regulations, and so on...).
4. It reduces uncertainty about European trajectory.	- Buoyant expectations about European competitiveness drive domestic and foreign investment. - Lower and more stable interest rates.	- A strong Euro may hurt price competitiveness, - High interest rate and erratic evolution of expectations due to the diversity of national interests and management.
5. The extension of Bundesbank principles to the European Central Bank delivers price stability in the long run.	- The credibility of the German monetary policy is extended to the rest of Europe. - The German institutions will permeate the restructuring of Europe.	- The imperfections of the Amsterdam treaty trigger some doubts from financial markets. - It is difficult to « import » German industrial relations, training systems, decentralisation of industrial policies. Therefore possible failures.
6. The European Central Bank will monitor monetary policy in accordance with European juncture.	- More symmetry between Nations than within the current system led by Bundesbank in conformity with German needs. - Better macroeconomic outcomes for the whole European economies and for each national economy. - In the future, most shocks will be symmetrical.	- The principles adopted may hurt the conventional ways for doing economic policy by economies far away from the German configuration. - If average European evolution does not exist, then *all* countries may worse off : ° Germany unable to take full account of the cost of reunification. ° Other countries are hurt by an inadequate *central* policy. - Some major asymmetric shocks are to be dealt with.
7. The countries with former weak currencies will get lower interest rates.	- There is a single European key interest rate. - The formally weak currencies benefit from the shelter provided by the Euro.	- Each national entity (firms, governments) will issue debts with its own rating. - The heterogeneity of fiscal and spending policies casts some doubts about the value of Euro: will the « weak » currencies drive out the « strong » ones?
8. The Maastricht criteria and the Amsterdam treaty pact promote better national public policies.	- The trends initiated during the 90's could not be sustained in the long run, even in the absence of EMU. - Euro is the starting point for political integration in Europe.	- The criteria fulfilment triggers pro-cyclical policies and untimely adjustments. - EMU severely restricts the autonomy of governments, that may loose legitimacy and support from citizens. - The building of an European political arena and related institutions is a requisite for the viability of Euro.

independence granted to the European Central Bank. Therefore, all the members should benefit from lower interest rates, which is specially important for countries which used to experience high inflation rates, such as Italy or Spain. Under the binding constraints of the Amsterdam Treaty, each national State faces strong incentives to rationalise and modernise its tax and welfare systems. Similarly, the labour markets are made more flexible, in order to cope with the loss of the exchange rate as an adjusting mechanism, when a loss of competitiveness has to be compensated. When all these mechanisms are added up, the European Union would benefit from a renewed dynamism under the new common currency: more innovation, faster growth, more employment, higher profit and even real wage increases. This is the charm of any Pareto improving reform.

But precisely, this is a drastic idealisation of the consequences of the Euro. Actually, many arguments can be opposed to this very optimistic presentation. The more so since after the European Summit of May 1998: then many analysts and even the experts of European Commission do recognise at last the costs associated to the implementation of the Euro (EC Commission 1997 ; 1998). This essay is devoted to the investigation of the costs and benefits of the Euro, that are quite contrasted according to each scenario. Before doing so, it is important to discuss some methodological problems, which are at the origin of the conflicting assessments of the EMU.

First of all, the optimism about the deepening of the Common European Market is built upon a very naïve conception about the *creation and functioning of any market*. It is assumed that a common currency makes easier price comparisons across national borders and therefore that the law of the single price will prevail all over Europe after the completion of the Euro. But , for instance, the price formation in the car industry clearly shows that the very same product may have quite different prices according to the system of retailing, taxation, the relative strength of the national producers and of course, the tastes of domestic consumers (Commission Européenne 1996b). Basically, markets are social constructions (Favereau 1989), not the outcome of any “natural” economic process, and they may take contrasted configurations (White 1998). Furthermore, modern economies do combine markets along with private hierarchies, State interventions, communities, associations and networks and their performance is not related to the purity of market mechanisms but the *coherence of the institutional arrangements* combining all these coordinating mechanisms (Hollingsworth and Boyer 1997).

A second objection relates to the *conception of money*. The proponents of EMU exhibit a strange schizophrenia. On the one hand, most of the theoretical models, such as Real Business

Cycles ones, postulate a complete neutrality of monetary creation in the medium and long run. If so, the management of any currency may only have transitory effects. Thus, the Euro would not be important at all and one may wonder why governments have accepted to abandon a fraction of their sovereignty against such minimal and transitory gains. On the other hand, the official statements (de Silguy 1998: 110-18) argue that job creation will result from the Euro, as was previously mentioned. But then, money is no more neutral, neither in the short run, nor the long run, since monetary policy influence interest rates, credit and capital allocation, the direction and the speed of innovation, i.e. long term growth pattern. This contradiction between *the technical references and the popular presentation* is quite damaging for the legitimacy of the Euro. Last but not least contradiction, as soon as the Monetary Council of the ECB has been appointed, its very first statement has been to stress that the national monetary policies followed during the second phase of the EMU have had no responsibility about the level of European unemployment and that in the future, the Euro will have not any impact at all upon job creation. The Council of ECB seems to confuse the theoretical model of a market economy with actually existing capitalism, and this discrepancy may hurt the realism and acceptance of the policy followed by the European Central Bank.

Similarly, the discussion about *the objectives and the tools of the ECB* seems to consider that any national economy do resemble one with another, probably because they are supposed to be market economies, bound to converge towards an idealised Walrasian equilibrium. If this assumption were true, no problem for the viability of a common European monetary policy. Unfortunately, many comparative studies, be institutional, statistical or econometric, confirm that the functioning of the domestic economies remain quite different (Crouch and Streeck 1996 ; Berger and Dore 1996), even for the countries as closely linked as France and Germany. Not to speak about the large discrepancy between Northern and Southern economies, or the major differences between the UK and continental Europe about the conduct of monetary policy . Therefore, these major institutional differences show up into different adjustments on the product, credit, and of course labour markets (Crouch 1993 ; Dore, Boyer and Mars 1994). Consequently, *the same monetary policy* may have *totally different outcomes* for various countries: instead of homogenising Europe as a continent, the EMU may well exacerbate national heterogeneity…even if the common European policy may remove some of the previous idiosyncratic shocks associated to the autonomy of national economic policies (Calmfors & Alii 1997: 312-24). Incidentally, this argument relates to real convergence, and of "régulation modes", not to the typical nominal convergence of inflation and interest rates which has been achieved by the eleven countries admitted into the first round of the Euro. This benign neglect for these institutional differences may be quite risky for the future of the EMU. This is a central theme of the present essay, and it is largely developed subsequently.

A fourth limit of the conventional approach to the Euro is to polarise the analysis over a very specific form of uncertainty, that related to *exchange rate variability* in the context of full capital mobility. No doubt that the fixing of the rate of conversion of each national currency into the Euro will remove definitively the repetition of the European currency crises which have been so frequent. But uncertainty is intrinsic to the very process of capitalist competition and it is enhanced when financial markets are fully developed and sophisticated. Therefore, one may expect *the shift from one kind of uncertainty (about exchange rate among member States) to other forms:* uncertainty upon the exchange rate of Euro with respect the Dollar and the Yen, the degree of cooperation or alternatively conflict between national budgetary policies, the credibility of the Euro as a permanent feature of European integration, and so on…. Will finally the degree of uncertainty be lower after the Euro than before? The jury is still out. Any economic system is reducing some type of uncertainty at the cost of a possible extension of another kind of uncertainty. In assessing the post Euro configuration, too many analysts tend to consider that exchange rate uncertainty is the most detrimental (De Ménil 1996) and that therefore the stability of the EU will be enhanced. But a fully convincing empirical evidence is far from available: there is no consensus among economists about the effective costs of exchange rates variability (Calmfors & Alii 1997: 19-39). To paraphrase a motto of the French historical school of the “Annales”, “*any economy displays the uncertainty associated to its structure*”. But it is reasonable to think that on the whole financial and economic uncertainty will be reduced due to the fact that Member States are more dependent from intra than extra European trade and financial transaction. But new forms of external or political uncertainty may emerge.

A final, but fundamental, criticism may be addressed to the usual vision of economists about the significance and impact of EMU. The role of the national governments would be to implement the reforms which are deemed necessary by European experts in order to adapt each economy to the requirements of the Maastricht and then Amsterdam Treaties. *Polity would be the direct expression of the economy*…a quite economicist vision indeed! Actually, the very tradition of political science and the recent resurgence of political economy convincingly convey the message that politicians deal with power relations whereas entrepreneurs are concerned by economic activity and capital accumulation . From a logical point of view, these two motives have no direct relations, even if ex post, the two economic and political spheres are indirectly linked (Théret 1993 ; Palombarini 1999). On the one hand, a stable constitutional order is quite essential for property rights enforcement. On the other hand, any State requires minimal material resources, i.e. a sufficient level of economic activity as a potential for tax basis. Therefore, any viable society has to combine these two requirements, which ex ante are not necessarily compatible. In many instances, this compatibility is the unintended outcome of structural crises, during which both polity and economy are in a sense synchronised again. If one adopts this vision, then the EMU project does not exhibit any clear viability, since the inner logic of both European and national political arena is not taken into account. Will citizens accept this transfer of responsibility without countervailing power at the European level? If important decisions are taken by the ECB, a priori largely independent, who will control this new body? If the building of the credibility of Euro imposes some large costs, for instance in terms of slower growth, will public opinion accept such adverse outcomes, specially within the countries where the Euro has been presented as a solution to the unemployment problem? (Mazier 1997).

All these questions relate to the issue of the political aspects of the Euro and its impact upon institutionally rich societies, a problem largely neglected by most of research on the consequences of EMU.

Integrating polity and economy.

For conventional theory, economic policy is assumed to be the consequence of a rational calculus operating on purely economic variables: the evolution of consumption, a measure of welfare and the rate of interest. Basically, according to this vision, there is no autonomy whatsoever between polity and economy, the former being the direct expression of the later. In a sense, the old Marxian theory had the same simplification, when it stressed that the State was operating to the benefit of the class of capitalists, and not for the well being of the society as a whole. As already mentioned, this is the implicit presentation of the Maastricht and Amsterdam Treaties by European Commission Officials. It is a quite common vision among contemporary economic theory (Figure 2 – first part).

There is a part of truth in this presentation. The large financial liberalisation creates strong tensions into the European Monetary System, which is a threat to the completion or even the viability of the Single Market. Thus the Community may have pursued “an inconsistent quartet of free trade, exchange rate discipline, free capital movements and autonomous domestic policies” (Padoa and Schioppa, 1985: 116). Three options were opened in early Eighties: “(i) directly following consistent and coordinated policies; or arriving at such policies through either (ii) capital market integration or (iii) monetary union" (Padoa and Schioppa, 1985: 116). But the path followed is up to political intergovernmental decisions, which was clearly recognised by the Delor's committee for the Study of Economic Union: "Although in many respects a natural consequence of the commitment to create a market without internal frontiers, the mode towards economic and monetary unions represents a quantum jump which would secure a significant increase in economic welfare in the Community. Indeed economic and monetary union implies far more than the single market programme and (…) will require further major steps in all areas of economic policy-making (…). The question when these stages should be implemented is a matter for political decision" (Committee for Study of Economic and Monetary Union 1989: 116). This programme presented in March 1989 could never have taken place. It was approved by the Madrid Council of June 1989 and this could be done to previous discussion among French and Italian Ministers of Finance in order to build a countervailing power to the role of Germany in designing the monetary policy for Europe. Polity is therefore strongly present in the process. One may even consider that the German reunification gave a definite impetus to the EMU. The French government wanted to tie firmly Germany to Western Europe and proposed to launch the EMU, whereas the German government was eager to develop a political integration of Europe, possibly along federal principles (Story 1998). This explains why both the Maastricht and Amsterdam Treaties display three pillars, not only the monetary side but defence and security aspects. Since German public opinion is highly attached to the Deutsche-Mark as a symbol of monetary stability, strong requisites were imposed to the expected participants to the Euro in order to preserve the same monetary stability as experienced in Germany. Clearly, the Euro does not derive from a cost benefit analysis about the reduction of transaction costs and exchange rate externalities but it is the outcome of a political bargaining among Nation-State. According to a second vision, polity comes first, and the economy should follow…according to a second vision which is the strict opposite of the first one (Figure 2 – second part).

But is it that sure that any decision taken by governments will be compatible with the inner dynamics of economic adjustments and their transformations? Specially if the reform is structural and far reaching as the EMU is. Since the breaking-down of the Bretton Woods system, exchange rates are no more a purely political variable since they are formed upon currency markets via the interactions of various expectations. Given the financial globalisation, they play a major role than governments. Therefore, the Euro has to convince the international financial community about its relevance, viability and long run legitimacy.

FIGURE 2 : POLITY AND ECONOMY : THREE VISIONS

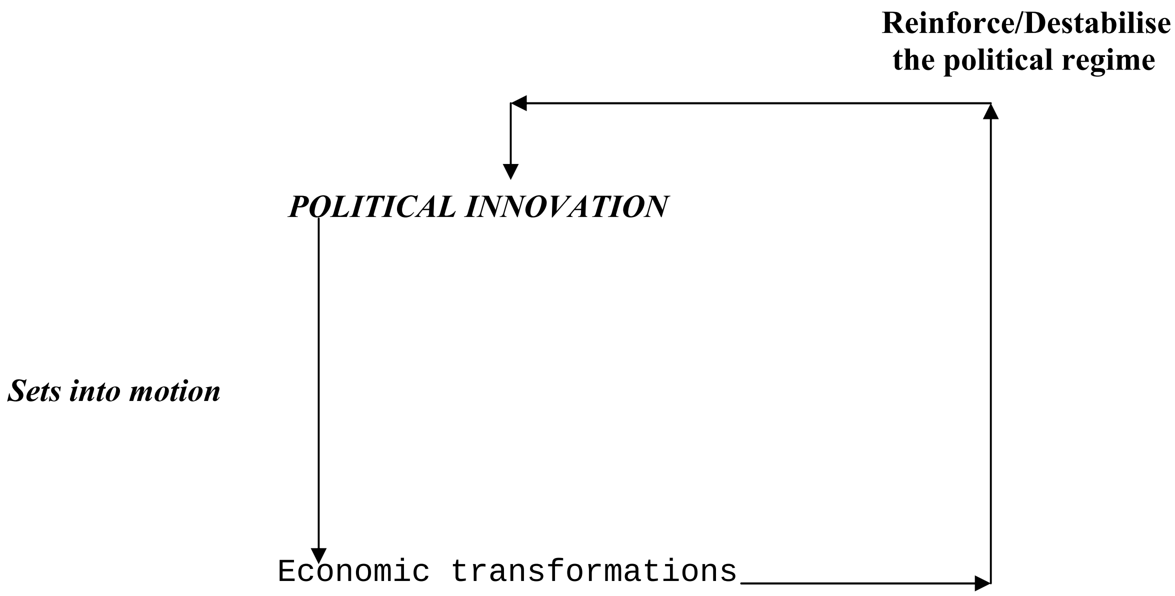
- ***The first vision : the primacy of economic determinism over political decisions.***

ECONOMIC RATIONALITY ⟶ ***OPTIMUM ECONOMIC POLICY***

- ***The second vision : polity comes first, economic forces do follow.***

POLITICAL PROCESS ⟶ THE COMMAND ECONOMY

- ***The third vision : the nestedness of polity and economy sets into motion a dynamic process of structural changes.***



Consequently, *neither the economicist vision nor the primacy of polity define a correct vision fort the future of the EMU.*

A third vision seems much more satisfactory since it deals with the two sided causality: from the economy to the polity and conversely. Furthermore it stresses upon the evolutionary aspect of these interactions with possible unintended effects (Figure 2 – third part). The political innovation put forward by the Maastricht Treaty sets into motion a series of economic transformations, most of them being probably unintended. Just to take one example, analysts have paid a large attention to the consequence of the Euro upon the product market. But as the first of January 1999 approaches, the most dramatic impact seems to bear upon financial markets, banking and insurance (Davies, Graham 1998). In turn, the related concentration will influence the governance mode of industrial firms, their investments, localisation and finally employment and income distribution (Froud and *alii* 1998). By comparison, the completion of the Single Market for manufacturing goods may seem of minor influence, compared with this epochal change. But in democratic societies, citizens are entitled to express their feelings about the conduct of domestic economic policy. If structural changes, triggered by the Euro, end up in opposing losers and winners, then the political regime has to take into account this polarisation, and consequently, revise its economic policy.

Euro will define a coherent socio-economic regime only if it can *make compatible the evolution of the "régulation mode" along with the transformations of the political regime*. This conception, which links polity and economy, is implemented by the subsequent developments of the present essay.

The Euro seals a complete shift in the hierarchy of post-W.W. II institutional forms

Therefore, the current phase of monetary integration is not simply a "rationalisation" of previous national policies, nor an incentive to the deepening of the Single Market. Basically, it implements a major structural change in the way national economies operate and interact. It is quite partial to compute the welfare gains associated to the Euro, as if it was a simple marginal reform around a well established market equilibrium in order to reach a Pareto optimum. Actually, the very adjustments governing credit, finance, capital formation, employment decisions and even innovation will necessarily be transformed. Thus, not only are the national business cycle possibly transformed, but the very growth pattern is likely to be affected. It is therefore important to adopt a long term view and to reassess the specific impact of the Euro along with other contemporary major transformations. “Régulation” theory might be useful in analysing this issue (Aglietta 1982 ; Boyer 1986 ; Boyer 1988 ; Boyer and Saillard 1995) since it is specially concerned by the institutional transformations of capitalist economies.

Instead of referring exclusively to markets mechanisms, this framework analyses capitalist economies as an architecture of institutional forms which are social constructions and generally result from past political compromises. The *monetary regime* describes the rules governing the credit and payment system. Competition, collective agreement, labour laws, define the rules governing labour organisation, wage formation and the life-style of wage-earners, i.e. the *wage labour nexus*. Competition laws, the barriers to entry, the number pf firms and the implicit or explicit coordinating procedures among them, are the source of alternative *forms of competition*. The nature intensity and level of public interventions, the degree of embeddedness of State into economic activity define various *forms of the State*. Finally, the way a Nation-State relates to rest of the world in terms of trade, investment, finance, diplomacy and Defence may take many features and shape alternative *forms of insertion into the world economy*.

Given these basic concepts, then “régulation” theory analyses whether the conjonction of these institutional forms, with distinct or even opposed logic, deliver a viable development pattern. This pattern has two components: first a long run accumulation regime, and second a short run process of adjustment to the recurring disequilibria of accumulation and social conflicts inherent to any capitalist economy, i.e. the “régulation” mode. This framework has delivered a fresh interpretation of the long term evolution of American (Aglietta 1982) and French capitalism (Bénassy, Boyer and Gelpi 1979), the post World War II golden age (Marglin and Schor (Eds) 1990) and the reason of its demise (Basle, Mazier and Vidal 1984 ; 1994) and the origins of European unemployment (Boyer (Ed.) 1988 ; 1997b). The European integration is the current challenge addressed to this theory (Dehove 1997 ; Mazier 1997) and the present essay is a first step into this research agenda.

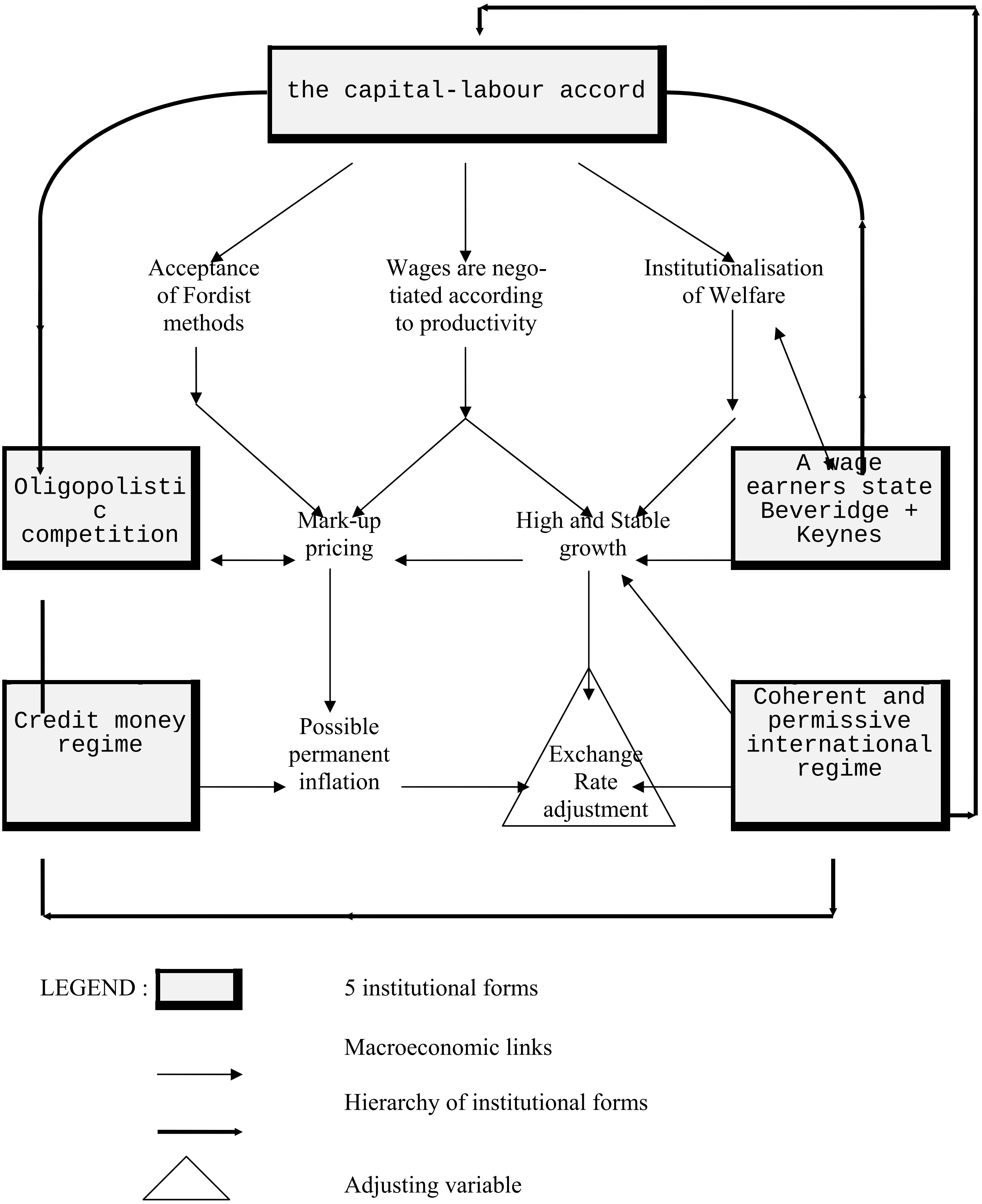
1945-1973: the national labour compromise rules over the monetary regime.

It might be useful to go back to the origin of the post-WW II exceptional growth. The major political and social transformations which occurred at that epoch have been preventing the repetition of the dramatic events of the inter-war years, i.e. a major financial crisis, then a depression which precisely lead to the second WW. Structural and diverse public interventions have been at the core of this success. Paradoxically enough, this is contrary to the current conventional wisdom about what should be a sound economic policy. In most countries, the Central Bank was highly dependent from the Ministry of Finance, markets were severely regulated and controlled by public authorities. Capital mobility was very low, external trade limited but growing. Last but not least the labour contracts were highly institutionalised (minimum wage, indexing of wage with respect to productivity and past inflation, surge of internal labour markets,…). Nevertheless, economic performance has been exceptional in terms of productivity, standard of living, full-employment and even business cycle dampening.

For "régulation" theory this a priori surprising outcome is the result of *the coherence of the institutional architecture* built upon the central role of the post-WW II capital-labour accord (Figure 3). The implementation of productivity sharing allows the development of mass-production and consumption, which stabilises the growth pattern by approximately synchronising the extension of production capacities and the generation of effective demand, within societies where wage earners are the vast majority of the population. The State is transformed by the impact of this capital-labour accord since it then promotes the access to education, housing, healthcare, retirement funding. Clearly the nominal wage is no more a price set upon a typical market, but the consequence of a series of labour contracts, frequently implementing a seniority principle and a competition for internal promotion. Given this structural compatibility between the trends of supply and demand, the price of manufactured goods, specially the durable ones, is set according to a mark-up principle, with minor influence of transitory market unbalances.

In this context, *monetary policy used to be the "servant" of the capital labour accord and oligopolistic competition*. Capital was not really mobile across borders and the international relations were stabilised under the hegemonic role of the US and specially the institutions defining the Bretton-Woods system. Given this international stability, the exchange rate used to be set by national public authorities and it was adjusted when the previous fixed rate could no more be sustained, mainly due to trade deficit and after the Seventies, the emerging phenomenon of flight of foreign capital. If one country experienced an higher inflation than the rest of the world, a devaluation allowed a return to external trade equilibrium, while mitigating the conflicts upon income distribution. In a sense, the national monetary policy was in charge to alleviate tensions upon income distribution and the exchange rate was a discretionary tool, when inflation became too important. This pattern was prevailing in the

FIGURE 3 : THE POST W.W.II CAPITAL-LABOUR ACCORD SHAPED MOST OTHER SOCIO-ECONOMIC INSTITUTIONS



vast majority of European countries. One exception, Germany, which experienced a rather different hierarchy…quite similar to the one which is now embedded into the Amsterdam Treaty.

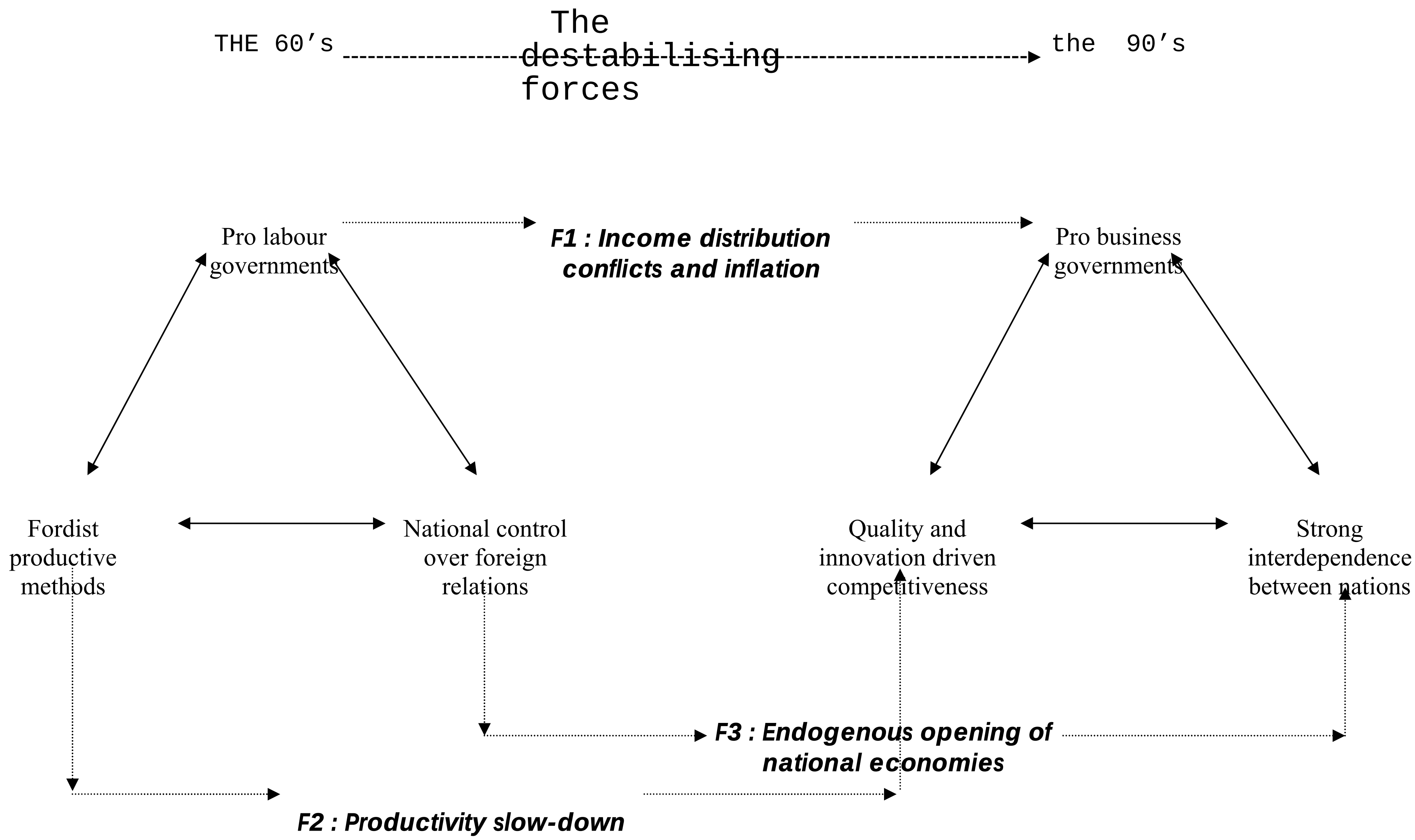
Therefore, an *accommodating monetary policy was essential in preserving the cohesiveness of the national architecture of institutional forms* and specially the primacy of capital labour accord. This mode of "régulation" was very convenient for policy makers, since it was reconciling dynamic efficiency and social justice in the direction of wage earners. Why did this system come to an end?

Since 1973, three major structural changes.

Basically, the very success of this style of economic management has led to the endogenous erosion of the stabilising properties of this unprecedented regime. Three structural transformations explain its demise. The EMU is partially a tentative answer to some of these transformations (Figure 4).

- First of all, the mass-production techniques and organisations have been experiencing a productivity slow down, initiated in the American economy, but which has diffused to other industrialised countries after the two oil shocks. Therefore, the conflict upon income distribution became more acute, inflation tended to speed up, triggering significant financial instability. In a sense, the monetarist counter-revolution is a response to this potential threat, whereas the shift towards flexible exchange rate takes into account the significant heterogeneity in inflation rates. After two decades, *new productive organisations* are emerging and tend to replace the Fordist ones, but until now total factor productivity has not recovered the previous trends. Again this has an impact upon Industrial Relations which have to take into account a slow-down in real wage, as well as more decentralised wage bargaining in order to cope with sectoral changes and new sources of competitiveness.
- Second, the significant slow-down in growth rates, specially in Europe, do affect the previous political alliances, according which even the rather conservative governments had *pro-labour policies*. The surge of unemployment weakens the bargaining power of unions and workers, whereas a new wave of organisational and technological innovations destabilise the job demarcations and hierarchy of skills which were at the core of the post-WW II capital - labour accord. Further more, the large freedom granted to productive and portfolio investment gives a premium to internationalised firms, which tend to look for markets and production sites faraway from their domestic space. Again this is destabilising the capital labour accord, and the wage labour nexus has to be adapted to the new conditions for

FIGURE 4 : THE THREE REASONS FOR THE DEMISE OF THE POST-W.W.II SOCIO-ECONOMIC REGIME



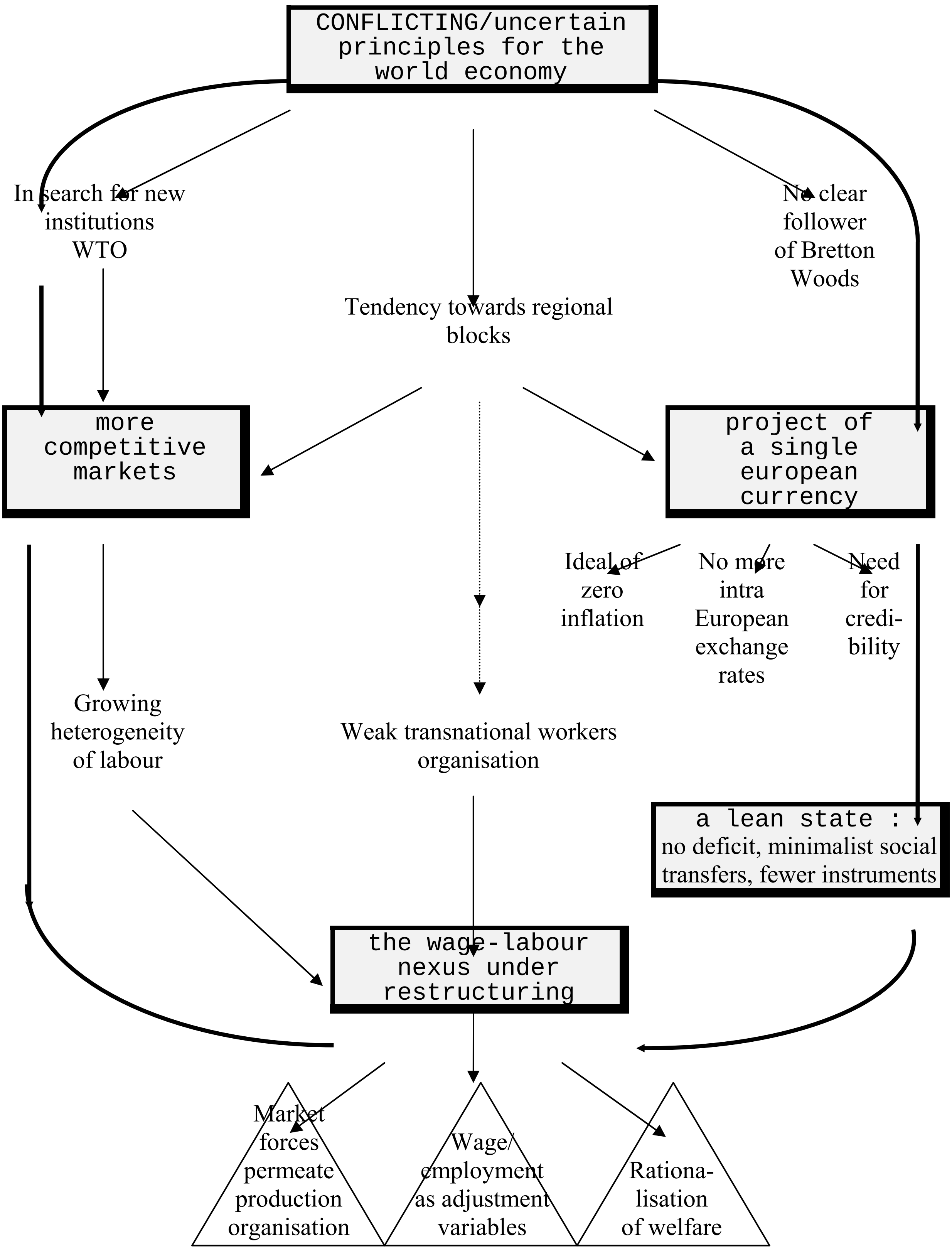
competition. This is a second evidence about the shift in the hierarchy of post-WW II institutional forms. Last but not least, the governments themselves, whether conservative or social democrat, tend to adopt *pro-business legislation, taxation* and welfare reforms.

- But the most relevant transformation is without any doubt the growing *de-connection* between the space upon which *economic activity* takes place and the *territory controlled by public authorities*. Since a larger fraction of production is exported and a significant part of the investment may come from abroad, the domestic circuit of mass-production and consumption opens up and tends to be replaced by an export led regime, at least for some countries (Bowles and Boyer 1995). Last but not least, the dynamism of financial innovation, the creation of world financial markets and the difficult curbing down of public debt totally change the conditions and objectives of national monetary policies. After 1982, financial markets have promoted anti-inflationary policies, via high interest rates and then they have been pushing and extending such a strategy all over the world. The national Central Banks nowadays put the main emphasis on price stability, whatever the costs in terms of growth and unemployment. The exchange rate is then a pure market variable, with fewer and fewer controls from national or supra-national public organisations. Simultaneously, the financial markets diffuse quick changes in the formation of expectations and they usually over react to public statements and budgetary policies.

The EMU project, already present in the discussion back in the Seventies, has been arising a renewed interest in the Eighties, for it was a tentative in order to restore a minimal control over monetary policy, let it be nowadays at the European level and no more the national one. Speculation among European currencies is by definition forgone, whereas the density of intra-European trade tends to synchronise the cycle of the core countries, but not necessarily that of the more recent member-states. Not to forget that the overall exposition of EU to external trade is similar to the level observed both in North American and in Japan. Consequently, a common monetary policy could have the same relative autonomy as the one enjoyed by the Federal Reserve Board….or the Japanese Ministry of Finance.

This historical retrospect helps in correcting a frequent misperception about the Euro. For most anti-EMU, it is the main culprit for all the evils borne by European countries, from financial concentration to mass unemployment. Actually, the common European currency is a response to already *existing structural problems*, which of course are transformed – for better or for worse –, but not created by its launching. Any scenario with the Euro should always be compared to alternative evolutions, built upon different measures in order to tentatively overcome the (same) current European problems.

FIGURE 5 : THE EURO IMPLIES A NEW HIERARCHY AND ARCHITECTURE OF EACH NATIONAL SOCIO-ECONOMIC REGIME



Nowadays the monetary regime and the form of competition come first.

Nevertheless, the Euro is a component of the complete shift in the hierarchy of institutional forms which differs drastically from the configuration of the Golden Age (Figure 5, to be compared with Figure 3). Basically, the national territory is now inserted into dense international relations, in such a way that the competition at the world level permeates nearly all other institutional forms. The large freedom of national competition policy is now restricted by international treaties extending the GATT to the World Trade Organisation (WTO): a government may object to a fusion or absorption of one company by another, even if this concentration takes place faraway from its domestic territory. This process is sometimes called the *globalisation of competition*. It takes another form within the NAFTA or the EU, where a transnational organisation is in charge to check the legitimacy of any concentration, under the general principle of fair and open competition. Therefore, price competition is more acute in the Nineties than during the Sixties, even if price wars are limited to a small number of sectors. Clearly, the workers have to take into account this pressure of competition in nearly any component of the labour contract and wage labour nexus.

Market forces tend to permeate *production of organisation* with such innovation as Just In Time or more traditionally the flexibility of working time in reaction to the evolution of demand. Similarly, firms look for more rapid employment adjustments, but of course voluntary labour mobility usually declines along with the scarcity of job opportunities which is observed since a decade in Europe. May be the most numerous innovations concern *the pay systems*, which have been transformed in various directions: diffusion of profit sharing, individualisation and decentralisation of wage bargaining, reduction of seniority wage opportunities, recognition of individual merit and ability, much more than general increases decided through collective bargaining. Finally, even the *Welfare State* is transformed since the slow growth reduces the tax basis, whereas a high level of unemployment, frequently of long duration, and the rapid development of early retirement extends social expenditures. Consequently, many reforms have been implemented in order to curb down the recurring tendency to Welfare Systems to run into deficit. In other words, the wage labour nexus has become dominated by the logic of competition and the objective of a "lean State", at odds with its central role during the Sixties.

The European single currency is part of this general picture, since it brings other pressures and opportunities over the restructuring of the wage labour nexus. The fixing once for all of exchange rates among members does remove the “security valve” that represented devaluation and conversely appreciation of the national currency. This will bring a major change for the national “régulation” modes that used to solve income distribution conflicts by an accommodating monetary policy, i.e. possibly more inflation and in many instances devaluation. Some Industrial Relations systems already take into account the objective of competitiveness of national firms without any use of exchange rate variations. But others don’t and are therefore undergoing some strains: long run unemployment, erosion of the extent of legal protection and Welfare benefits,…. The motto *“let us make labour markets more flexible”* is adopted by many governments, that undertake more or less ambitious reforms. For instance, the French government in 1995, the German Chancellor in 1997 have tentatively changed labour laws and welfare components in order both to fight against unemployment and to be ready to the Euro.

Such reforms are not so easy, as evidenced by the general strike in France on December 1995, the similar mass protests in Germany. Similarly, the fact that European multinationals now optimise their production over the whole continent has caused a highly emblematic first Euro-strike, when Renault decided to close its Vilvorde factory in Belgium. Finally, once the decision of creation of the Euro has been taken, national governments, experts from the European Commission and the Advisory Council of the ECB talk more and more frequently about the need for *daring and radical reforms* of labour laws and the welfare system. There is a strong presumption that the old “régulation” modes cannot enter unchanged into the next century and the Euro is *adding* one reason for such reforms. This would be the case even if by an extraordinary conjunction of favourable factors, the wage labour nexus became more and more Europeanised, in tune with the ECB policy.

This last remark raises the important issue of a new institutionalisation of the wage labour nexus, which cannot be summarised as a simple convergence towards pure labour market mechanisms, an ideal which is out of reach and non necessarily optimal for the society as a whole (Boyer 1993b). Furthermore, the Euro may resemble to the gold standard system, but with a major difference: during the 20th century, wage earners have won significant welfare benefits, concerning education, training, health care, housing, retirement. These components definitely remain managed at the national level, not at all at the European one. Therefore, the present European construction is threatened by a hidden but important risk. Workers may finally consider that the *Amsterdam Treaty is a source of reduction in their social and* *economic rights and that it does not bring any new advantage for them*. Hence a polarisation between an internationalised elite that would reap the benefits of the Euro and various social groups, nationally centred, which would bear the costs of adjustments. This is one *major institutional and political deficit of EU*.

This danger has been perceived by the European Commission experts as well as by the European Parliament. The Maastricht Treaty does display some social clauses, precisely to restore such a balance between economic objectives and social concerns. But it is to be noted that these clauses are quite few and only set *minimal rights or legislation* about equal treatment of men and women, work duration and night work as well as information procedures when a European firm closes a plant. Of course, under the aegis of the “Social Dialogue”, representatives of business associations and workers unions periodically meet in order to define possible agreements which could become the skeleton of a social legislation at the European level. For the time being, the achievements of this dialogue have been very modest, concerning for instance parental leave, part time job or information disclosure by European multinationals. The closure of the Renault factory at Vilvorde has shown both the need for such a cross-border negotiations and legislation and the considerable difficulties in implementing the embryo of a social Europe. The negotiation of the Amsterdam Treaty has not fulfilled the wishes of workers unions, nor the statements of the President of the European Parliament according which the new treaty should have displayed an important social component (Gil-Robles 1997).

This is not a real surprise, since the density of cross-border links between wage earners unions is quite weak, whereas business associations and sectoral interest groups have much more opportunities to meet and coordinate their strategy, specially when the European Commission is designing new norms rules or legislation (Schmitter 1997a ; 1997b). Not to mention the high frequency of financial transactions which tend to optimise in real time the rate of return of invested capital and therefore exert a strong influence upon exchange rates, stock market indexes, public bonds interest rates. By contrast, the workers are quite immobile and severely lack the dense coordination procedures that would be necessary to defend their common interests at the European level. This asymmetry has another important consequence upon the viability of the EMU.

One single monetary policy but still contrasted national "régulation" modes.

Thus, monetary policy becomes European, but labour policies remain national…and they are quite heterogeneous indeed, since the post-WW II capital - labour accord took many contrasted configurations, which are far from equivalent (Boyer 1988). *The second structural deficit of EU is precisely that it is difficult to have a common monetary policy in the presence of such different national interests, economic specialisation, labour laws, and even business cycle patterns*. Of course, this is not a total novelty: since the implementation of the European Monetary System (EMS), the *«Bundesbank»* was playing the role of a Stackelberg leader in the determination of European interest rates. They were set according to the situation and needs of the German economy, and other countries had to follow, even if their domestic situation was different. The management of the German reunification is a good example for such an asymmetry: real interest rates have been raised to finance the German public deficit, at the very moment when other economies needed an expansionary policy. But precisely, the Euro project intends to develop a more balanced European monetary policy. Germany has accepted to abandon the highly symbolic Deutsche-Mark – not without significant political costs at home as evidenced by the loss of popularity of Chancellor Kohl between 1997 and 1998 –, provided that Europe adopts a German style for monetary policy. This meant a highly independent European Central Bank with the quasi exclusive objective to control inflation.

If money were neutral, as most neo-classical economists assume, all economic agents, being fully rational, would immediately adjust their behaviour to this new context, and actually the ECB would not exert any influence upon real economic activity, but would only curb-down inflation. Unfortunately, this is not the way really existing economies are managed. If for instance, many unions are in conflict to attract membership or if wage bargaining is fully decentralised by enterprise unions, then causal observation as well as game theory teach that nominal wage rigidity will prevail, since nobody will accept ex-ante a reduction in the relative wage. John-Maynard Keynes had already pointed out this configuration in the chapter of the General Theory devoted to the formation of nominal wage. The argument can be updated and it delivers a suggestive analysis about the dilemma the ECB is facing.

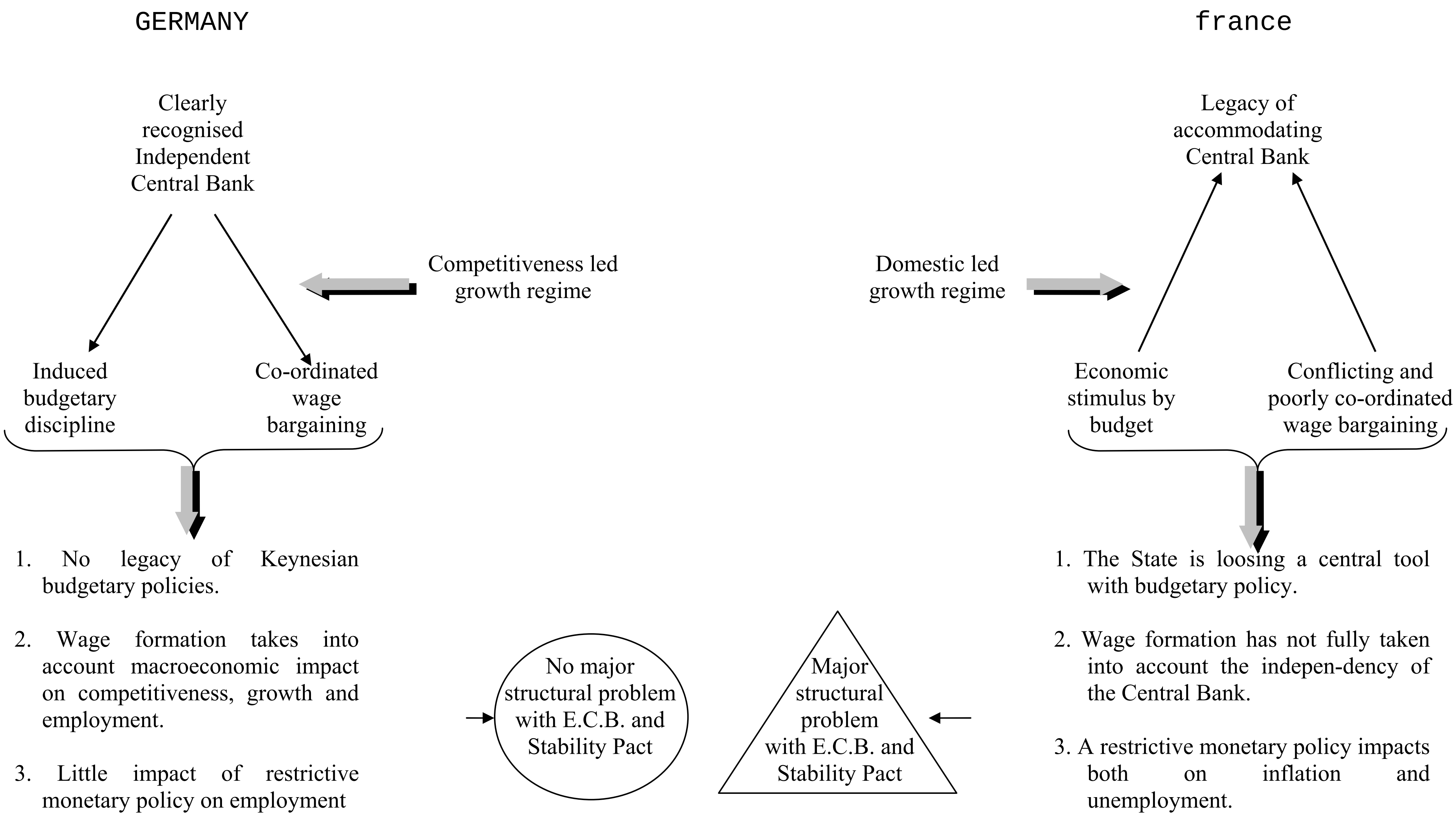
France and Germany have quite contrasted institutional architectures.

Monetarists tend to credit the *«Bundesbank»* for the German achievements in terms of low inflation and until recently rather moderate unemployment. They imply that the same policy implemented at the European level would deliver the same macroeconomic achievements. This might be true in a purely theoretical Walrasian world, with an exogenous monetary supply. But these two hypotheses do not fit with the basic features of contemporary economies. On the one hand, many *institutional arrangements* govern each market organisation and deliver different adjustment processes, and the labour market is a good example of such a variety. On the other hand, *credit is largely endogenous* since its volume result from the behaviour of banking system and the strategy of the borrowers, and therefore the Central Bank is only marginally affecting this process by changing a series of interest rates. Consequently, the same monetary policy may deliver totally different results according to the way products, credit and labour markets function. A comparison between Germany and France is quite enlightening (Figure 6).

- *In Germany*, the independence of the Central Bank and its commitment to price stability are fully embedded into other institutional forms and internalised by quite any economic actor, be it workers, unions, firms, business associations, länders, and the federal government itself. Consequently, a strict budgetary discipline is implemented, since the Ministry of finance cannot ask the Central Bank to finance any public deficit. Simultaneously, the history of the labour movement has produced a very specific process of wage bargaining, which is coordinated at the sectoral level by powerful and unified professional associations. Furthermore, the German growth regime is built upon the competitiveness of exports, by quality differentiation and not only price (Streeck 1997). Thus, the monetary regime enforced by *the Central Bank is structurally compatible with the form of competition, State interventions, international insertion and still more the wage labour nexus*. A priori, the change brought by the Euro is of degree not of nature : the social partners should now look at the ECB and no more the *«Bundesbank»* and adjust their strategies accordingly.

- *For France*, the *picture is quite different indeed*. First of all, there is a strong competition among workers unions not to accept any concession and therefore getting more memberships. Consequently, wage formation is evolving very slowly, mainly via the disciplinary role of high unemployment, and not at all the internalisation by the social partners of the costs of poor job creation. Second, until the early Nineties, the government frequently used monetary creation in order to finance public deficits, since the Central Bank

FIGURE 6 : THE SHIFT TO AN INDEPENDENT EUROPEAN CENTRAL BANK (E.C.B.) IS LESS CHALLENGING FOR GERMANY THAN FRANCE



was basically controlled by the Ministry of Finance. Of course, French inflation rate usually was higher than the German one…but until 1986 it was rather easy to alter the exchange between the Franc and the Deutsche-Mark in order to compensate the loss of competitiveness experienced by the French exporting sector. Furthermore, exports were conceived as a complement to the sales to the domestic market and the growth regime was mainly led by the dynamism of consumption, itself related to the rapid growth of the real wage (Bowles, Boyer 1995). In this second configuration too, the accommodating French monetary policy was in tune with the State interventions and the highly conflicting wage labour nexus. Therefore, the independence given to *"Banque de France"* in order to comply with the requirements of the Maastricht Treaty brings a *real novelty* into the "régulation" mode, far more challenging than the shift from the *«Bundesbank»* to the ECB.

This opposition in national policy styles has important consequences. In Germany, the growth rate and the unemployment are not directly affected by the EMU, and the tools available to the länders and Federal Government are marginally affected. Quite on the contrary, in France, the very core of State interventions are affected and given the near "anomy" of Industrial Relations, a drastic reform of wage formation at the initiative of social partners is hard to imagine. Thus, unemployment has been the cost be paid in order to keep unchanged the parity between the deutsche-Mark and the Franc. Under this respect the Euro is a follow-up of this process, with possible lock-in effects upon the future of State interventions and the form of competition. This institutional analysis delivers a surprising result: even if since one decade many macroeconomic indicators tend to be synchronised both in Germany and France, this outcome does not result at all from a convergence of the respective "régulation" modes. Therefore, the same policy of the ECB will probably have a distinct impact on both sides of the Rhine. Potential political conflicts are in the making….the more difficult to solve, the more vocal have been the statements about the complete independence of the ECB. But this result is not specific to the important but problem ridden German-French relations.

The less synchronised wage bargaining the higher the costs of an independent Central Bank.

From a theoretical point of view, the opposition between France and Germany can be generalised by considering two dimensions : firstly the degree of Central Bank independence, secondly the degree of coordination of wage bargaining across firms, sectors, skills and regions. In retrospect, one may compare the relative macroeconomic performances of OECD countries according to the four configurations obtained by combining these two criteria (Hall and Franzese 1996). It comes out that the best results are obtained when an independent Central Bank is facing social partners able to efficiently coordinate their decisions about nominal wage formation. The worst case, i.e. fast inflation and relatively high unemployment is observed in the opposite case (Table 3).

TABLE 3 : THE INDEPENDENCE OF THE CENTRAL BANK DELIVERS CONTRASTED MACROECONOMIC OUTCOMES ACCORDING TO THE INSTITUTIONS GOVERNING THE WAGE LABOUR NEXUS.

Observed macroeconomic performance 1955 - 1990.

		LEVEL OF CENTRAL BANK INDEPENDENCE	
		LOW	**HIGH**
DEGREE OF COORDINATION IN WAGE BARGAINING	**LOW**	**I** Misery Index 12,2 Inflation 7,5 Unemployment 4,7	**II** Misery Index 10,9 Inflation 4,8 Unemployment 6,1
	HIGH	**III** Misery Index 8,9 Inflation 6,2 Unemployment 2,3	**IV** Misery Index 7,6 Inflation 4,8 Unemployment 2,8

Source : Peter Hall, Robert J. Franzese (1996):39.

But the most interesting cases are the two others:

- When the Central Bank independence is associated to a very low organisation of Industrial Relations, then the inflation was nearly the same (4,8 % in cells IV and II) from 1955 to 1990. This supports the now fashionable idea that *Central Bank independence is good for price stability or at least low inflation. But, the cost in terms of extra unemployment is* *important*, since the absence of wage coordination brings an extra-unemployment (+ 3,3 %). Therefore contrary to the monetarist vision, which assumes that money is neutral in the long run, in this configuration, monetary stability has a significant cost in terms of growth and employment. This non neutrality is related to the institutional structures governing Industrial Relations.

- *Wage coordination seems quite important for reducing unemployment, whatever the statutes of the Central Bank*. If a highly decentralised and not synchronised wage formation could be replaced by a centralised and/or synchronised system, then the gains in unemployment are between 2,4 % et 3,4 % and the inflation is the same (IV versus II) or slightly inferior (III versus I). This is another evidence that monetary policy cannot be assessed independently from the prevailing institutional architecture and that it is not necessarily the unique nor the ultimate anti-inflationary tool.

This general conclusion is confirmed by a large number of research, which have used different tools and data. The analysis of the role of wage formation in the completion of the Single European Market (Marsden 1992). The study of governance modes and their relations with the monetary system and labour market institutions (Soskice and Iversen 1997). An in depth study of the origins of the German macroeconomic success (Streeck 1997). An analysis of the Dutch miracle (Visser and Hemerijck 1997). The investigation in the transformations of Italian institutions under the pressure of the Euro (Regini 1997). An historical retrospect of the links between the monetary regime and labour market institutions (Boyer 1993a). Thus, it is grounded to expect that the single European monetary policy will encounter *significant difficulties in the context of very distinct Industrial Relations systems* and specially wage formation.

This point had completely be neglected during the preparation phase of the Maastricht Treaty but may play a key role for the future of European integration. Of course, if pay systems remain basically unchanged, then, likely, labour market segmentation, or still worse balkanisation, will be the implicit solution given to the inability to work out innovative labour contracts. Actually, if unions are weak and divided, if industrial organisations are heterogeneous and if the national legacy in Industrial Relations has produced strong ideological oppositions between firms and workers, then adverse macroeconomic outcomes are quite likely. Specially unemployment and social exclusion of the low skilled workers will be the cost to be paid for such a conservatism in Industrial Relations. The efforts to be deployed in order to run against these adverse consequences will be the larger, the more distant the domestic labour institutions from the German ones. Will Germany be immune from any structural adjustment? The answer is not that self evident.

From the Bundesbank to the European Central Bank: A shift detrimental to Germany…or reinforced hegemony?

If the text of the Amsterdam Treaty is to be followed strictly, the ECB should decide its monetary policy according to average European indexes and primarily the evolution of *average inflation*. But inflation rates remain rather different. For instance in 1998, the inflation in Ireland should be around 2.7 % but only 1.0 % in France and 1.3 % for Germany, i.e. a significant discrepancy around the average European rate, forecast to be around 1.5 %. The heterogeneity of wage formation, productivity increases and forms of competition across Nations explain this discrepancy, which is likely to remain even though the common European monetary policy ends up in synchronising all national business cycles, which is currently not the case (see Figure 19 – infra).

Given this heterogeneity, the ECB should adopt a more severe policy than the *"Bundesbank"* would have decided, even if the target is European inflation were still the German underlying inflation rate. From a more theoretical point of view, the model proposed by Peter Hall and Robert Franzese (1996) stresses that the heterogeneity in wage formation is increased with respect to the large sectoral centralisation observed in Germany. Thus, if Industrial Relations outside Germany are not reformed at all, the following paradox could emerge from the implementation of the EMU (Table 4).

- *For Germany*, the European monetary policy is no more decided according to the situation and interests of Germany. For example, an idiosyncratic shocks equivalent to the German reunification should not a priori alter the monetary supply by the ECB as much the *"Bundesbank"* did after the collapse of the Berlin Wall. Conversely, if the other members of the Euro are growing faster than Germany, the interest rate should be higher than required to smooth the German business cycles. Thus, after the implementation of the Euro, one could logically expect a lower German inflation, at the cost of more unemployment. A quite surprising result indeed!
- *For other countries*, with highly decentralised wage bargaining, if a lower inflation is to be obtained on a medium term basis, more unemployment than before the Euro is to be expected. Since the Euro was supposed to enhance growth and promote job creation (de Silguy 1998), workers, unions and public opinion might be quite disappointed by this unexpected outcome. Of course, the European boom initiated in 1997 may hide the higher

underlying structural unemployment level, but as soon as a recession will come, this basic fact will be apparent

TABLE 4 : SOME UNDESIRABLE (UNEXPECTED?) CONSEQUENCES OF ECB : LESS INFLATION, BUT MORE UNEMPLOYMENT SPECIALLY FOR GERMANY

DEGREE OF CO-ORDINATION IN WAGE BARGAINING	**LEVEL OF BANK INDEPENDENCE**	
	LOW	**HIGH**
LOW	**FRANCE, ITALY, SPAIN**	1 Less inflation, more unemployment Low inflation but much more unemployment
HIGH		2 **GERMANY**

1 Stronger ***independence of the European Central Bank*** with respect to the objectives of the national governments.

2 ***Larger heterogeneity in wage formation*** across Europe than within Germany (before reunification) : nor European unions neither European collective agreements.

This surprising results derived from an econometric studies for the period 1955-90 (Hall and Franzese 1997) is confirmed by the simulations of a multi-econometric model (Fair 1998). When the European economies shift from the current monetary regime to the EMU, it turns out that Germany is hurt the most in terms of increased output variability. According to these analyses, the Euro would be a Pareto deteriorating move! But this is only a possibility and one may argue that other mechanisms will benefit to Germany. First, the very principles of the ECB fit much more to the economic specialisation of Northern Europe than Southern

Europe and thus the economic weight of Germany could be reinforced. Nevertheless until the mid-Eighties, the "periphery" of Europe has been catching up and experiencing a higher growth and foreign investment has flooded out of Germany, in the direction of lower wages but high-medium skilled regions.

A second possibility relates to a new style of industrial relations spreading across Europe. Social partners may perceive the origins of the disappointing outcome delivered by conventional strategy and decide to synchronise wage formation all over Europe. Since the institutional structures for such a coordination are for the time being missing, they could simply decide to set wage in accordance to the German wage. This wage would itself be negotiated between the IGMetal and the German business association, both of them taking into account the signals emitted by the ECB, instead by the *"Bundesbank"*. This very simple hierarchical device would prevent that price stability should be obtained against more unemployment in the majority of the eleven members of the Euro (Soskice and Iversen 1997). But such an happy end is not totally likely, because it assumes that all the national, sectoral and local unions in Europe will immediately look at the ECB's signals as soon as on the 1st January 1999 and no more the national authorities' ones, nor at the domestic economic situation. For instance, the Irish or Portuguese workers unions should not exploit the bargaining power linked to a national booming economy (the respective GDP forecasted rate of growth being 8.5 % and 4 % in 1998) but take into account the preservation of the competitiveness of domestic firms, at least in the sector exposed to European competition. Such a rational calculus may take place but it is not at all granted nor will it be general, given the strategic game which take place when many unions compete for membership (Boyer 1993a).

Will this conflict be limited to the domain of Industrial Relations or will it pop out into the political arena?

Emerging conflicts about the policy of ECB.

Actually, the legitimacy granted by German public opinion to the *"Bundesbank"* will not be automatically capitalised by the new European Central Bank. First of all, the adhesion of many European countries to the idea that the Central Bank should be independent is quite recent. It has to prove its positive outcome, by promoting financial stability and possibly fast growth. This hope will be disappointed if the first steps of the ECB bring more restrictive policy than previously. The objectives and the tools of the ECB would become a matter of public concern, since after all the political process may change what has been agreed by the

Maastricht and Amsterdam Treaties. Nevertheless, it is not easy to change a treaty which has been signed by fifteen members, which may have contrasted views about the needed revisions, or have changed their objectives in relation with a transformed economic context.

Secondly, even if every one agreed upon the wording of the Amsterdam Treaty about the statutes of the ECB, the heterogeneity of national "régulation" modes brings potential conflicts about the conduct of the monetary policy (Table 5).

- Should the *German principles* be still applied to the *German evolution*, the ECB being the faithful follower of the *"Bundesbank"*? Incidentally some observers have pointed that ECB is located in Frankfurt. But of course, other governments and Central Bankers may complain that this was not at all the aim of the EMU, which intended on the contrary an "Europeanisation" i.e. more symmetry in the determinants of monetary policy.
- A second option is to implement the same general conception but to apply it to *European evolutions*, which would respond to the previous objection. But this neglects the heterogeneity of short run evolutions and the fact that the statistical system in order to follow the impact of the common monetary policy across the different members states is, for the time being, not well developed, at least less sophisticated than the monitoring tools available to the American Federal Reserve Board. Still more, the interest groups which indirectly used to affect the policy of the *"Bundesbank"* have no equivalent for the time being at the ECB level. There is therefore a lot of uncertainty about the weight given to each national economy in the fixing of European monetary policy. Still more the constitution of interest groups about this issue, be it informal or formal is uncertain too. The more so since the text of treaty seems to forbid such pressures.
- A third option, seemingly rather unlikely but not to be excluded considers that the Central European Bank, whatever its firm statements in favour of price stability, may progressively learn by experience that the EU is in fact a rather closed economy with more degree of freedom than expected. Thus it could, implicitly at least, promote a stable growth and not only a low inflation. Therefore, *new principles would be applied to European evolutions*. This strategy would benefit to Southern Europe and still industrialising countries. Even German public opinion could agree to such a move, provided it finally delivers better results including for Germany. This scenario would be the most likely, the more problematic would become the German specialisation: a sluggish innovation in sunrise sectors (Soskice 1997) could induce a shift in the German industry, from largely price-maker to price-taker. A

TABLE 5 : THE CONFLICTING INTERESTS OF MEMBERS ABOUT THE MANAGEMENT OF THE ECB

		THE EUROPEAN MONETARY POLICY IS SET ACCORDING TO		
		GERMAN PRINCIPLES APPLIED TO		EUROPEAN PRINCIPLES APPLIED TO
		GERMAN EVOLUTION	EUROPEAN EVOLUTION	EUROPEAN EVOLUTION
EXCESSIVE DEFICIT PROCEDURE IS ENFORCED	STRICTLY	*Germany* **0** **--** Less inflation, larger unemployment *Rest of Europe*	**-** more symmetrical outcomes **-**	**0/+** More growth, slightly, more inflation **+/0**
	SOFTLY	**0/-** Possible doubts upon Euro **-** Moderation of inflation, but more unemployment	**-** Larger inflation, weaker Euro **-/+**	**--** Higher interest rates, lower Euro, more unemployment **+** :If accepted by financial markets **0/-** :If revolt of the financial markets

strong Euro, i.e. over-evaluated with respect to the dollar, would not be any more rational nor desirable, even from a German point of view.

These three options can be combined with two contrasted approaches of the Excessive Deficit Procedure (EDP).

- Either the clause could be implemented strictly, the more easily the more buoyant the growth rate.
- Or the inability to a majority of countries to fulfil the criteria during a severe recession or a long period of stagnation would lead to the de facto rejection of the EDP.

In each of the six scenarios, the costs and the benefits of each policy are quite differently distributed between Germany and the rest of Europe. This is a strong evidence that even the implementation of the most basic clauses of the Amsterdam Treaty will bring potential acute political conflicts, whatever the independent statute of the ECB. Monetary history suggests that *the legitimacy of any currency is closely linked with political sovereignty*. Thus, the long run viability of the Euro cannot be warranted without *a clear and stable political alliance at the European level*. Again the political deficit of the EMU is pointed out. But the national policy arena is severely challenged too by EMU.

Economic policy between "Europeanisation" and subsidiarity.

How will the responsibility of economic policy be shared between the European and the national levels, if for simplicity sake the regional level is not considered here? Before capital liberalisation and the EMU, each national State had a significant autonomy in using monetary, tax and public spending tools in order to achieve the macroeconomic results which would satisfy a coalition of interest groups or/and a majority of citizens. This clear division of responsibility is removed and a much more sophisticated configuration is implicit to the Amsterdam Treaty. For a purely technical point of view, is this configuration coherent and viable in the medium-long run? The next section will extend the analysis to the formation of political alliances and address the issue of the social legitimacy of the Euro.

Back to Tinbergen's framework.

Nowadays, analysts tend to use quite exclusively "new classical" models in order to assess the consequences of the EMU. In this kind of model, markets are assumed to be self-equilibrating, but public authorities and specially the Central Bank, may create some

INSERT 1 : AN OLD BUT STILL USEFUL METHOD FOR ANALYSING ECONOMIC POLICY.

Let us represent by **X** the vector of endogenous macroeconomic variables, **Z** the vector of policy instruments and if the relations are assumed to be linear, then an economy can be, as a simplification, represented as

$$\underset{(n,1)}{X} = \underset{(n,n)}{A}\,\underset{(n,1)}{X} + \underset{(n,m)}{B} \bullet \underset{(m,1)}{Z}$$

which can be solved as :

$$\underset{(n,1)}{X} = [I - A]^{-1} \bullet B \bullet Z = \underset{(n,m)}{C}\,\underset{(m,1)}{Z}$$

which summarises the impact of economic policy tools on macroeconomic variables. Therefore, governments may choose target variables for a subset of m endogenous variables, and set accordingly the economic policy instruments

$$\begin{array}{l} (1,m) \\ (m+1,n) \end{array} \underset{(n,1)}{\begin{pmatrix} \mathbf{OBJ_1} \\ \mathbf{OBJ_2} \end{pmatrix}} = \underset{(n,m)}{\begin{pmatrix} \mathbf{C_1} & \mathbf{C_2} \\ \mathbf{C_3} & \mathbf{C_4} \end{pmatrix}} . \underset{(m,1)}{Z} \quad \text{or to simplify} \quad \underset{(m,1)}{\mathbf{OBJ_1}} = \underset{(m,m)}{[\mathbf{C_1\,C_2}]} \,.\, \underset{(m,1)}{\mathbf{Z}}$$

Therefore if the matrix C is of rank m, any objective **OBJ*** can be fulfilled by an adequate **Z***, provided it belongs to admissible value for **Z*** (positive interest rate for instance)

$$\mathbf{Z^* = [C_1\,C_2]^{-1} \,.\, OBJ^*} \quad \text{with} \quad \mathbf{Z^*} \in \mathcal{Z}$$

In the general case, there may exist more objectives than instruments and the « optimal » policy associated to a given weighted of objectives is set according to

$$\begin{cases} & \mathbf{Max} \ \underset{(1,p)}{\alpha} \ . \ \underset{(p,1)}{\mathbf{OBJ}} \qquad P>m \\ \text{Subject to} & \mathbf{OBJ} = \underset{(p,m)}{\mathbf{C}} \ . \ \underset{(m,1)}{\mathbf{Z}} \\ & \underset{(m,1)}{\mathbf{Z}} \in \mathcal{Z} \end{cases}$$

Source : Freely adapted from Tinbergen (1991).

perturbations by altering money supply, quite unexpectedly with respect to the rational expectations of the private agents who have perfectly mastered the functioning of this idealised Walrasian economy. In such a framework, it is clear that governments exclusively introduce Pareto deteriorating shocks. Therefore, the Central Bank should be independent from any political power and should be submitted to the implementation of strict principles, such as price stability or alternatively a given target monetary supply. In a sense, the Amsterdam Treaty seems to be inspired by this kind of vision.

Unfortunately, such a framework hides more problems than it helps understanding the formation of European/national economic policies. Thus it is interesting to go back to a more conventional framework, which was at the core of the Keynesian or more generally the interventionist conceptions of the role of governments. Basically, markets such as credit or labour markets are not self equilibrating, due to uncertainty, asymmetric information and power, imperfect competition,…and so on. In such a case, the government may have a positive impact upon the welfare of the society by promoting the return to full-employment or alternatively fighting against inflation and reducing external deficit.

How should a rational economic policy be decided? A school in macroeconomic modelling has proposed and implemented a useful framework (Tinbergen 1991). Basically, macroeconomic activity is largely endogenous, because consumption, investment, exports and imports are related to wages, profits, effective demand, relative prices, i.e. variables set by private agents. But generally, involuntary unemployment is observed or an inflationary boom may imperil financial and even social stability. The government may correct these evolution since it masters some instruments such as the taxation rates, public spending, wage norms for the public sector, interest rates or exchange rate. By an adequate move of these instruments, a better macroeconomic equilibrium can be reached (Insert 1).

At the very abstract level, it has to be assumed that the major macroeconomic mechanisms can be captured by modelling and estimating the related equations. Then the government may try to decide its economic policy according to target variables concerning growth, inflation, unemployment or external trade equilibrium. But of course, under the pressure of various social and economic groups, the government may be induced to pursue much more objectives than instruments freely usable. In this case, none of the single objectives will be fulfilled but a composite of them will be optimised. Incidentally, the weight given to each objective might be the solution of a political game played by various groups in order to get the support of public policy. If the wage earners are part of the political game of government formation, unemployment and real-wage are taken into account by the government, whereas the business

INSERT 2 : THE VARIOUS PHASES OF ECONOMIC POLICY IN EUROPEAN NATIONAL STATES : 1954-2001

1. The Keynesian era : 1954-1972

$$\begin{array}{l} \text{Output} \\ \text{External trade} \\ \text{Price} \\ \text{Unemployment} \end{array} \begin{pmatrix} Q \\ X-M \\ P \\ U \end{pmatrix} = \begin{pmatrix} C_1 \end{pmatrix} \cdot \begin{pmatrix} M \\ e \\ G \\ T \end{pmatrix} \begin{array}{l} \text{Money supply} \\ \text{Exchange rate} \\ \text{Public spending} \\ \text{Taxes} \end{array}$$

Objectives

With $(G-T)/Q \leq \alpha$

2. An income policy variant with limitation of public deficit spending

$$\begin{pmatrix} Q \\ X-M \\ P \\ U \end{pmatrix} = \begin{pmatrix} C_2 \end{pmatrix} \cdot \begin{pmatrix} M \\ e \\ G \\ W \end{pmatrix}$$

(more output if more public spending)

3. The monetarist/conservative alliance

$$\begin{pmatrix} Q \\ X-M \\ P \end{pmatrix} = \begin{pmatrix} C_3 \end{pmatrix} \cdot \begin{pmatrix} G \\ e \\ M \end{pmatrix}$$

(more output if less public spending)

4. The free capital mobility and the schumpeterian move

$$\begin{pmatrix} Q \\ P \\ X-M \end{pmatrix} = \begin{pmatrix} C_4 \end{pmatrix} \cdot \begin{pmatrix} Rd \\ i \\ T-G \end{pmatrix}$$

(innovation as the engine of growth)

community asks for low taxes and high profits and the “rentiers” high interest rates and low inflation (Palombarini 1997 ; 1999).

By comparison with “new classical” macroeconomic theory, this framework is not without merit. First it leaves open the question whether the government is stabilising or destabilising the economy. Second, it considers a large spectrum of relevant macroeconomic variables and intervention tools, and not only monetary policy. Third, such a formalisation builds a bridge between macroeconomic dynamics and economic policy formation, a quite important theme indeed for any assessment of the Euro.

The objectives and tools of national economic policies: drastic transformations from 1954 to 1998.

The conceptions of national economic policy have actually drastically changed through time, and the emergence of the idea of Common European Currency is part of this general process. Thus, a short historical retrospect is useful to assess the novelty of the present European configuration.

- *During the Keynesian era*, most governments, including the conservative ones, had adopted nearly the same four major targets for their macroeconomic policy: promote growth, limit external trade disequilibrium, keep inflation under control and operate near full-employment. Only the weight given to each objective used to vary according to the colour of the political coalition: more emphasis upon full-employment for social-democrats, more importance granted to price stability for more right-wing governments. Furthermore, the diffusion of Keynesian macroeconomics had made popular the following assignment of public intervention tools to the different macroeconomic objectives. Both the monetary supply and public spending contributed to the level of output and price, whereas taxes could be used as an incentive to moderate wage demands, therefore limit unemployment. Finally, the exchange rate was set by public intervention, with few influence of private capital, unless during acute external financial crises. Therefore the governments were taking pride for achieving *a “fine tuning” of macroeconomic activity* and usually they were reaping political support from the citizens for this achievement. As the subsequent part of the story tells, this self attributed economic merit by politicians was partially or largely an illusion! (Insert 2).
- *After 1967*, inflationary pressures have been hard to contain and public deficit tended to surge and therefore limit the ability to continue typical Keynesian full-employment policies. If one of the conventional instrument came to be missing, it had to be replaced by another one, for instance *income policies* under various variants. Either strong and well organised social

partners agreed upon wage and price restraint in order to limit inflation and still more enhance employment. Or labour markets were decentralised and uncoordinated, and a tax based income policy was tentatively introduced, for instance by taxing any wage or price increase above an upper limit. Actually countries able to implement such *a corporatist social pact* usually enjoyed less in employment and less inflation than otherwise (Dore, Boyer and Mars 1994). But this was not at all the end of the story, quite on the contrary.

- *After 1979*, a new *monetarist and conservative alliance* has come to power both in the US and UK and this model of economic policy has be spreading all over the world, quite independently from the colour of the government. First, unemployment is no more a concern for a government because it is assumed to be voluntary and to respond to a structural rise in the so-called "natural rate of employment". During this period, social deregulation takes place in many countries and tend to destroy the very legitimacy of any incomes policy. Thus wage formation is no more an objective of public authority concern. Given the regime of managed flexible exchange rates, the budgetary policy looses a large part of efficiency. The Keynesian multiplier is supposed to decrease toward zero. For the "*supply side economics*", any public spending is made at the detriment of private consumption or investment. Thus, due to crowding-out effects, more public spending means even less output and employment. Again the structure of macroeconomic adjustments has changed. So did the political alliances and consequently the conception and implementation of national economic policy.
- *Since the mid-Eighties*, a different and new conception has emerged. With *financial liberalisation*, the multiplicity of new financial instruments and the "globalisation" of some markets, the exchange rate is no more a variable which can be significantly affected by the national Central Bank. The interest rate becomes an instrument which can be used first to curb down the inflation rate according to the so-called Taylor rule, according which any incipient inflation should be defeated by raising the real interest rate. This same action has the property to reduce inflation expectations, thus it has a positive influence upon the exchange rate. But then, how to monitor the level activity, since the interest rate is affected to another objective. The new tool for public intervention has turned to be *innovation policy*, via subsidies or tax reductions for Research and Development expenditures. Basically, *this neo-Schumpeterian orthodoxy* has been implemented by many governments. Finally, the public deficit is assumed to influence, at least partially, the external trade position of each country. The IFM frequently uses this argument in its structural adjustment plans for developing countries. It is important to note that the management of domestic effective demand is rarely taken into account in the contemporary period, specially in Europe. But in the US, the policy-mix is

much more balanced and could be a reference for the ECB, at least for some scenarios (See Figure 18 – infra).

Thus, the EMU comes after this long run trajectory and is partially explained by the search for new tools of intervention. If the intra-European exchange rates are governed by the expectations of the international financial markets, the instability thus created becomes an obstacle to economic integration. The Euro might be a solution but then, what could be the division of tasks between European authorities and national governments?

An unprecedented configuration for European and national policies.

The situation created by the Amsterdam Treaty is *radically new*. It is neither the full autonomy of independent national States, nor is it a typically federalist configuration (Dehove 1997 ; 1998). The responsibility of economic policy is now shared at two levels and *nested* in the sense that neither the *supranational rules* nor the *subsidiarity principle* exert a dominant role (Insert 3).

- Clearly the *monetary policy* is the full responsibility of the ECB, in charge of maintaining price stability in Europe. But the credibility of the Euro and specially its exchange rate with respect to the Dollar is significantly affected by the conduct of national budgetary policies. Given the fixed exchange rate system which is irrevocably installed by the Euro between the eleven members, the Mundell-Fleming's model implies that the *budgetary policy* becomes the only efficient instrument left to national governments in order to control the domestic level of activity (Wyplosz 1997). Therefore each national State may have an incentive to "free ride" upon the collective good produced by the wise budgetary policy followed by other Nation-States (Laskar 1993 ; Martin 1995). Thus, the Amsterdam Treaty has extended the rule put forward by the Maastricht Treaty, and sets a 3 % limit to the maximum public deficit as a fraction of GDP, precisely to convince the financial markets that the credibility of the Euro cannot be challenged by the misconduct of any national budgetary authority.
- This clause of the treaty is highly controversial. For many economists it is a symbolic and redundant rule since the ECB is forbidden to buy any national public bond, nor to bail out

INSERT 3 : THE NEW ARCHITECTURE FOR EUROPEAN/NATIONAL ECONOMIC POLICIES : SOME COUNTRIES ARE ABLE TO FIGHT AGAINST UNEMPLOYMENT, OTHERS ARE NOT.

THE EUROPEAN LEVEL

$$\begin{pmatrix} p_{Euro} \\ e_{Euro} \end{pmatrix} = D \times \begin{pmatrix} i_{Euro} \\ (T-G)_{Euro} \end{pmatrix}$$

THE national LEVEL

Countries with coordinated wage

$$\begin{pmatrix} Q_{Nat} \\ U_{Nat} \end{pmatrix} = F_c \cdot \begin{pmatrix} Rd_{Nat} \\ W_{Nat} \end{pmatrix} + G_c \overline{\begin{pmatrix} i_{Euro} \\ (T-G)_{Nat} \end{pmatrix}}$$

Some degree of manoeuvre for fighting against unemployment

POSSIBLE VIABILITY

Countries with uncoordinated wage

$$Q_{Nat} = F_{uc} \,.\, Rd_{Nat} + G_{uc} \overline{\begin{pmatrix} i_{Euro} \\ (T-G)_{Nat} \end{pmatrix}}$$

No room left for policies against unemployment

UNCERTAIN VIABILITY

any bankrupt domestic bank (Wyplosz 1997). Still worse*, in case of severe recession, this clause removes an instrument from the national authorities*, whereas they are in charge to fight against unemployment and promote high growth. Furthermore, from a purely institutional point of view, this violates the *subsidiarity principle*, which is so important in the process of the European integration. A common counter-argument states that government should use the 1998 European recovery to build a budgetary surplus which will be quite useful during the next recession in order to alleviate unemployment, without hitting the 3 % threshold for public deficit (European Commission 1998a ; 1998b). But the national governments, under the pressures of their constituents, seem to have different objectives, may be because the electoral schedule brings an intrinsic *"short-termism"* in the decisions about economic policy. In any case, this conflict of interpretation and responsibility will, without any doubt, trigger many conflicts after January 1st 1999. This dilemma will be exacerbated by the heterogeneity of national "régulation" modes and specially Industrial Relations systems.

- On one side, the economies which enjoy *wage coordination*, still have a tool in order to affect the level of unemployment: the social partners will adapt their strategy to the Euro and still have *an influence upon the level of economic activity*, even if budgetary policy were nearly neutralised by the 3 % limit. Eventually the bargaining between business associations and workers unions may concern public welfare management, with the objective to reduce the level of public deficit, for example, by internalising the costs of unemployment. Recently admitted member-States such as Finland have evolved accordingly and negotiated contra-cyclical device concerning unemployment benefits, pension funds and nominal wage formation (InfEuro 1998). Under this condition, the medium-long term viability of the EMU is roughly warranted, provided of course the absence of any major national idiosyncratic shock.
- On the other side, *where wage formation is uncoordinated, the perspective is more gloomy*. Frequently, the public deficit is high because the bad configuration of Industrial Relations has been converted into welfare spending (such as early retirement funding…) and in any cases structural public deficit. Thus, the budgetary tool is nearly neutralised, unless the governments launch an ambitious plan for rationalising and reforming the whole structures of social and public spending and taxation. But they often face a strong social and political opposition, as was observed in France in December 1995. In any case, this move towards a *"lean State"* does not solve the short run adjustment problems, but it is a means for promoting higher growth and eventually innovation. Under this respect, the incentives for RD

have exactly the same long run horizon as Industrial Relations reform and they are unable to have a short run and significant impact upon employment. In this case, *the subsidiarity principle boils down to the crude absence of fiscal solidarity across European countries*. The EMU exacerbates underlying structural problems but prevents to give them a socially acceptable solution, given the overarching principle about the need for Euro credibility.

To sum-up, the dividing line between the Europeanisation of monetary policy and the subsidiarity of budgetary policy brings a structural disequilibrium, potential political conflicts and it exacerbates the heterogeneity of national Industrial Relations and "régulation" modes. This discrepancy is not restricted to economic policy, since it is much more severe in the arena of domestic policy formation, in general.

The long run legitimacy of the Euro within national policy arena.

Should any government join the EMU? Within each domestic society, will anybody gain from the adhesion and implementation to the Euro? Will politicians get a permanent support for the current phase of European integration? Is the Amsterdam Treaty resilient to a large variety of world conjunctures, specific sectoral crises and domestic political opposition to a part of the measures and the processes set into motion by the EMU? To all these questions, European officials have the same and quite optimistic answer: the Euro will bring financial stability, it will reduce uncertainty, thus enhance growth and employment, in such a way that every economic agent and citizen finally gain. This follows a quite conventional vision of institution building: politicians propose institutional arrangements which increase the social welfare of the society (Posner, 1981) and of course, individuals accept these proposals. Only irrational activists or backward looking politicians could oppose to such improvements.

But this view is far from satisfactory since many Pareto improving innovations can be blocked in their diffusion by the prevalence of existing conventions and institutions (Boyer and Orléan 1992). Quite on the contrary, the major economic institutions absolutely require political interventions and often the permanent enforcement of law (Streeck 1996 ; Sabel 1997). This view explains far better the historical record (North 1990) as well as the variety of national institutional arrangements (Hollingsworth and Boyer 1997). The Euro is not an exception since it was designed and created nor by financial markets, neither by economists, but by Heads of State, in order to overcome the political disequilibrium created by the destruction of the Berlin wall and the new dimension of Europe (Milesi 1998). But then the assessment of economic consequences of the Euro are much more complex than a simple exercise on monetary theory. It becomes a debatable topic, which can be given different answers in various countries.

A matter of political deliberation, not a pure efficiency problem.

There is no better proof of the strong political content of the Euro, than the evidence that some countries which could have complied with the Maastricht convergence criteria have been unwilling to join the Euro. The British government took into account the opinion of a majority of the voters (The Economist 1998), along with a tradition of Euro-scepticism, and a fear of Brussels interventionism. This stance was reinforced by the fact that the British business cycle is quite desynchronised with the rest of continental Europe. The Danes have been anxious to preserve the specificity of their social arrangements and an extended welfare, which could have been affected negatively by the European common legislation. The Swedish government was divided between a pro-European feelings of the economic and political elite and a reluctant public opinion. Therefore the government appointed in October 1995 *a Government Commission on the EMU* in order to analyse the consequences for Sweden of the adhesion of monetary union. This initiative has delivered the most careful and interesting assessment of the benefits and costs of the Euro. Actually the report drafted for this purpose has concluded that Sweden should not join the EMU (Calmfors & alii 1997). Behind the specificity of the Swedish case, many interesting conclusions can be extracted from this pluralistic approach, at odds with the eulogy traditionally proposed by the governments which have adhered to the Euro.

- First there exists *no single and synthetic criteria* which could summarise all the consequences of the Euro, because some are positive, others negative and still others ambiguous. It is therefore interesting for economists and political scientists to deliver a detailed and a complete assessment of the consequences of the Euro. Basically, the authors have summarised their findings under three major headings dealing respectively with *social efficiency, stabilisation policy, and political impact* (Table 6). The conclusions are quite contrasted and the final choice depends a lot about the political preferences of each citizen or the general orientations of the government. Social scientists investigate possible outcomes, citizens express their opinion and the government take the final decision. This is a fair division of labour, rarely observed elsewhere.

TABLE 6 : JOINING THE EURO : PRO AND CON FOR SWEDEN

ASSESSMENT CRITERIA	ADVANTAGES	DRAWBACKS
SOCIAL EFFICIENCY		
1. Transaction costs	• Saving 0,2 % of GDP with EMU	• Extra costs for accounting and conversion costs (probably inferior to the gains)
2. Short term fluctuations in exchange rates	• Less uncertainty would benefit to trade and investment	• Total uncertainty may increase (third countries exchange rate, future of national policy)
3. Interest rates	• Lower real interest rates, similar tp the German one	• In the long run, no relation between the Euro and the real interest rate
4. Competition in the single market	• No more unexpected shift in national competitiveness due to exchange variations, less protectionnist pressures	• Mainly valid for the financial sector, not so much product market
5. Inflation	• Given ECB strong independence, lower inflation is expected	• Large efficiency effects are unlikely
ASSESSMENT ON SOCIAL FFICIENCY	*Probably <u>a positive impact</u> for Sweden….* *….but many other policies (tax, education, welfare) have much more impact*	
STABILISATION POLICY		
6. Symmetrical and asymmetrical shocks	• The greater credibility of ECB would allow a stronger response to a common recession	• The lack of synchronisation with the core of Europe and possible asymmetric shocks are very costly for Sweden
7. Other adjustment mechanisms		
• International labour mobility		• Few and small impact of the Euro per se
• Nominal wage flexibility		• Very difficult to increase (not observed in the US)
• Internal exchange rate changes (by shifting the tax burden)	• Possible wage moderation	• Limited size of these adjustment compared with external exchange
8. Monetary policy autonomy outside the currency union		• Less possibility to stabilise the economy
9. Macroeconomic imbalances and exchange rates	• Reduction in the swings in nominal and real exchange rate.	
10. Fiscal policy	• The excessive deficit procedure helps in curbing down public debt • Need for some transfers between countries	• Interference with the role of fiscal policy as an automatic stabiliser • …but political objections
ASSESSMENT ON STABILISATION	*OVER ALL NEGATIVE IMPACT* • *The loss of autonomy in off setting country specific shocks is not compensated by the general expected decline in the frequency of asymmetric shocks in the EU* • *The Euro does not make easier labour market and supply side reforms.*	
POLITICAL IMPACT		
11. The role of EMU in the European integration	• A step towards political integration	• Strains on Unity between IN's and OUT's • Conflict upon ECB policy • Unpopular national policy in order to cope with EMU, specially if unemployment is high
12. Democratic control and accountability	• Some (limited) control over ECB • Report to the European Council, ECOFIN Council at the Commission • Formal possibility to change the ECB's statutes by a <u>new</u> treaty	• Opposition between an inter-governmental model (national parliament control) and a federal project (strengthening of European parliament) • Small influence of any national parliament
13. Legitimacy of a decision on the Euro		• Euro is seen as a project for the "political and economic elite" • Risk of political polarisation • Time is required to organise a democratic debate
14. National influences within the EU	• Larger if the country joins the EMU ("give and take" process) and the common foreign and security policy (CFSP)	• …but in any case limited influence of any single country • possible opposition between national preferred policy and EU's position
ASSESSMENT ON POLITICAL IMPACT	*Joining the Euro increase, the country's influences within the EU, at the cost of less democratic control upon monetary policy.*	

OVER ALL ASSESSMENT

<u>Small</u> but <u>certain</u> efficiency gains, <u>reduced</u> macroeconomic imbalances but <u>less ability</u> to cope with country specific disturbances, a <u>positive</u> contribution to European political integration but possible <u>conflicts</u>.

"It is difficult to see that the advantages of the EMU are very substantial and unequivocal"….but a failure to implement would create acute credibility problems.

Source : Built upon Calmfors & *alii* (1997:305-339).

The gains in social efficiency turned out be far more modest than put forward by the official studies under the request of the European Commission. The so much celebrated reduction of *transaction costs* brings a very modest saving, less than 0.2 % of GDP, which in the short run could be quite reduced by the costs of conversion from the national currency into the Euro. If exchange rate uncertainty would be reduced, it may be at the cost of an increase in other sources of uncertainty, for instance concerning the sustainability of the national policy under the Amsterdam Treaty. Furthermore, a reduction in the Swedish inflation rate could be obtained by more independence given to the *"Riskbank"*. Similarly, the gain of efficiency related to the Single Market concerns more the financial sector than the typical manufactured products. Last but not least, the overall efficiency gains are likely to be modest, in any case far inferior to those delivered by reforms affecting the tax system, the welfare or education and labour institutions. This down-sizing of the benefits of Euro has become more common as the date of implementation approaches: it is now presented as a *catalyst of far reaching transformations* which could have been undertaken quite independently, if public opinion and firms had been ready to accept them before (Rohatyn 1998 ; d'Arvisenet 1998).

- By contrast, *the costs in terms of stabilisation policy are quite important*, at least for Sweden. First, the economy is not synchronised with the rest of Europe and in the past many asymmetric shocks have occurred. Of course, the adhesion to Euro would reduce the probability of the idiosyncratic shocks generated by an independent monetary policy, but simultaneously it would remove one important tool from the Swedish economic policy. Second, it is quite unlikely that labour mobility would be significantly enhanced by the adhesion to the Euro. Third, it is quite difficult for social reasons to develop further nominal wage flexibility and the Euro will not be necessarily the required catalyst. Fourth, the clause of the Amsterdam Treaty on EDP puts a severe limitation to the ability of Swedish authorities to react to large recessions and to use the automatic stabiliser mechanisms, which have proved their utility during previous phases of the Swedish history. Fifth difficulty, the absence of increased transfers among European countries in order to compensate uneven business cycle makes problematic the political acceptance of the budgetary discipline imposed by the Euro. The Swedish report therefore concludes that Sweden would loose a lot in joining now the Euro, specially given the high employment rate which calls for active public policies. More generally, this means that *the adhesion to Euro is conditioned by the initial situation of each country*: the more easy, the more healthy the domestic economy is.

- According to a third criteria, *the political impact of Euro is mitigated* for Sweden. On one side, the *influence of the Swedish government* would be enhanced if it decided to join the

Euro (for instance, a say in the Euro-11, i.e. in the coordination of budgetary national policies, is conditioned by the belonging to the EMU). More generally, the bargaining power of a member-states is enhanced if it belongs to the core institutions of the EU, because it can exchange a concession in one domain against a benefit in another sphere of European negotiations. But on the other side, the costs in terms of *democracy and transparency* of common decisions may be important. For the time being, the control by the European Parliament and the national representative bodies is quite limited indeed, unless the reforms about the European institutions succeeds before the Euro is launched. Many observers agree with the *Swedish Commission* that this is quite unlikely, since the progressive and pro-European forces have shown their weakness during the negotiations of the Amsterdam Treaty (Bourlanges 1998).. Therefore, most governments face the same dilemma as the Swedes: build national influence upon the future of European institutions by joining the EMU, but at the cost of less democracy at home on economic policy issues, and few transparency in Brussels, Strasbourg and Frankfurt! And of course, a lost monetary autonomy, which used to be one of the attribute of the national States since the birth of the Westphalian order. This prerogative is clearly challenged by the process of European integration, since its beginnings, and the Euro pushes this process a step further (Dehove 1997).

The overall assessment of the Swedish Commission is therefore balanced and careful, even if finally globally negative, as far as Sweden is concerned, but other countries may have different interests and take an opposite decision. For Sweden, experts expect small but certain efficiency gains, probably reduced macroeconomic imbalances, but less ability to cope with country specific disturbances and urging social problems such as unemployment. To quote one of the last sentences of the report “it is difficult to see that the advantages of the EMU are very substantial and univocal…but a failure to implement it would create acute credibility problems for the whole European construction”. This recognises that *the Euro is politically driven, largely past and path dependant and will have quite uncertain economic outcomes*. The same complex consequences are observed within each national political space.

The winners and losers and the domestic polity.

Once the adhesion to the Euro decided, is the future of the Amsterdam Treaty warranted? This is far from sure. Until now, the European project has been mobilising the energy of political elite in order to convince reluctant economic or social groups to accept reforms, which would have been blocked otherwise. Such a phenomenon has been observed clearly in Italy (where a European tax has even be levied in order to comply with the Maastricht criteria) but in Spain and Portugal too, countries which have come to identify democratisation and modernisation with adhesion to the EU. After January 1999, the issue is transformed: how will public opinion accept the good and less palatable consequences about the conduct of budgetary policy, competition enforcement, and the implementation of European of a new series of norms and rules?

THE WINNERS AND THE LOSERS OF EURO: HOW DOES FRENCH PUBLIC OPINION PERCEIVE EURO?

TABLE 7 : A MAJORITY OF PRO EURO, BUT A LOT OF CONCERN OR ANXIETY

QUESTIONS	APRIL 1996		OCTOBER 1996	
1. Are you in favour of European single currency ?				
Highly favourable	17	57	16	54
Rather favourable	40		38	
Rather opposed	19	37	20	39
Very opposed	18		19	
Without opinion		6		7
		100 %		100 %
2. How do you see the coming Euro ?				
With confidence	39		35	
With anxiety	51		55	
With indifference	8		7	
With opinion	2		3	
	100 %		100 %	

Source : SOFRES [1997]: 106, Survey, 15-19 October 1996.

France is a good example about how ambivalent the European feelings of the citizens are. On the one hand, both the Gaullist conservative party and the socialist party have worked for the creation and then the implementation of the EMU. The European project has permeated among public opinion that globally declare to be in favour of the European single currency: 57 % in April 1986, 54 % in October 1996 (Table 7). This proportion has not declined, quite on the contrary, after the official launching of the Euro with eleven countries, including France: in May 1998, 62 % of the French population was thinking that the Euro was a very good or rather good thing, one of the higher score in Europe, after Italy (66 %), but well ahead from Germany (43 %) (IPSOS 1998).

Everybody knows that polls are quite subtle and shaky instruments, not necessarily accurate. Nevertheless, it is interesting to note that the same French public opinion which is in favour of the single currency express a lot of anxiety about its consequences. In April 1996, 51 % of French people were expecting with anxiety the coming of the Euro, and this proportion seems to have climbed up to 55 % in October 1996. This might be an evidence for a kind of cognitive dissonance: on the one side, from a *general point of view*, Europe is associated with modernisation and a positive a priori, but on the other side, some French women/men expect some negative fallout from a *personal point of view*. This means that potentially public opinion may change its positive valuation if for instance the economic and social consequences of the Euro are perceived as too negative. In retrospect, the adhesion to European integration is the easier, the more favourable the economic environment and conversely a lot of pessimism pops out as soon as a recession and the surge of unemployment mitigate the core pro-European feelings. One of the first real tests of the viability of the Euro will therefore take place either during *the next European bust*, or if *an unexpected social/political crisis* bursts out within one of the eleven members of the Euro.

But there is a *more structural analysis about the viability of the EMU*: in the long run, will the *groups benefiting* from it be more numerous and politically active than the *groups that will be hurt* by the endogenous trends at work within each domestic society? Again, some French public polls give some hints: the unequal consequences across the different groups and members of the society are clearly perceived (Table 8).

- On one side, *large firms and younger people* are considered to be able to adapt quite easily to this new configuration. Actually, all over Europe, business associations and large enterprises are the most active supporters of the Euro…including in the UK. Their strategy is already directed toward the whole continent and the monetary integration makes easier and less risky the choice of localisation across EU. For young people, the impact of Euro is less clear. In many countries, they are the more unemployed among all age groups, and it may be argued that one of the hidden evil of the Europe is precisely to have privileged mid-career workers and early retirees, penalising the entry of new generations into the job market. May be, the Euro will trigger ambitious labour reforms, which would allow the reversal of this adverse selection against young people, but the jury is still out.

TABLE 8 : FRANCE: EURO IS PERCEIVED TO HAVE DIFFERENT CONSEQUENCES FOR VARIOUS SOCIAL GROUPS.

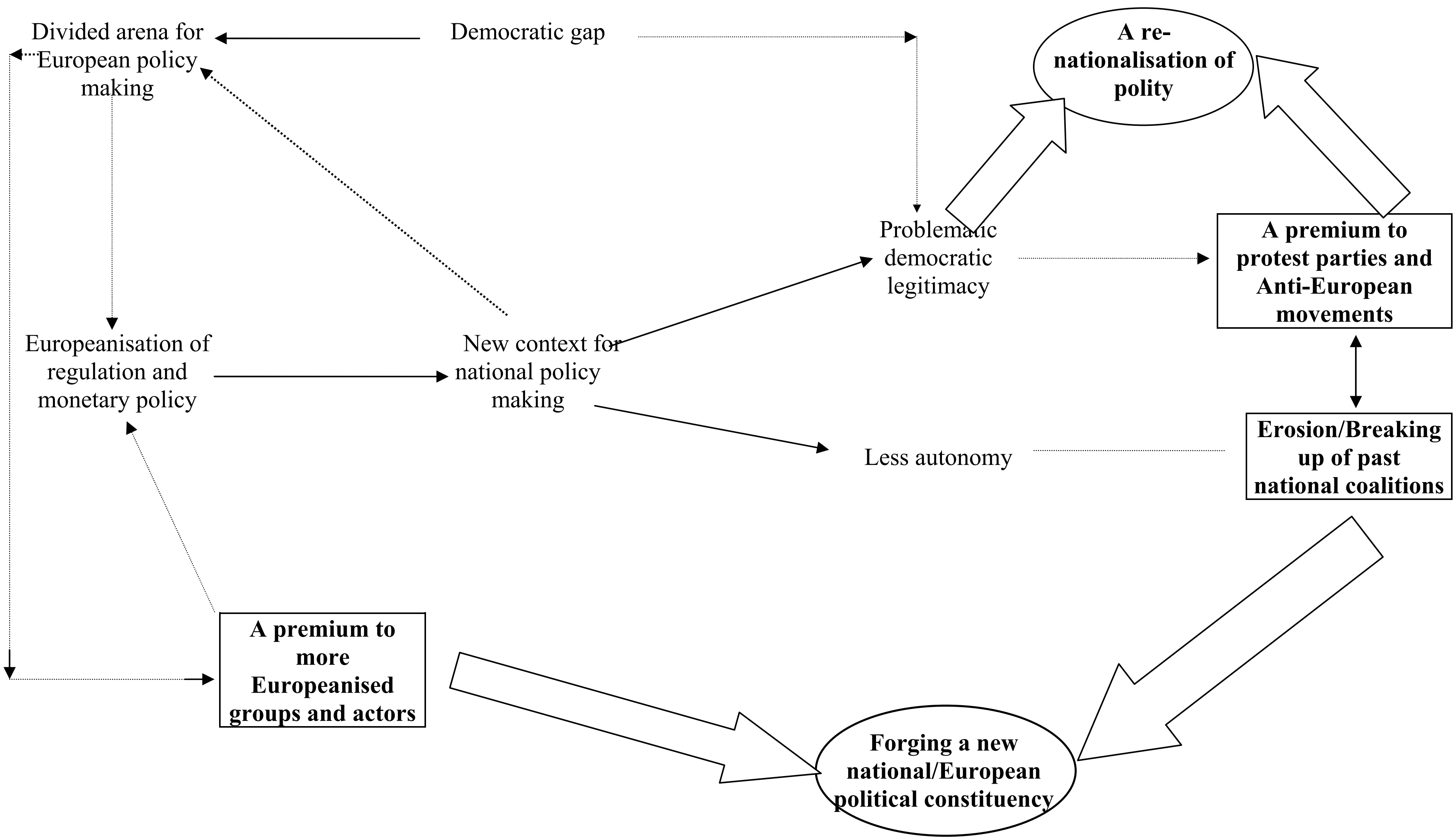
<u>Question</u> : What are likely consequences of EURO for each of the following groups?

		Not too many problems	Transitory difficulties only	Long lasting problems	Without ant opinion
Large firms	100 %	$\boxed{62}$	32	4	2
Younger people		$\boxed{60}$	31	7	2
Small and medium size enterprises		37	$\boxed{53}$	6	4
Retailers		22	$\boxed{65}$	11	2
Savers		20	$\boxed{51}$	21	8
People with low incomes		7	49	41	3
Old people		1	8	$\boxed{90}$	1

Sources : SOFRES [1997]: 110.

- On the other side*, low income groups and old people* are expected to experience long lasting problems in order to cope with the new European order. The difficulties might be more transitory for *small and medium size enterprises, retailers and small savers*. Basically, most of these persons rely either upon an extended welfare system, which has tentatively been reformed in order to prepare the French economy to the Euro, or upon the domestic/local

FIGURE 7 : THE POLITICAL VIABILITY OF EUROPEAN INTEGRATION : A FIRST CUT ANALYSIS



markets which may decline relatively as European integration promotes a new division of labour across the borders. The individuals who are the less talented to deal with modern technology, foreign languages, managerial tools will probably experience a decline of their relative income. This down-grading has been taking place since two decades in the US, but it would be a relatively new phenomenon for European countries, where collective agreements, legislation and a quasi universal welfare had contained the widening of social inequality. But the UK has already explored such path (Atkinson 1998).

Thus, *the Euro will contribute to shift the border line between the winners and the losers*. In democratic societies, citizens express themselves in various occasions, including the elections to the European Parliament. But paradoxically, the turn-over is specially low for the European elections compared with the local and the national polls. This means that even the consequences of Europeanisation are dealt mainly within the *domestic political arena*. More generally, internationalisation and even globalisation are still matter of domestic politics (Keohane and Milner 1996). Can such a process be analysed?

The political viability of European integration is at stake.

In a sense, both processes of globalisation and Europeanisation display some similarities: the more internationalised actors try to redefine the national rules of the game, using the leverage provided by their access to other territories (Boyer 1997). Of course, if this group too can try to influence the design of the rules of the game for the international system itself. But this second process is far more difficult than the first one, due to the diversity of interests and the lack of a unified supranational State. Mutatis mutandis, the deepening of European integration has introduced equivalent tensions, but the project of a Federal European State is less distant than the unification of the world under a single hegemon. Thus, nowadays the European political process is submitted to two contradictory forces (Figure 7).

- *The economic and social actors who have access to the European Community* benefit from extra markets, knowledge about relevant legislation and subsidies, cross-borders networks. Thus they are generally better off than the agents whose horizon is limited to local or regional transactions. Some of these Europeanised actors can even participate to the process of rule formation at the level of Brussels, Strasbourg or Frankfurt. Of course, this power has to be shared with other members of the European elite and the perception of own interest and the representations are therefore transformed by this very process of interaction at the European level. Thus there *is the potential formation of a European elite* and by extension polity (Schmitter 1997c), even if it is not devoid of conflicts and tensions between the

European Commission, some European representative bodies, the European Parliament, the European Court of Justice. For instance, about 70 % of current national legislation is no more than the translation and implementation of rules and treaties decided at the European level. But these Europeanised actors are quite few indeed in proportion of total population.

- For still *a vast majority of citizens, European affairs are exclusively or mainly a matter of domestic polity*. First because their contacts with foreign actors are quite episodic and superficial contrary to the first category of internationalised actors. Second, because the main access to the political power is via the national politicians which are held responsible for the decisions taken both at the national level and European one. Of course, since the Brussels authorities are generally far from the national politicians, this allows sometimes the rejection of the responsibility of adverse consequences of Europeanisation to the so-called *"Brussels' Bureaucrats"*, assumed, for the sake of the argument, to be ill informed and politically irresponsible! Third and more basically, the most significant advances in European integration and specially the EMU have been decided after *inter-governmental conferences*, where the Head of the States have signed international treaties on the model of the Maastricht or Amsterdam ones. From a democratic point of view, the main voice of the average citizen is still expressed within the national political arena. Thus, an emerging peril: that the more nationalist movements and parties take the leadership in organising the protest against the adverse effects of European integration on selected social groups or a majority of them. In some countries, the anti-European protests are frequently voiced by the more xenophobic right wing parties.

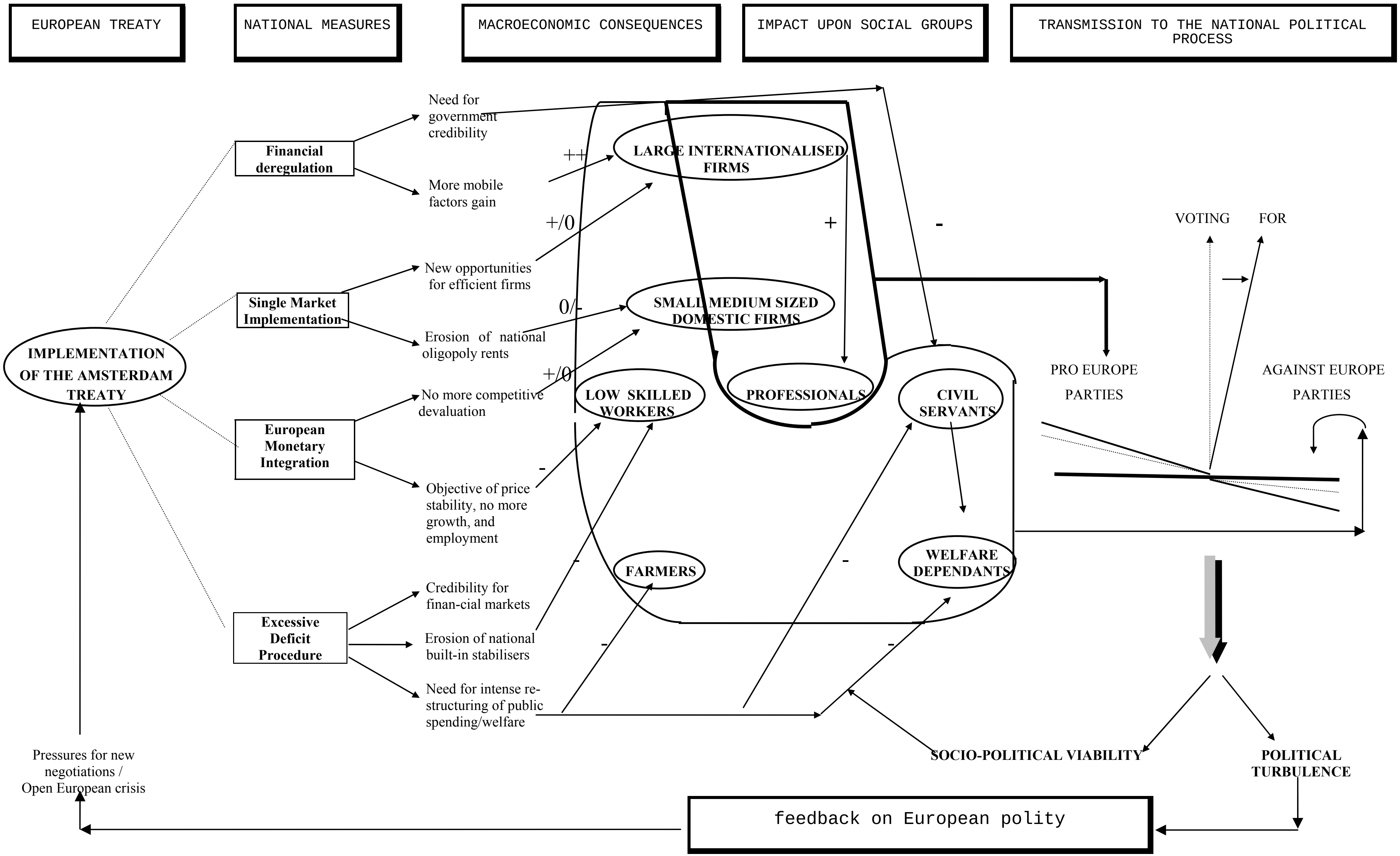
In the future these two groups with conflicting interests and visions could enter into frontal, if not violent, opposition about the trajectory to be followed by European integration. Either forging as quickly as possible a true European polity where every citizen could have a say about such radical transformations as the EMU, Common European Diplomacy, Defence and Security. Or rejecting any further Europeanisation in the name of the preservation of democracy and transparency and the defense of national identity. In some extreme cases, the destruction of previous European advances…such as the Euro could even take place. The first solution would be highly preferable but it takes decade to build new institutions, and the European political innovations might be far slower than the emergence of the major structural problems triggered by the EMU. The second solution builds upon already existing political institutions at the national level but seems to forget that European economies have become so inter-dependant that the affirmation of national autonomy would have a significant and probably large economic costs in terms of standard of living, growth and even employment.

Nevertheless, it is easier to *destroy* institutions than to *build* them and *populist arguments* are generally more appealing than *rational plans* calling for the forging of an Euro-polity.

But this dichotomy is quite crude indeed and it is only a starting point for a more satisfactory but of course a little bit complex framework. First elaborated in order to understand the origin of the 1992 Italian political crisis (Palombarini 1997), it can be extended to a stimulating analysis of the dynamics generated by the EMU. Under which conditions will the Euro be viable in the different domestic political arena? Only if the economic evolutions that the Euro sets into motion, are affecting the various social groups in such a way that *the support to the deepening of European integration is growing through time* and delivers a continuous democratic support to the governments which have proposed and implemented the current phase of Europeanisation. But this process has become quite complex since it bears upon monetary integration, financial deregulation, Single Market extension and the limit over national public deficits (Figure 8).

Basically, the very implementation of the Euro shifts the boundaries between social groups or even redefines them. The large internationalised firms have of course a basic interest in quite any of these four structural changes. It is not a case for medium and domestic firms, which might be hurt by the deepening of Single Market, according to an opposition which can be perceived in quite any country and shows up into polls and surveys (see Table 8, supra). By contrast, welfare dependants, most civil servants, farmers and low skilled workers are unlikely to benefit from the new conception of economic policy and State interventions which are implicit to the Euro strategy. According to the initial size of these groups, economic specialisation, the specificity of interest aggregation via political party formation, the nature of the constitutional and political order, the same European policy may have quite contrasted impact upon the legitimacy and "durability" of pro-Euro governments. Another important variable has to be added: the individuals do not react only to the consequences of the Euro upon their material life and status but they may have general feelings about the desirability of European integration, on purely political or ideological grounds. Finally, the general macroeconomic evolution plays a role in the acceptance of the Euro: if for instance 1998 initiates a long economic boom, no doubt that the acceptance of the Euro will be easier and

FIGURE 8 : IS THE AMSTERDAM TREATY POLITICALLY VIABLE IN THE MEDIUM-LONG RUN ? A MORE DETAILED FRAMEWORK



will give more time to solve the emerging problems. If on the contrary, the current Asian financial crisis happened to affect European growth and even trigger a world depression, the fate of Euro could be completely changed. For the better, if the crisis were an incentive to speed up European integration in order to isolate the continent from the vagaries of the international finance. For the worse, if nationalist and xenophobic forces take the power in some countries and put a term to the very essence of the European project.

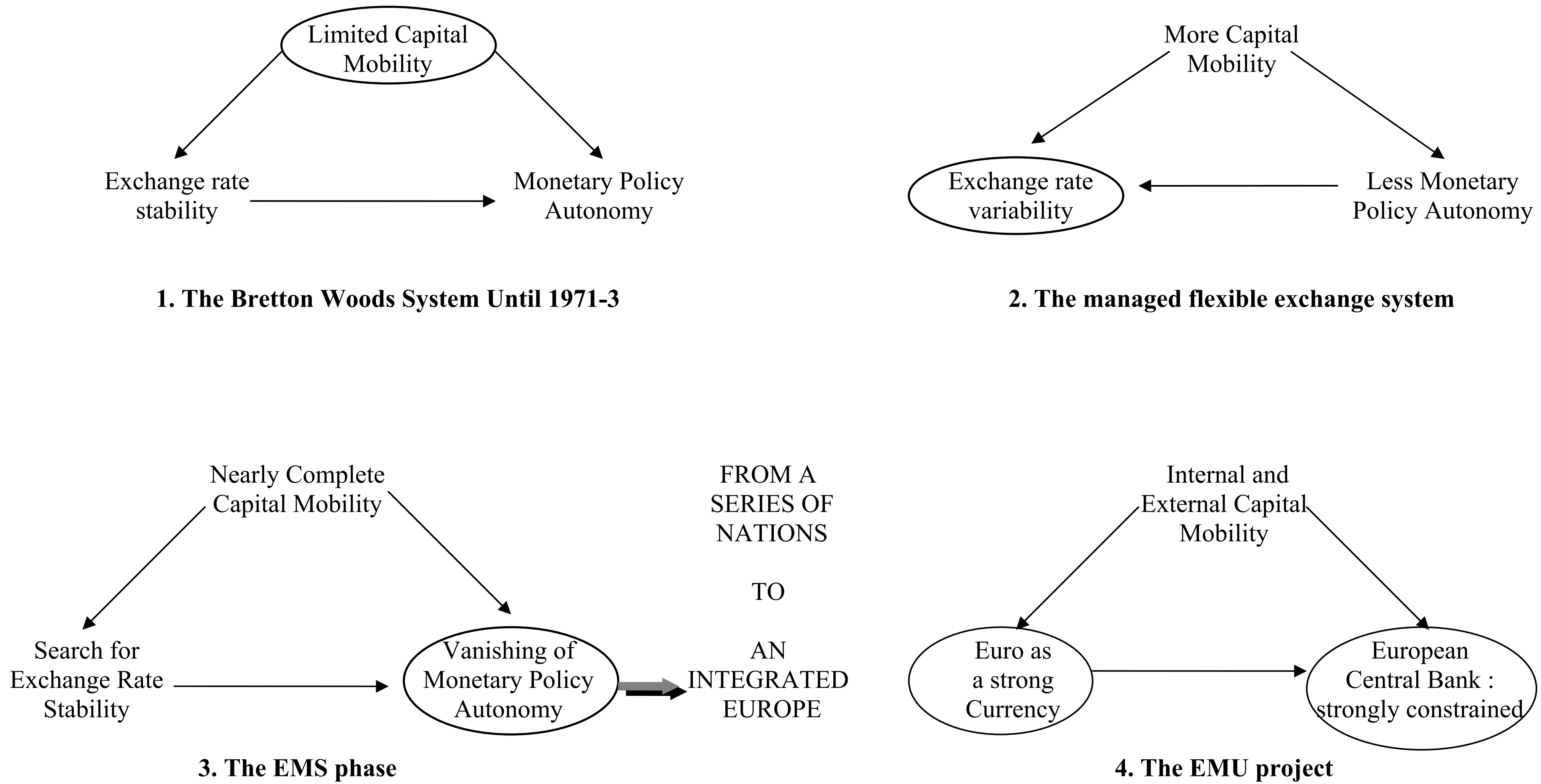
But *many other scenarios* are opened from these interactions between *economy and polity*. The challenge of the Euro may actually trigger a move toward more solidarity at the national level. Thus the losers could be compensated by the winners and a new social pact and cohesion could emerge within each national State. Or, quite on the contrary, the inertia of the past institutional architecture may deliver unemployment and social exclusion as adjusting variables to the Euro. If the socially excluded individuals or groups tend to be politically excluded too, by not voting and being part of the political process, Europe could well follow an American track. Widening inequalities would not be so challenging for the stability of the pro-European elite. But alternatively, given the ideological traditions of some countries, these groups may feed extremist parties, with drastic anti-European programs. In other words, as soon as the interplay of political, economic and social forces is taken into account*, the legitimacy and viability of the Euro is one of the key issue of the next decade*.

The future is largely open, and this hint concerns the very core of the EMU, i.e. the objective and the role of the European Central Bank. The precision of the clauses of the Amsterdam Treaty may give the impression that every thing has already been decided and therefore the trajectory of the Euro is already fixed, on the model of a rocket to the moon launched by the NASA. This feeling is largely misleading.

The ECB is facing various strategic options.

Actually, alternative policies might be decided without altering the text of any European Treaty, partially because the various clauses authorise contrasted interpretations about the need of economic policy coordination, the consequences of severe and unexpected national crises and of course, the opportunity to strengthen economic policy coordination if a fraction

FIGURE 9 : THE STAGES OF MONETARY INTEGRATION IN EUROPE SEEN FROM THE MUNDELL IMPOSSIBILITY THEOREM.



of member States agrees to do so (Jacquet 1998 ; Muet 1998). Again a brief historical retrospect is useful in order to understand the factors that shape the changes in monetary principles and regimes.

The Mundell impossibility theorem revisited.

The so-called Mundell-Flemming's impossibility theorem is a good starting point. This core analytical framework about the macroeconomics of open economy states that it is impossible to have simultaneously complete capital mobility, a fixed exchange rate and an autonomous monetary policy. Its interest is to show the possibility for a plurality of national monetary regimes and international financial regime. Actually, most of the theoretical possibilities have been observed since the second WW (Figure 9).

The launching of the Euro defines the fourth phase of a rich and interesting story:

- *From the end of the WW II until 1971*, the international regime was built under a strong *public control over international capital mobility*, a legacy of the dramatic financial crisis of the inter-war. Within the Bretton-Woods system, each national government had to declare a fixed external parity to IMF and stick to it unless a cumulative trade deficit, or more rarely capital flight, constrained to a devaluation, which was, in theory, operated under the control of IMF. In this context, the monetary policy enjoyed a considerable autonomy at the national level, and this was captured by the Keynesian IS-LM model. The interest rate, along with tax and public spending, were the key variables in determining the level of activity by the joint action of the Central Bank and the Ministry of Finance which were frequently closely and directly linked to the government strategy, largely discretionary (Figure 9 – first part).
- *From 1971 to 1978*, this configuration underwent some structural transformations which have been preventing such a fine tuning by economic policy at the national level from continuing (Figure 9 – second part). First of all, the creation of the Euro-Dollars speeds up international capital mobility and puts a pressure upon the system of fixed exchange rate. Since inflation is quite high and heterogeneous across countries, the Bretton-Woods system cannot be sustained. The de-connection of the Dollar with respect to gold sets into motion a system of *flexible but managed exchange rates*. More and more, the exchange rates are set according to the expectations of inflation by the financial markets and the domestic interest rate set by the Central Bank, i.e. a mixed system where market forces and public control interact. The national monetary policies are more and more constrained by international capital mobility, but the national authority still have an influence upon the level of economic activity. The Keynesian ideal of fine tuning is decaying but still not dead!

- *From 1978 to 1998*, European countries have desperately been trying to organise a minimal stability of their internal exchange rates, in order to mitigate the large and frequently unexpected variations of exchange rates observed between the Dollar, the Yen and other extra European currencies. The distant, but still present origin of the Euro, is the European Monetary System (EMS), which was launched on December 1978 by a European Council held in Brussels (de Silguy 1998: 43-70). The underlying factor pushing towards the fixing of internal exchange rate is not else than the dramatic surge of short run international capital movements, which tend to be a large multiple of the every day external trade (Palan 1998). Therefore, purely financial variables and expectations govern exchange rate formation. It is not a surprise if many crises have taken place within the EMS, the most severe ones in 1992 and then 1993: how to impose a full public control when even the alliance of major Central Banks is unable to go against private speculative movements? But the implementation of the Maastricht Treaty has again put exchange rate stability at the core of national economic policies. In this third configuration, *the majority of European countries, with the exception of Germany, had lost any autonomy in their monetary policy* (Figure 9 – third part). This is precisely the origin of the EMU: set irreversibly internal exchange rates and recover some degree of freedom for a common European monetary policy.
- *After January 1999*, a totally new configuration is scheduled. The only continuity is about private capital mobility which continue to govern the evolution of exchange rates at the world level. In a sense, the completion of financial liberalisation under the Euro will have a major impact on the Single Market and bring an optimisation of the rate of returns all over Europe, once the risk of exchange rate variations will have been totally removed. Building the credibility of the Euro will probably be the first objective of the ECB. If this is understood as preserving the exchange rate between Euro and Dollar, then the Mundell's theorem implies that *the autonomy of the European monetary policy will be severely restricted*. Of course, one imagine that keeping a very low inflation rate is an insurance against a weak Euro, but conceptually the two objectives are distinct and imply different interventions. It is the case, if for example, in spite of a low inflation, financial markets prefer to transfer their assets to Wall-Street which would provide higher interest rates and long term stability. For instance, in 1998, the Japanese economy is experiencing a near deflation, but interest rate is so low that short run capital is flooding into the US markets. Consequently, the Yen is sliding against the Dollar. Paradoxically, if this scenario turned out to be correct, the EMU would extend to the European level the dead-lock previously experienced at the national level (compare part 4 and 3 – Figure 9).

Thus, some interesting teachings are to be learnt from this historical retrospect. First, there is *no perfect monetary regime* which would last for ever. Quite on the contrary, the very success of a given international/national regime feeds destabilising forces which call for the emergence of another configuration. Second, the Euro is to be understood as a tentative in order to alleviate *the contradiction between monetary policy autonomy, full international capital mobility, and the preservation of the Single Market*. Third, the ECB will face the following dilemma. Should it stick to the objective of *price stability* whatever the consequences for the Euro/Dollar exchange rate? Or will it be induced to first assess the *Euro as a strong currency*, which would benefit afterwards to the fight against inflation? Or could international capital mobility be institutionally reduced, thus opening new perspectives to the ECB?

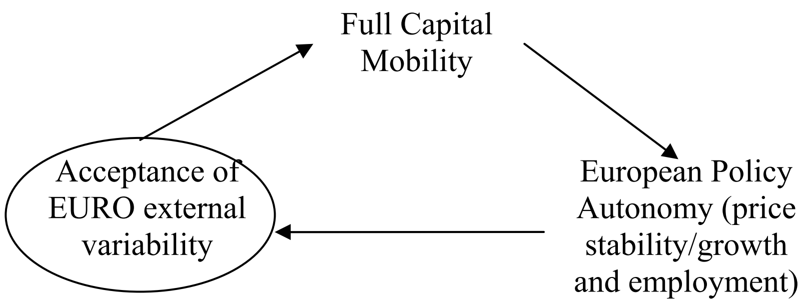
Three options with contrasted outcomes.

The present situation can be extrapolated according different directions, which in the long run may make a lot of differences about the process of European integration. It is interesting to present them from the more likely nowadays to the quite unlikely (Figure 10).

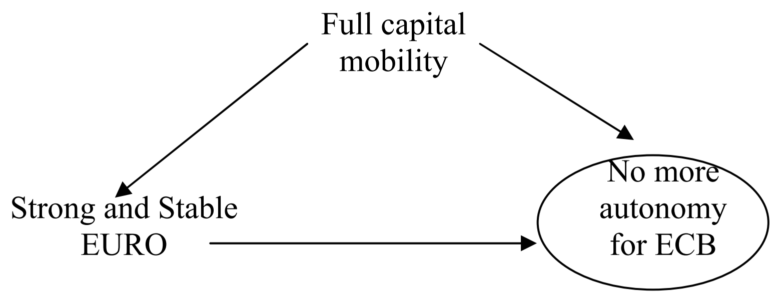
- Most analysts agree that *price stability* will be the main objective of the first decisions of the ECB, because it is so important for financial markets and the acceptability of the Euro by public opinion of countries that used to enjoy a strong currency, such as Germany. Initially it was assessed that this anti-inflationary objective would deliver, as a side effect, a smooth evolution of the Euro with respect to the Dollar. Nevertheless, a more careful theoretical and applied research now tends to conclude that quite on the contrary the volatility of the external rate of exchange will be increased. Actually, in the absence of any risk about internal exchange rates, with the same objectives of the Central Bank before and after the Euro, the monetary policy is likely to be less accommodating, as soon as price uncertainty is dominant with respect to demand uncertainty (Cohen 1997). Thus, willingly or unwillingly, the ECB would converge toward nearly the same policy as the Federal Reserve Board, not so much by ideological conversion to a more pragmatic view of the monetary policy (Aglietta and de Boissieu 1998), but because ECB would take into account *the continental size* of the European economy after January 1999, or progressively learn to do so (Figure 10 – strategy A).

FIGURE 10 : WHAT FUTURE FOR ECB AND EURO ? THREE OPTIONS WITH CONTRASTED OUTCOMES

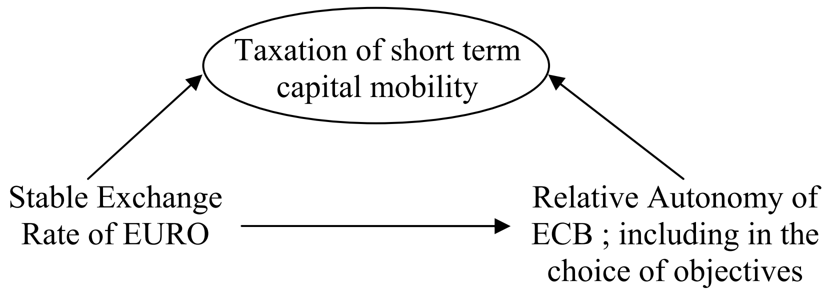
STRATEGY A : An autonomous european monetary policy



strategy B : euro as a strong currency



strategy C : taxing short term capital...the forgotten option



- This first strategy has itself *a pro-growth variant*. Instead of looking exclusively at the inflation rate, the ECB could try to get the better trade off between growth and stability. After all, a majority of European countries have complied with the 3 % criteria for public deficit in 1998, precisely because the economic recovery has alleviated the pressures on public finance (along probably with some *creative accounting*). More generally, a pro-growth monetary policy could deliver Pareto superior results (Fitoussi 1998). Again the Mundell-Flemming's model suggests that an adverse shock common to all European countries should be dealt by monetary policy (Wyplosz 1997). One could even imagine that an optimal policy mix emerge from a more and more pragmatic ECB, confronted with a powerful Euro-11 coordinating national budgetary policies (Muet 1998). A political pressure in favour of the accountability of the ECB before the European Parliament and other European bodies would propitiate such a variant of the main scenario.
- But of course, an alternative strategy may focus upon *the strength and stability of the Euro*. If the trend towards complete capital mobility is considered as irreversible, then the will to maintain a stable Euro/Dollar parity would remove any autonomy to the newly created European Bank (Figure 10 – strategy B). From a strict economic point of view, this is not a very rational strategy, because it reproduces at the continental level the policy which has been so detrimental to growth and employment during the convergence toward the Euro. But the pressure of some national public opinions or the perception of the actors intervening on the global financial markets make this strategy possible, if not highly desirable. Furthermore, the notion of a strong currency is not self evident at all, since it may recover quite contrasted understandings.
    - First, it could mean an *overvalued Euro* with respect to the Dollar and the Yen : the deflationary pressure imported would be paid by a loss of market share and a further de-industrialisation (Munchau 1998).
    - Second, and more realistically, a strong currency allows *a lot of freedom in the conduct of the monetary policy*, directed towards typical domestic objectives: given the credibility built during past episodes, the Central Bank may have a strategic action and be relatively immune from confidence crises when, for instance, a short run bad macroeconomic index is released. The *"Bundesbank"* had this privilege and this explains why the reaction of financial markets were different for the same decision taken by *"Banque de France"*. In spite of all the precautions taken by the Amsterdam Treaty, it will not be easy to convert this credibility from the Deutsche-Mark into the Euro. Contemporary financial markets scrutinise any structural weakness and act accordingly, since they turned out to be quite

suspicious indeed. Public economic policies have to cope with this drastic requirement and it is not an easy task (Lordon 1997).

° Third, a strong Euro may mean that it becomes *a reserve currency* challenging the long lasting Dollar hegemony. This definition is not at all equivalent to the previous one, since for instance the Swiss-Franc is clearly a strong currency without aspiring to be a reserve currency. Even the Deutsche-Mark has not developed as a real challenger to the Dollar. The share of Deutsche-Mark in total world official reserves has been nearly constant over the last two decades (14.9 % in 1980, 14.1 % en 1996) and the decline of the Dollar has been very modest, from 68.6 % to 62.7 % during the same period (Peet 1998:23). In 1996, the reserves in Ecu represented only 1.7 %, whereas the rise of the Yen has been relatively modest, from 4.4 % to 7 %. Clearly Europe could gain a lot from such a status of the Euro, but the road is still long before being independent from the evolution of the US Dollar.

° Fourth, if European countries could *pay their debts in their own currency*, then the Euro would become a strong currency. Basically, this is the privilege of the American economy and of course it would help a lot the reduction of the current interest charges on the public debts, to be able to repay with its own currency and still enjoying low interest rates. This implies that Europe would have a powerful financial centre, which would compete with Wall-street in attracting the savings and mobile capital from all over the world. Under this respect, the way the current Japanese financial crisis will be solved, will have a long lasting impact upon the evolution the Euro and more generally financial intermediation at the world level.

- Precisely, the deepness of the Asian financial crises reminds to the financial community itself that speculating may in some cases stabilise market and be good for individuals who get rich…but quite dangerous for the systemic stability of the world financial system, when the game is played on highly sophisticated and abstract future indexes. This message was usually voiced by Keynesians (Minsky 1982) or critical analysts (Aglietta 1995) and the proposal of James Tobin to put a tax on short run capital was then received as non-realist by most governments and of course financiers. It is therefore highly remarkable that one of the most visible speculator has written a whole book in order to denounce the danger of unleashed international financial speculation over the very stability of the whole system (Soros 1997). Thus, the probability of a third scenario has increased since the summer 1997: the implementation of a Tobin's tax on short run capital (or alternatively institutional barriers to speculative capital) would give a nice issue to the Mundell's impossibility theorem. A more or less stable exchange rate of the Euro could be made compatible with a relative autonomy of the ECB monetary policy. In this case, the merits of Euro would be evident (Figure 10 – strategy C).

However binding might seem the monetary clauses of the Amsterdam Treaty, a lot of options are opened. The road actually taken will depend upon the circumstances (will the European boom be as durable as the American one, will the Japanese financial crisis be solved in 1999, will the speculation at Wall-Street end up into a soft or a hard landing?) and the nature and speed in constituting a political arena around the ECB. The same *wealth of futures* can be contemplated for the other aspects of EU.

A single treaty, a multiplicity of conflicting political programs.

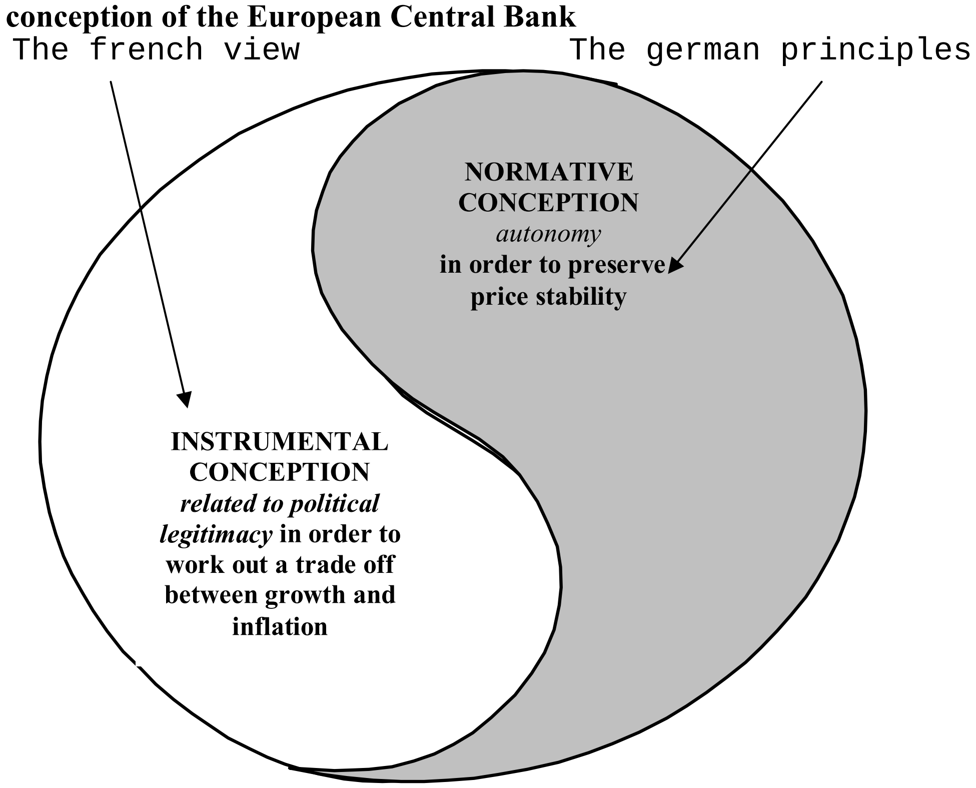
The charm of international treaties is to try to be as precise as possible but simultaneously to compromise over important issues, where underlying representations and national interests may differ significantly. A careful reading of the European Treaties brings a lot of optimism about the flexibility which can be managed through a text, so difficult to agree upon. The diversity among the eleven members of the Euro is so large, that it would be surprising not to observe quite soon conflicts of interpretation and the forging of a jurisprudence in order to live with the Amsterdam Treaty, without negotiating a new charter. But of course, the extension to new members may call for such a drastic revision of the institutions if the EU. Some clear tensions may already be perceived under various headings.

The links between monetary, budgetary and structural policies.

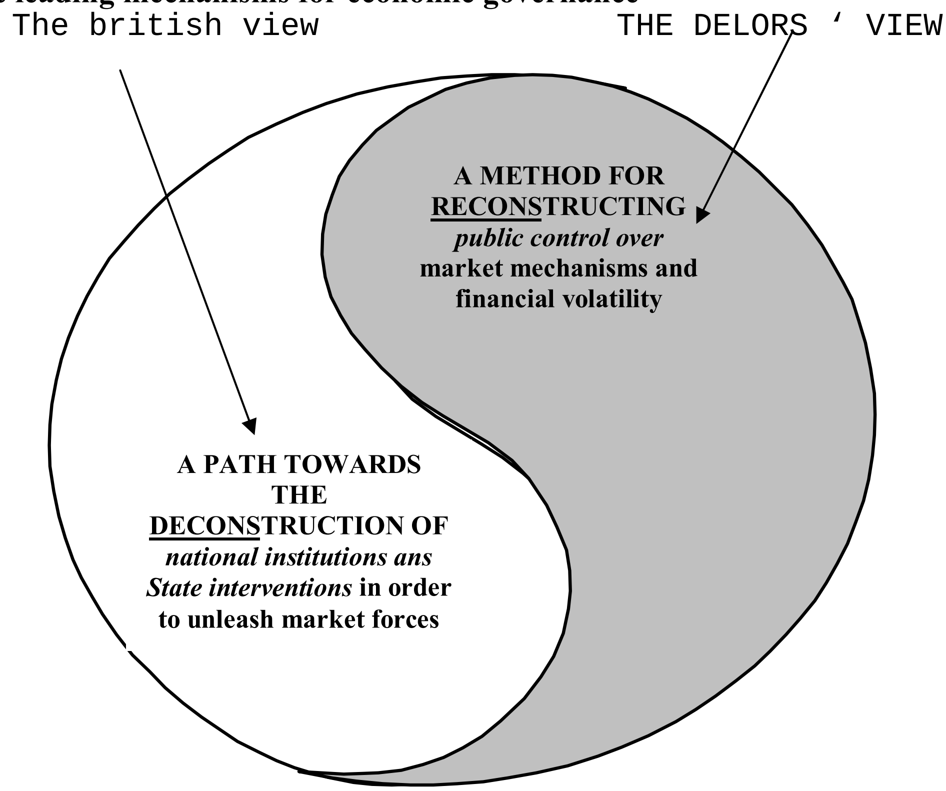
Many observers have pointed out a basic ambiguity in the launching of the Euro. After all this was a *divine surprise* nobody would had expected back in early 1997. But the agreement for an independent European monetary authority, along with disciplinary rules for national budgetary policies is located at the crossing of two strategies and visions of the world: “For the French, it is a step in order to build a political union which would constitute the European Union as a clear *economic actor*, who would have a full capacity to *govern macroeconomic adjustments*. For the Germans, the objective is to remove the monetary management *from any political pressure* and to induce the Europeans to undertake structural reforms, i.e. to substitute many and bold *microeconomic actions* to a macroeconomic regulation, without any relevance, in the absence of any asymmetric and exceptional shock” (Bourlanges 1998: 143).

FIGURE 11 : THE SAME AMSTERDAM TREATY…BUT CONFLICTING VISIONS OF THE DYNAMICS IT IMPLIES

1. **The conception of the European Central Bank**



2. **The leading mechanisms for economic governance**



This opposition is permeating quite any aspect of the ECB management (Figure 11. 1). Traditionally the French governments, whatever their colour and orientation, have an *instrumental conception* of the monetary policy. Of course, *"Banque de France"* has been made independent and the ECB is still more autonomous…but it was conceded to the Germans and other partners in order to convince them about the French determination concerning the whole Euro project. The final objective is to work out a better trade off between growth and inflation, under the strong impulse of inter-governmental coordination. The German vision is quite opposed. The independence of the Central Bank is an integral part of *a normative conception* about what is a good economic system. No discretion should be left to government for influencing monetary policy, which should be submitted to transparent and steady rules. Furthermore each domain of the economic policy should be independent, at odds with the French voluntarism about the required coordination of the ECB and the Euro-11 Council.

Therefore it is highly likely that during the very early implementation phase of the Euro, both sides of the Rhine will have opposite feelings about the policies decided in Frankfurt. But of course this is now no more a German-French issue but a European one, which make the matter still more difficult. The Northern countries tend to follow the German principles, because they have a long experience of adjusting their policies in accordance with the decisions of the *"Bundesbank"*. But the Southern countries may be receptive to the French position according which the Euro should be submitted to a common political will. Strong conflicts ahead! The irony is that after all the European would have interest in adopting a still different conception of the monetary policy, the American one (Thygesen 1992). In this country the legitimacy is reached via the publicity of the deliberations of the FED and a check and balances between the Federal Government, the Congress and the Central Bank. A rough comparison suggests that this accountability benefits to the overall performance of the American economy, probably because the objectives are set in conformity with a large variety of interests and clear signals are usually sent to financial markets. For the time being, the FED pragmation is far from being a reference, nor an ideal for the Board governing the ECB…but monetary integration takes a long time and circumstances and mindsets may change!

But this is neither the unique conflict of visions, nor is it limited to a German-French dialog. The issue of the ideal governance modes under the Euro is a quite controversial issue too (Figure 11. 2).

- *For the British*, the Single Market (and eventually if they joined it, the EMU), are conceived as a device in order to destroy or considerably erode all the institutional arrangements which have been so detrimental to the British and European performances during the Seventies and Eighties. Therefore the basic aim would be to create a free trade zones with competitive product, labour and credit markets. The idea that Brussels could impose new and complex rules of the game or constraints appears as an heresy which goes against the very unfolding of the conservative strategy and the victory of "market" against "bureaucracy". According to this position, political integration is not at all required, it would be even dangerous since it could recreate at the continental level, the regulations that have been finally destroyed or eroded in Great Britain, a move which is assumed to have reversed its long run decline.

- *For Jacques Delors*, the former President of the European Commission, along with a majority of social democrats, the agenda is strictly the opposite. The internationalisation of economic activity has eroded the capacity of control and monitoring by national public authorities. But a new form of control can be re-instituted at the now relevant level i.e. the European one. A second divergence with the British view is about the role of markets. For social democrats free markets are neither efficient nor conform with a minimum social justice. Therefore they have to be monitored by adequate regulations which should be decided at the European level if strong externalities spill over across national borders, but at the national or regional level, if it is not the case. The subsidiarity principle intends to give a clear criteria for the agenda and non agenda of Brussels, at odds with the *"laisser-faire"* vision which postulates that the maximum decentralisation is, the better is economic performance.

This ambiguity is no less challenging that the opposition about the statutes of the Central Bank. For the British, the European construction is a method for implementing free trade on the continent, and ultimately to be part of the larger world movement in favour of deregulation, in alliance with North-America. For the social democrats, quite on the contrary, the European integration means a well organised competition and the constitution of a strong regional zone, which could become more and more independent from the Dollar, American technologies and even culture. When the French and British Prime Ministers meet the German Chancellor, the potential sources of misunderstanding are numerous, but conversely diverse and a priori paradoxical compromises can be struck, inspired by quite opposed long term objectives. For instance an alliance of the British and Germans on the issue of structural policies may coexist, along with another alliance between French and Germans about the EMU and so on…Until now, this kind of ambiguity has been quite fruitful indeed for European integration, but there is no guarantee that this happy outcome will continue with the Euro, which clearly design a new and much more challenging phase (Bourlanges 1998).

Deepening of European integration versus admission of new members.

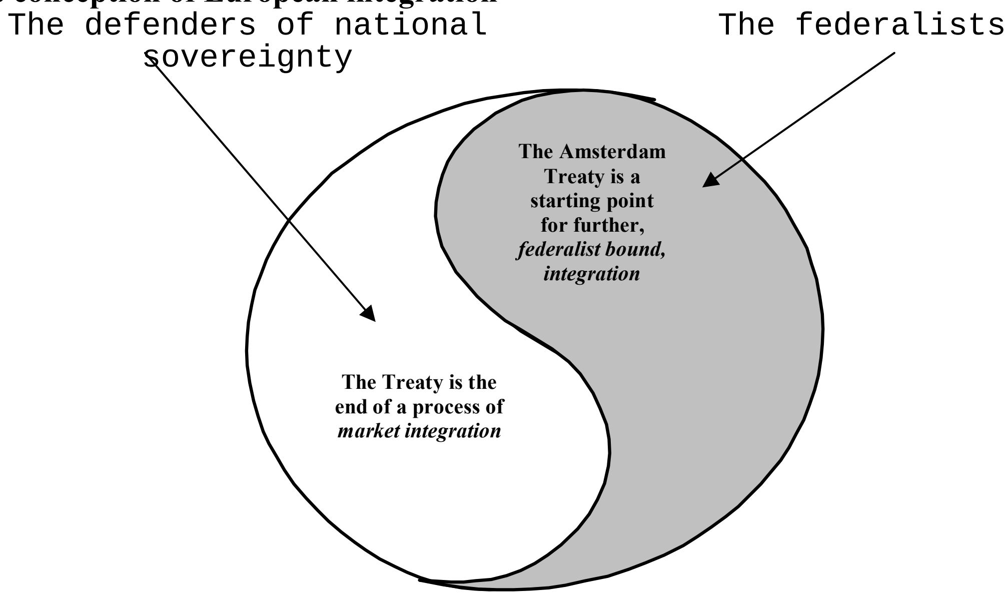
There are many other sources of potential conflicts, both within the Amsterdam Treaty itself and still more concerning its compatibility with the extension of memberships from fifteen to twenty five countries. Again the visions, the objectives, the interests and the strategies are opposing at least two groups (Figure 12).

Is the EU a matter of economic efficiency or a political issue? This ambiguity is at the core of the European integration till the early years and this paradox has already be pointed out in many occasions by this essay. Nevertheless the Euro puts a crude light on this issue. Economic history suggests that no money can exit without a clear political backing. But two opposite conclusions can be derived from this evidence. The defenders of national sovereignty argue quite rightly that the current status of Euro is not viable because no supra-national State is governing this institutional creation, and that conversely a national State without its own currency is a contradiction in terms. The Federalists do not disagree about the first statement, but they think that the political gap has to be overcome precisely by creating a European State, which should be the ultimate warrant of the viability of the Euro (Figure 12 – 1). There is of course still another position, already mentioned, which insists upon the radical novelty of the EMU and the implicit political construction of the Amsterdam Treaty, which is neither an embryo for a European national State, nor a step towards a Federalist State (Théret 1997; Dehove 1997). In this context, the Amsterdam Treaty could well represent the zenith of European integration, since it will be quite difficult to go further and create a European polity. There would not be any ambitious common challenge left, which could be put on top of the agenda of political leaders overcome the density of national interests and promote a new wave of reforms in domestic institutions for Europe's sake.

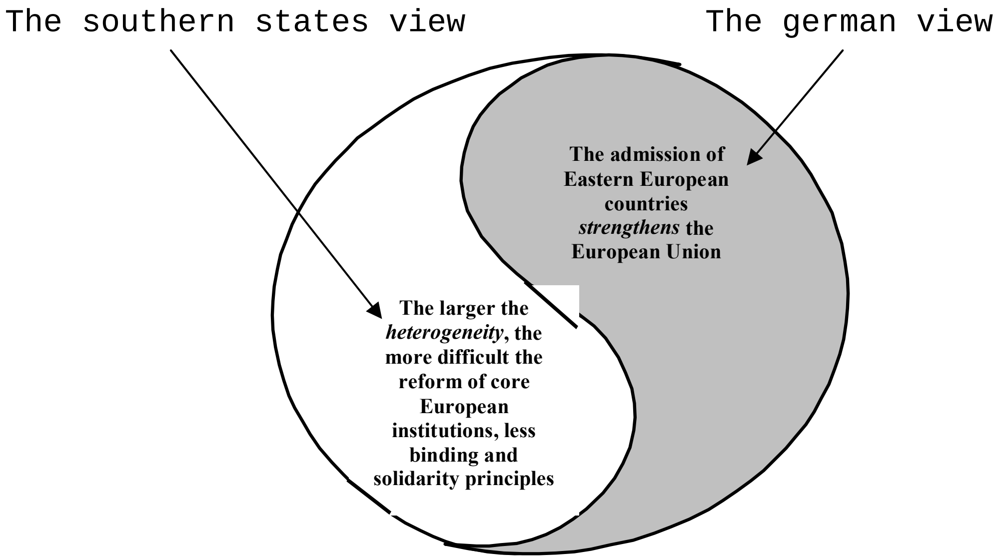
- *Should EU first reform its institutions and then admit new members or the other way around*? This is intrinsically a quite difficult question which challenges the very significance of European integration. But again, two positions are present and hard to reconcile (Figure 12 – 2). On one side the Germans consider that the inclusion of former European "socialist" countries is a high priority both for geopolitical reasons and due to the traditional role played by Germany with respect to Poland, Hungary and other Central European countries. If the political project is clear enough, the economic side is more difficult to deal with, given the large heterogeneity of economic institutions and specialisation of many of these countries and their difficulty to comply with the present European norms and requirements. Furthermore, the rebuttal by major Western economies to extend their

FIGURE 12 : STILL OTHER POTENTIAL CONFLICTS

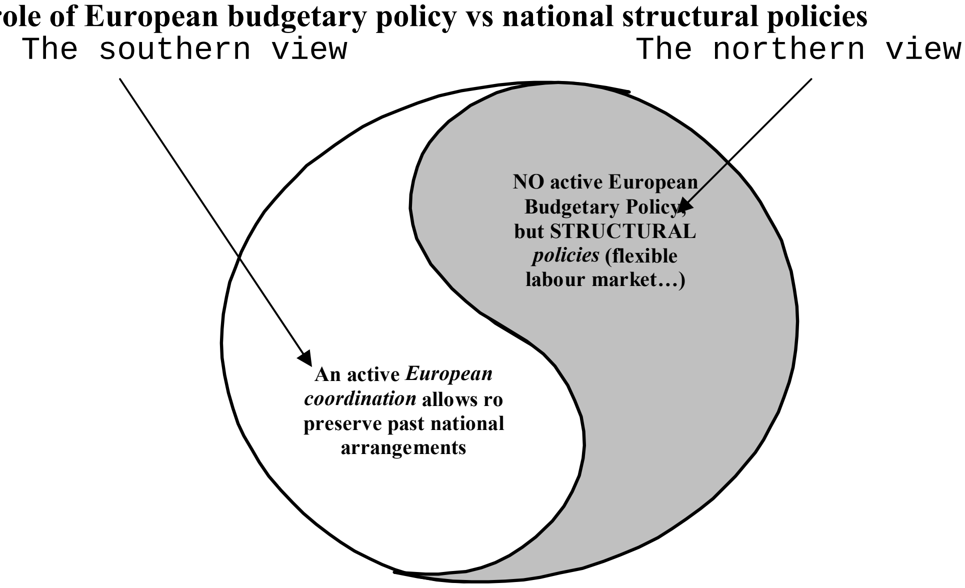
1. The conception of European integration



2. The admission of new member states



3. The role of European budgetary policy vs national structural policies



contribution to the European budget makes quite problematic the survival of the present interventions for agriculture or regional structural funds. The dilemma between polity and economy is specially acute. On the other side, Southern European countries fear to be marginalised by the opening to the East. First because typical mass-production may go to Poland or Hungary instead of Portugal and Spain. Second, the structural European funds available for them would be drastically reduced. Third the centre of gravity of Europe would shift towards a East, with a lot of economic and political consequences. Still other governments, not directly concerned, may think that the larger the heterogeneity of economic and political institutions across members, the more unlikely is the success of any reform of the core European procedures, given the unanimity principle which is applied in the vast majority of decisions. A logical analysis suggests that the process of integration should be differentiated by competence and/or participant members (CEPR 1995). But this *"Europe à la carte"* is basically challenging the ideal of Single Market and Common Currency and would probably make inextricable a decision process already very slow and cumbersome.

- *Are structural policies a substitute or a complement to the coordination of budgetary policies*? Again a North-South dividing line comes out (Figure 12 – 3). The Northern countries (Germany has already be mentioned) consider that no active European budgetary coordination is necessary, unless quite exceptional event. By contrast, for them, the viability of the Euro is up to active structural policies about labour market institutions, the financing of the welfare state, the tax system, the education and training systems, public sector management and so on. The EMU would define the only macroeconomic mechanism at work in Europe, all other topics being decentralised, at the more micro level. In the language of disequilibrium theory, the European unemployment would mainly be classical, i.e. caused by an *insufficient supply* linked to a too low profitability. The Southern countries (including France) have a different vision. Most of the difficult adjustment processes during the Nineties can be attributed not so much to an intrinsic rigidity of European institutions but to the strains brought by restrictive macro economic policies. Thus, the employment would largely be Keynesian, i.e. caused by an *insufficient demand*, itself generated by the monetary policy about high real interest rates and budgetary austerity. Coordinating national economic policies would make much more easier the adjustment to world trends in competitiveness and innovation. Again a synthetic position has been proposed by a group of economists: why not to reduce the social and fiscal taxes levied on low skilled labour in order to act both on the supply side and the demand side (Drèze, Malinvaud & *alii* 1994). Such a policy seems to have been implemented in various European countries, with a different mix of supply and demand components.

Alas, such a compromise is not always available for other topics and issues of European integration. *The ambiguity of the Amsterdam Treaty is both a trump but an hindrance* to the further deepening of the political institutions which are required for the long run viability of the Euro. Therefore, contrary to a quite common belief, the Amsterdam Treaty is not at all the end of the European history, it is only an episode, quite important by the subsequent reforms it calls for.

January 1999, the starting point for a series of unintended structural adjustments.

The surprisingly quiet and smooth transition from the second to the third phase of the Euro has given a false feeling of security, reinforced by the fact that after the May 1998 European Summit, the international financial community is convinced that the Euro will be born in accordance with the planned schedule on the 1st of January 1999. Can his success be extrapolated to the actual implementation of the Euro and the first steps and probably difficulties experienced then? Is there any firm prevision about the final outcome of the Euro or do experts disagree strongly about this issue? For some, Europe will end up as a variant of *"laisser-faire"* economy, after a de facto victory of the British vision, specially in terms of Industrial Relations (C. Crouch 1997). The Euro could contribute significantly to the evolution towards this scenario, because it strengthens competition among institutional regimes, tax systems and of course firms and individuals. For others Europe is bound to be politically integrated into a federal State, just to fulfil the requisites for a viable common currency. Opponents may comment ironically about this modern Hegelian vision (the EMU is rational therefore it will exist!)…but the Europeanists reply quite rightly that since its beginning, the European construction has been made by the very same strategy, that the Euro pushes at the extreme.

TABLE 9 : THE CONVENTIONAL DEBATE ABOUT THE EURO

SCENARIO / **COMPONENTS**	**EURO IS…**	
	…an incentive to co-ordination among nations and economic agents	**…the disintegrating device of post-WW II national institutions**
1. European Monetary Policy	Adopts a Federal Reserve Board style	More "royalist" than the Bundesbank
2. The policy-mix between national budgets and ECB	Euro X and ECB co-operate and optimise the policy-mix	Free riding of national budgetary policies brings instability and uncertainty
3. The Single Market	Along with the Euro, stimulates innovation and growth, alleviates budgetary austerity	Triggers more competition, institutional regime shopping, erosion of the tax base and restricts the autonomy of national economy policies
4. Industrial Relations	Co-ordinated wage bargaining and harmonisation of labour contracts and welfare systems	Balkanisation of wage bar-gaining, more heterogeneity in labour contracts and welfare systems
GENERAL ASSESSMENT	***Keynesianism at the European level****, which preserves most of the national legacy of institutional forms*	***Free market and supply side economics****, which dissolves the social cohesion at the national level*

Political debates and academic controversies are built upon dual oppositions, as if black and white were the only colour available…or more seriously as if the principle of "third excluded" was true. If the pro-Euro are wrong, then the anti-Euro are right and conversely. The central message of this essay is that this position is erroneous and misleading and id no more than a caricature of a highly complex process. Nevertheless, the conventional debate has the merit to define a clear starting point for the more convincing scenarios (Table 9).

A European dream: Keynesianism at the continental level.

For the Europeanists, the Euro is an incentive to a better coordination among economic agents and nations (Muet 1998) and ultimately it *is the first step towards a fully integrated Europe* (Bourlanges 1998). Basically, all economic units and political bodies will be constrained to take into account the new structural conditions created by the EMU and to innovate in order to build the other economic and political institutions which are required for the long run viability of monetary integration. Therefore, whatever the *initial ideological* *orientations* of advisory council its, the European Central Bank will finally adopt a Federal Reserve Board style : clear political accountability and search for an optimal mix between price stability and growth. Similarly, the national governments will perceive the externalities associated to domestic budget management and implement procedures in order to optimise the global policy-mix between monetary and budgetary tools.

Given the optimist expectations generated by this smooth handling of economic policy, firms experience strong incentives in order to innovate both in terms of products and productivity enhancing processes (Boyer and Didier 1998): thus the Single Market would finally deliver the long term benefits which had been expected since 1985. Social partners themselves learn that wage coordination is better than a myopic strategy and total decentralisation. Therefore, either each national bargaining process takes into account the wage evolution set by the German social partners, who themselves respond to the signals of the ECB, or explicit European wage negotiations take place at the sectoral level or within multinationals. In both cases, job creation is preserved and is not directly affected by the ECB policy. Thus, the final quasi neutrality of the money would not be the outcome of a "state of nature" but the result of a highly sophisticated institutional architecture of check and balances between various economic and political actors (business, unions, national governments, European Central Bank, European Parliament, European Commission,…).

In a sense, this is a rejuvenation of *Keynesianism at the European level* (Muet 1998), which, by the way would preserve most of national legacy in institutional forms. A still more optimistic vision would conclude that in the long run, this scenario will lead to a fully-fledge *federalism at the European level*. A minimal taxation and public spending should be done at the continental level, precisely to optimise the policy mix and organise a cross-border fiscal solidarity. This would enhance the political legitimacy of the whole European project, the common currency being a part of *a broader coherent configuration*. A quite happy end indeed!

A European nightmare: the victory of free markets and the balkanisation of societies.

For the anti-Euro, the EMU is *the disintegrating device of post-WW II national institutions and the starting point of an Europe governed by free market forces and ideologies*, with a complete loss of collective control over economic activity and the end of the pursuit of social justice. This is usually a criticism made social democrats experts (Mazier 1997 ; Flassbeck 1998) or leftist movements (Chevènement 1998). But there is an opposition to EMU which comes from monetarists such as Milton Friedman who blame on the contrary the excessive constructivism of the Euro (Rosa 1998). For the first group, the arguments are the strict opposite of the previous ones. The European monetary policy is condemned to be more monetarist than used to be the *"Bundesbank"* , because the clauses of the Amsterdam Treaty are binding and the financial community is expecting so. The only discussion taking place concerns the intermediate objectives followed by the ECB: an index of aggregate monetary supply or directly European inflation rate (Aglietta and de Boissieu 1998)? But well before January 1999, the debate has been set: the ECB will adopt the same intermediate objective as the *"Bundesbank"*, i.e. a money-supply target, even if it not necessarily the more efficient signal (The Economist 1998b). Growth and unemployment indexes are not even mentioned under the motto that "the monetary policy is not responsible for the European unemployment problem, nor should the Central Bank take into account job creation as an objective".

On the domestic side, national governments and parliaments will be jealous to keep their prerogatives about taxation and public spending, the more so since the budgetary procedures are quite idiosyncratic. Thus, the free riding of each national authority is quite rational, only limited by the 3 % EDP clause. When a recession will burst out, no degree of manoeuvre will be left in order to fight against unemployment. Then the tax levied on excessive public deficit will be quite unpopular in the domestic political arena. Some national governments may even challenge the orientations of the ECB, if they perceive, rightly or wrongly, that its restrictive or inadequate policy has exacerbated domestic problems, nearly impossible to solve within the constraints of the Amsterdam Treaty. In this gloomy macroeconomic context, the Single Market triggers more defensive competition than creative innovation: firms de-localise their activities from one country to another, in a permanent search for the more permissive institutional regime. High wage regions are losing jobs, whereas firms put a strong pressure on regional/national governments to get the maximum subsidy for job creation and the minimal taxation of profit and capital gains. Consequently, the tax base of the most Welfare oriented countries is eroded, whereas advanced labour legislation is challenged by new industrialising regions and tend to penalise low skilled workers. Therefore, Industrial Relations evolve towards a complete balkanisation of wage bargaining: unions are unable to organise workers across borders even within the same sector or the same multinational, and the domestic firms exploit their bargaining power in the context of a large pool of unemployed workers, including medium or highly skilled ones.

Some analysts have forecast a *de facto* convergence of most national Industrial Relations Systems towards a British configuration (Crouch 1994). Paradoxically, this system is far from ideal since it allows the coexistence of large pool of unemployed people, along with wage increases due to the scarcity of high skilled workers. Furthermore, rising wage inequality does not necessarily solve the unemployment issue. Still more, the fact that welfare benefits are closely linked to a limited regional/domestic space or are firms specific, hinders labour mobility, contrary to what would be expected, given the large heterogeneity of national unemployment rates. Clearly, due to the inability to forge new coordination mechanisms or European institutions, a market logic would govern most of economic adjustments and even influence the formation of economic policy, by reducing State interventions and promoting a privatisation of most of the welfare components and collective services. One could even imagine competitive wage reductions or alternatively productivity wars (Flassbeck 1998), which would give a typical *Hobbesian flavour* to this scenario. But of course it can be challenged by proving that such defensive strategies are less likely with the Euro than without (Artus 1998). The victory of *free market and the supply side economics* would mean *an Americanisation of continental Europe*, a quite gloomy scenario for the anti-Euro…but probably a desirable one for the high skilled professionals and European multinationals.

Ironically enough, these two scenarios are built on the analysis of the same European Treaty, a fact which by itself implies that no evident determinism is at work and that a much more complex analytical framework has to be worked out.

European integration, transformed political arena and changing institutional forms.

The previous developments suggest a three level analysis, which in turn may generate a whole spectrum of scenarios. Basically, the initial and structural change comes from the EMU, i.e. a new *European innovation* which by definition will alter the way national "régulation" modes operate in a very significant way. But, the *domestic political arena* it is itself transformed: the monetary policy which used to be decided at the national level, with more or less democratic controls, has irreversibly shifted to the ECB. Simultaneously, with the other clauses of the Amsterdam's Treaty, decisions which were part of national sovereignty (for instance the control of migration and borders) now become an issue only dealt at the European level. Therefore, the domestic political arena is shrunk by two mechanisms. On one side, the national legislation becomes the locus of implementation of European rules and directives, which restrict the autonomy of national interest groups. Some of them may protest and the conflict might be more acute than those already observed for fishing or migrating birds issues! On the other side, the common monetary policy and the enforcement of a competition policy at the European level, not to speak of complete financial liberalisation under the Euro, will necessarily alter the nature of national institutionalised compromises and still more the whole *architecture of institutional forms*, at least for many countries. The economic strains experienced by the domestic agents will be converted into political demands, mainly addressed to the national governments and in some cases the authorities in The Hague, Brussels and why not Frankfurt (Figure 13).

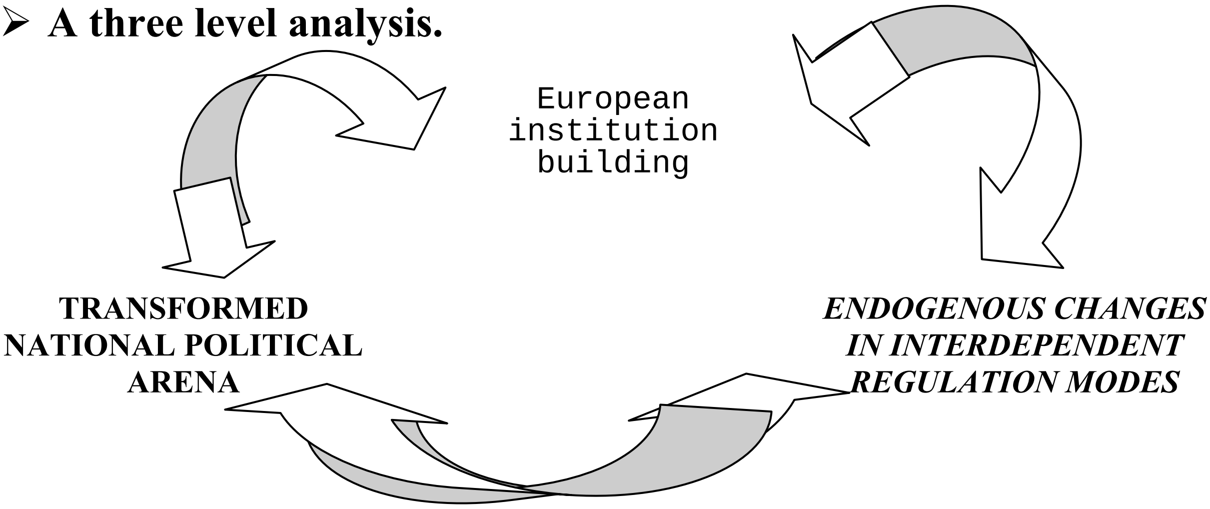
Thus, *these three level interdependency sets into motion a very rich dynamics*. It is quite hard to make any forecast, since the problem is similar to the famous problem found in astronomy, when three planets interact and may evolve according a whole spectrum of complex dynamics, from a smooth ellipse to a chaotic evolution, as the mathematical theory of chaos shows. Since strategic behaviour is common in political economy and innovations can always take place – contrary to astronomy where such a phenomena cannot exist –, the final dynamics of the Euro will be still more complex than previously analysed.

This three level analysis allows to propose a taxonomy for various scenarios, including the Europeanists' dream and the Hobbesian nightmare.

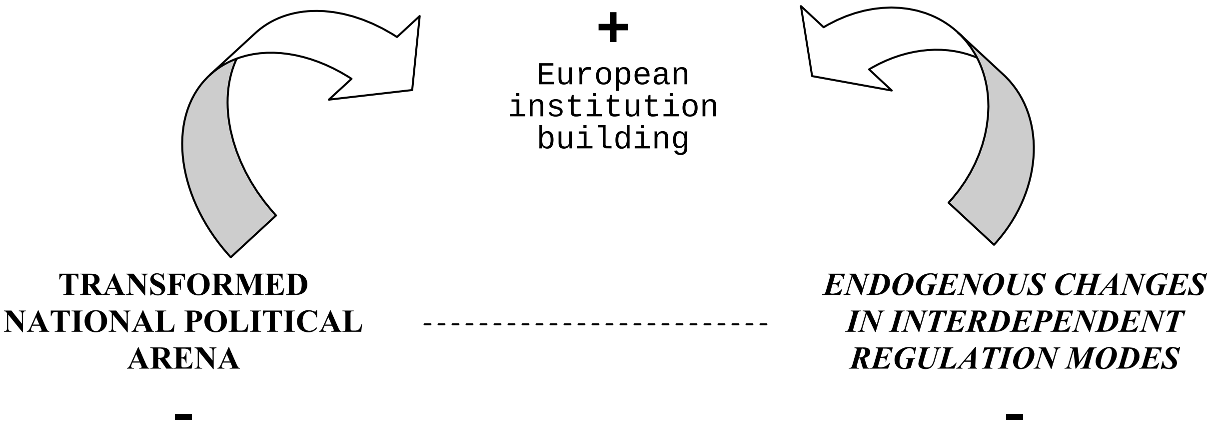
- Both Keynesians and Federalists think that European coordination or institution building should be proposed in order to minimise the transformations to be made in national "régulation" modes, even if they differ about the transfer of political sovereignty to European bodies. For the Keynesians, modest coordination procedures could solve the issue of national heterogeneity as well as the externalities associated to public budget…. Even if from a practical point of view this is not so easy to implement: how to comply with the recommendations from the Euro-11 Council given the specific timing and procedures of each national budget (Dehove 1998)? For the Federalists, the subsidiarity principle should be used to minimise the responsibilities transferred to Brussels, in theory preserving the maximum autonomy of local political authorities (see Figure 13 – second part). This scenario minimises the changes at the national level but maximise the innovations which should take place at the European level.
- The *"laisser-faire"* scenario assumes on the contrary that the European institutional construction has come to an end with the Amsterdam Treaty. Therefore it is up to national institutions, firms' strategies and individual behaviours to adapt to the new era initiated by the Euro. But of course, the social costs associated to such a restructuring will put some strains upon national solidarity, thus translating a fraction of the cost to the Welfare State System. The agenda of the domestic political arena cannot be unchanged…and it would be quite surprising if such an Hobbesian trajectory did not induce the emergence of new political demands and accordingly social and economic regulations.

FIGURE 13 : THE EURO SETS INTO MOTION A SERIES OF COMPLEX TRANSFORMATIONS, BOTH AT THE NATIONAL AND EUROPEAN LEVEL, WITH UNINTENDED FALLOUT

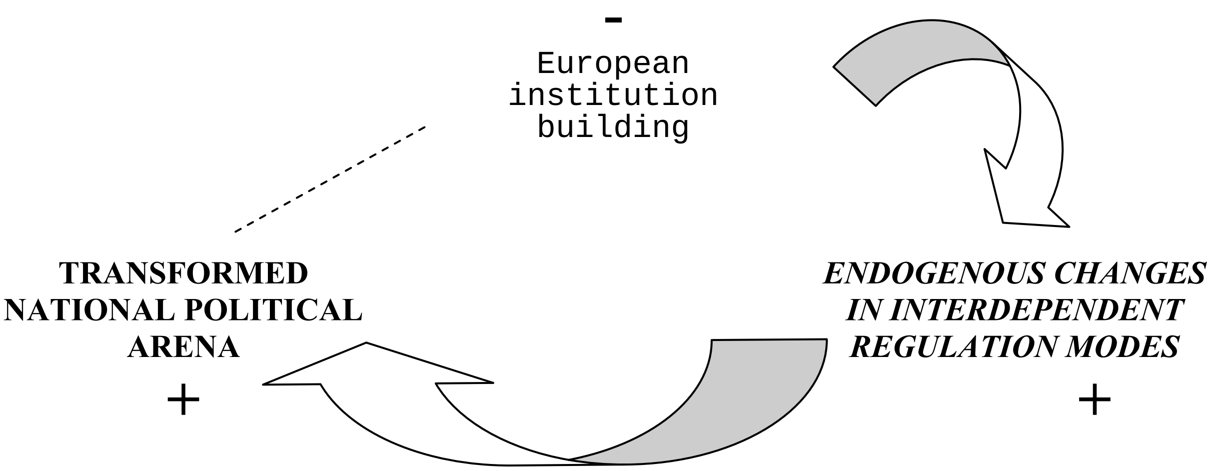
- **A three level analysis.**



- **Keynesianism at the European level : the primacy of national continuity but more European institutional building.**



- **Free market and supply side at the European level : not any more advances in European institutional building.**



+ : stronger changes **- : slower changes**

Thus, both scenarios adopt quite extreme hypotheses, do not take into account the positive and negative feed-backs between polity and economy, and drastically simplify a complex dynamics which is reduced to two "attractors" i.e. a necessary convergence towards a single configuration, of course different. But jointly they explicit most of the forces and dynamics which would be present in quite any scenario. How to elaborate richer and more diverse scenarios?

Three strategic parameters governing the future of European Union.

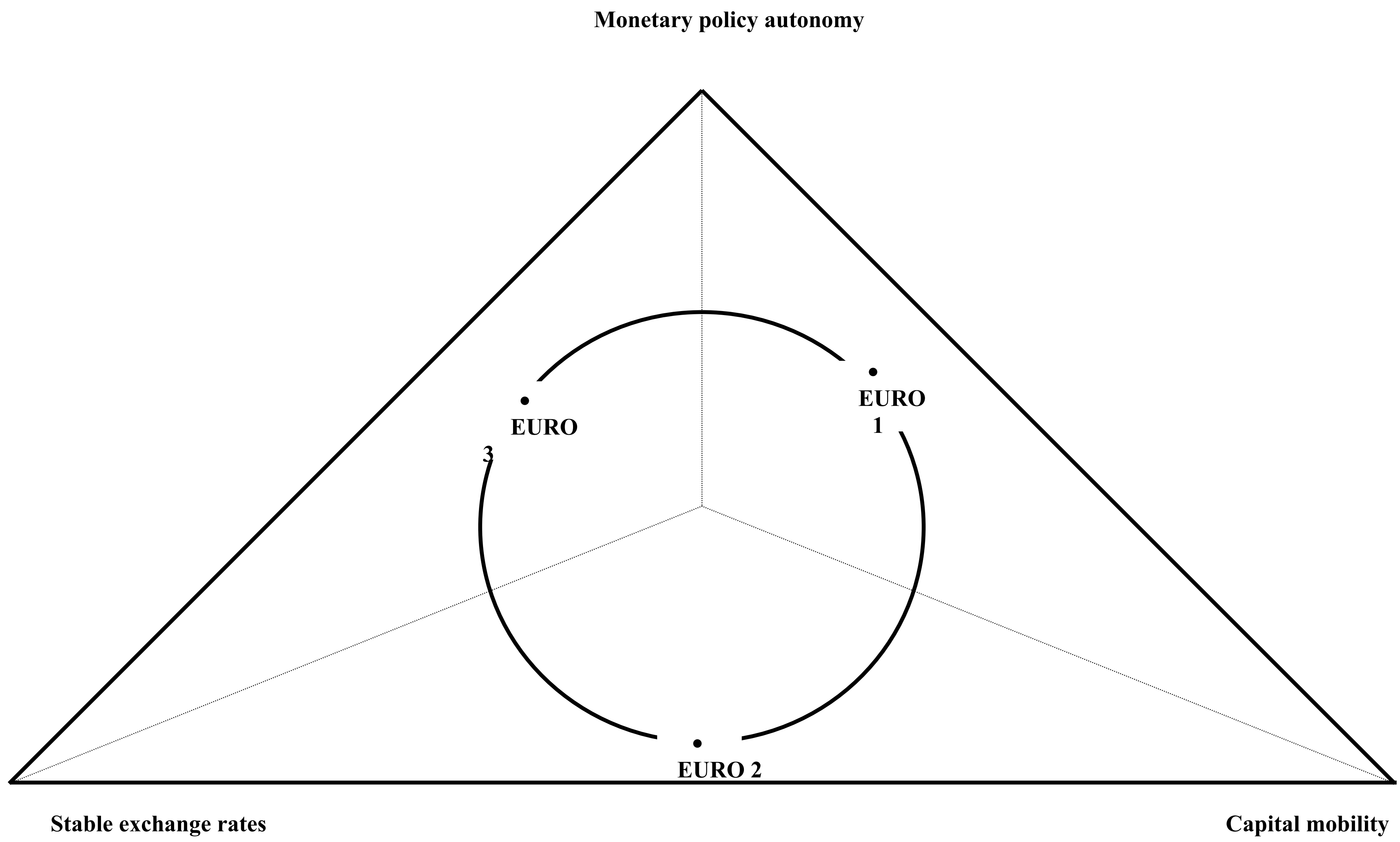
The previous developments have delivered many of the ingredients required in order to generate a series of configurations and dynamics. Basically each of them should assess the structural compatibility of a monetary strategy of the ECB, some complementary European institution and finally the ability of each society to adjust its institutionalised compromises to the current stage of European integration.

The choices facing the European monetary policy.

The European Central Bank has decided its *intermediate* objective i.e. a monetary aggregate target, but what will really be its final objective? The Mundell's model again helps to frame some options (Figure 14).

- The more likely seems to be the *strategy Euro 1*, which accepts full international capital mobility but focuses it action towards purely or mainly *internal objectives*, whatever the consequences for the variability of the exchange rate of the Euro. Some sub-variants may alter the weight given respectively to price stability, growth and in some extreme cases a modest concern for Euro/Dollar parity. Actually the general statement about the desirability of the Euro as a strong currency calls for a second scenario.
- *The strategy Euro 2* aims at stabilising the *exchange rate* or more generally to build the Euro as a competitor of the Dollar for world financial inter-mediation. Given the extreme mobility of financial capital, this would mean that the ECB would neutralise its governance role in terms of domestic monetary and credit policy. No doubt that most European actors, except modern rentiers and financiers, would object to such a strategy and would try to build active lobbies in Frankfurt in order to influence the decisions of the ECB. For completeness sake, a third option is opened and may be relevant in some rather extreme configurations.

FIGURE 14 : A FIRST POLITICAL OPTION: WHICH POLICY FOR EURO ?



- *The strategy Euro 3* could take place after a major international financial crisis, which would have shown how unstable might be a world financial system governed by short run speculation. If for instance, the three members of the triad agreed to create a new International System with fixed but adjustable exchange rates, then each Central Bank, and of course ECB, could obtain both a drastic reduction in exchange rate uncertainty and a large control other domestic monetary policy. No doubt that this third scenario would benefit to the legitimacy of the Euro, which would have been an intermediate step in the reconstruction of a new financial system for the 21st century.

No determinism can be invoked, since under definite world, European and national configurations, each of these strategies has a chance to be implemented and still more accepted as the ad hoc and convenient response.

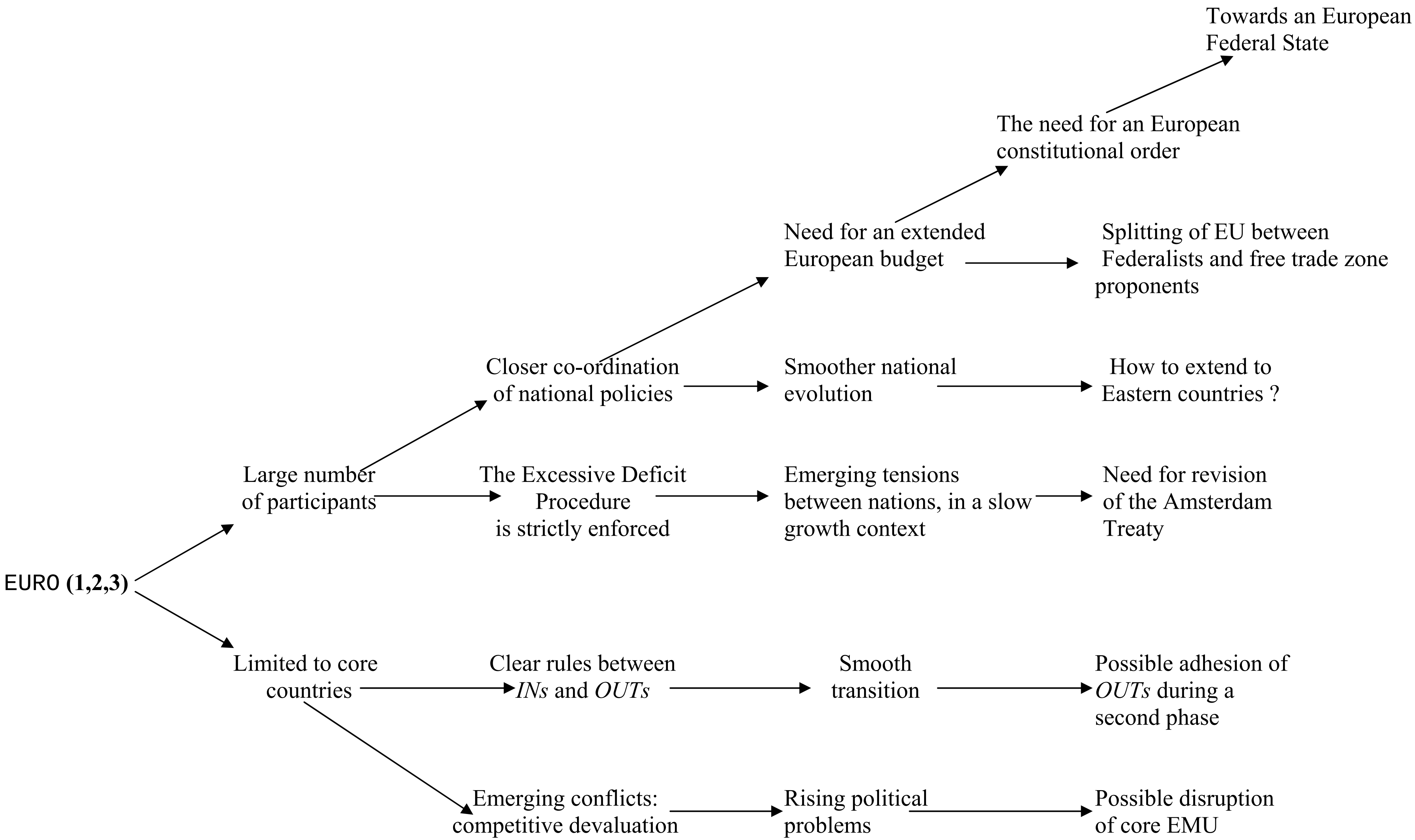
Innovations in European institutions in response to emerging problems.

The European institutions and procedures, will have to evolve in order to cope with the likely indirect fallout of the Euro, as well as emerging political problems (Figure 15).

- *The relations between the INs and the OUTs* might turn to be problematic. For instance, small or medium size countries, at the margin of the EU may have interest in competitive devaluations and not respecting EMS style rules which the ECB would like to impose to them. The case in favour of devaluation is more preoccupying if it comes from a medium sized and core European country, such as UK. It has to be remembered that after all Italy, Spain and UK benefited from the devaluation of their currency in 1992-1993 after the breaking-down of the EMS. Devaluation, specially in the context of slow and low nominal wage indexing, may have a short-medium term positive impact upon growth and employment. Hence, a possible disruption of core Euro-members. Under some circumstances, *a run out of the Euro* could may well take place. A more optimistic view would argue that the UK used to be rather marginal in setting European agenda and that financial markets may penalise countries which use competitive devaluation by imposing them higher interest ratesn even through devaluation may still have positive rela effects upon growth and employment.

Actually, *the very success of the Euro* may on the contrary create positive externalities: lower interest rates, less uncertainty about the costs of selling to the European markets, larger national influence upon new institution building at the European level. Therefore, one could observe *a run towards the Euro*, as soon as outsiders would observe that the members are better off than themselves, and that the international financial community and the

FIGURE 15 : A SECOND POLITICAL OPTION:
WHAT ARE THE OTHER EUROPEAN INSTITUTIONS WHICH COMPLEMENT THE EURO?



multinationals prefer to open new plants and branches within the Euro zone and no more outside. Remember the warning of Toyota to the British government if did not join the Euro, and conversely the opening of a new Toyota plant in France, in spite of much more constraining labour laws (concerning work duration for instance). The Euro will have definite consequences about the European geography, and probably give rise to a new division of labour among member-States (Krugman 1992).

- *Within the Euro-11*, conflicts may emerge about the conduct of *national budgetary policy*. The large member of countries admitted into the first phase of the Euro goes along with a lot of *heterogeneity* in tax system, public expenditure structures, welfare financing and still more Industrial Relations Systems. Even if a common European macroeconomic evolution would be observed as soon as the Euro is implemented, the evolution of public deficit may be diverse across the eleven countries. In case of a sharp but synchronised recession, some countries may comply with the EDP…and others not. Hence, a potential conflict which will be the more likely, the slower the European growth. One could even imagine such a severe and unexpected recession, during which even the most virtuous countries are unable to comply with the 3 % limit, a quite paradoxical situation indeed! If the rule were to be interpreted literally, the issue at stake would be no less than a *revision* of the Amsterdam Treaty. But there is a more optimistic hypothesis: all governments take seriously the stability pact and use the boom initiated in 1998 for building a public budget surplus during the high growth period. Therefore, the 3 % limit would not be binding during the next recession with a high probability. In between these two extreme scenarios, the governments could agree to adopt a rather flexible interpretation of the Excessive Public Deficit clause (Eichengreen and Wyplosz 1998). This is the more likely so, if both Germany and France were facing an European extra tax in midst of a severe economic recession and internal political turnmoil. Many other clauses of the Amsterdam Treaty might be subject to such a variety of interpretations: complying strictly with the rules…or interpreting them, without changing the text of the treaty, probably a too heavy task out of scope of a highly diverse membership.

- *The admission of new member-States* introduces a lot of uncertainty, specially because the imperatives of European institutional deepening and the extension of Europe towards Eastern societies might turn to be highly contradictory. The levels of development are quite unequal, these democracies are very young, the specialisation does compete with that of Southern European countries and a large fraction of the structural European funds should ideally be directed towards these new members. Similar problems may arise about agricultural policy, environmental and technical norms too. Of course, European multinationals have been investing in these countries, but the density of economic relations is far from sufficient to imply a quick membership. Furthermore, the Schengen space would be affected by new migratory flows. A lot of problems to be solved! Finally an increased *heterogeneity* will make monetary policy, competition policy and of course wage coordination (so important for the impact of the Euro) more problematic than ever. This scenario would propitiate a *flexible European integration* and in some cases a dissolution of the original European project, due to the balkanisation of European project into a myriad of domains and countries involved. In these matters, harmonising political aspirations and economic forces is not an easy task, and most of the issues are quite fuzzy indeed. For instance, it seems that the political elite in many Eastern European countries would like joint the EU and the Euro…just to be sure that they will be no more under the threat or control of the Russian army! *The Euro is also a matter of geopolitics…*and it does not make the solving of economic problems easier, quite on the contrary.

- *The choice between inter-governmental coordination and Federalism* will be specially important if national Ministries of Finance want to exert a countervailing power in front of the independent and powerful European Central Bank. According to the Keynesian vision, already mentioned, theoretically simple procedures of coordination would be sufficient to deliver a better policy mix than the actual one. In this scenario, the national autonomy is largely preserved, but submitted to common coordinating principles. But if the complexity of such a budgetary decision process is perceived, if pressures towards a Europeanisation of the public expenditures which have the more cross-border spill-over effects occur, and last but not least if social democrat governments come to power and promote a progressive approach of European issues, the Federalist project may again be put on top of the political agenda. But this initiative may well discourage the less Europeanist governments and trigger a *conflict between the Federalists and the free trade zone proponents*. Hence, two contrasted scenarios. Either a splitting of Europe between a core and a periphery or even a series of *"Europe à la carte"* . Or the Euro could well have launched the long march towards a Federalist State or alternatively a totally new type of shared responsibility between different bodies and various local entities.

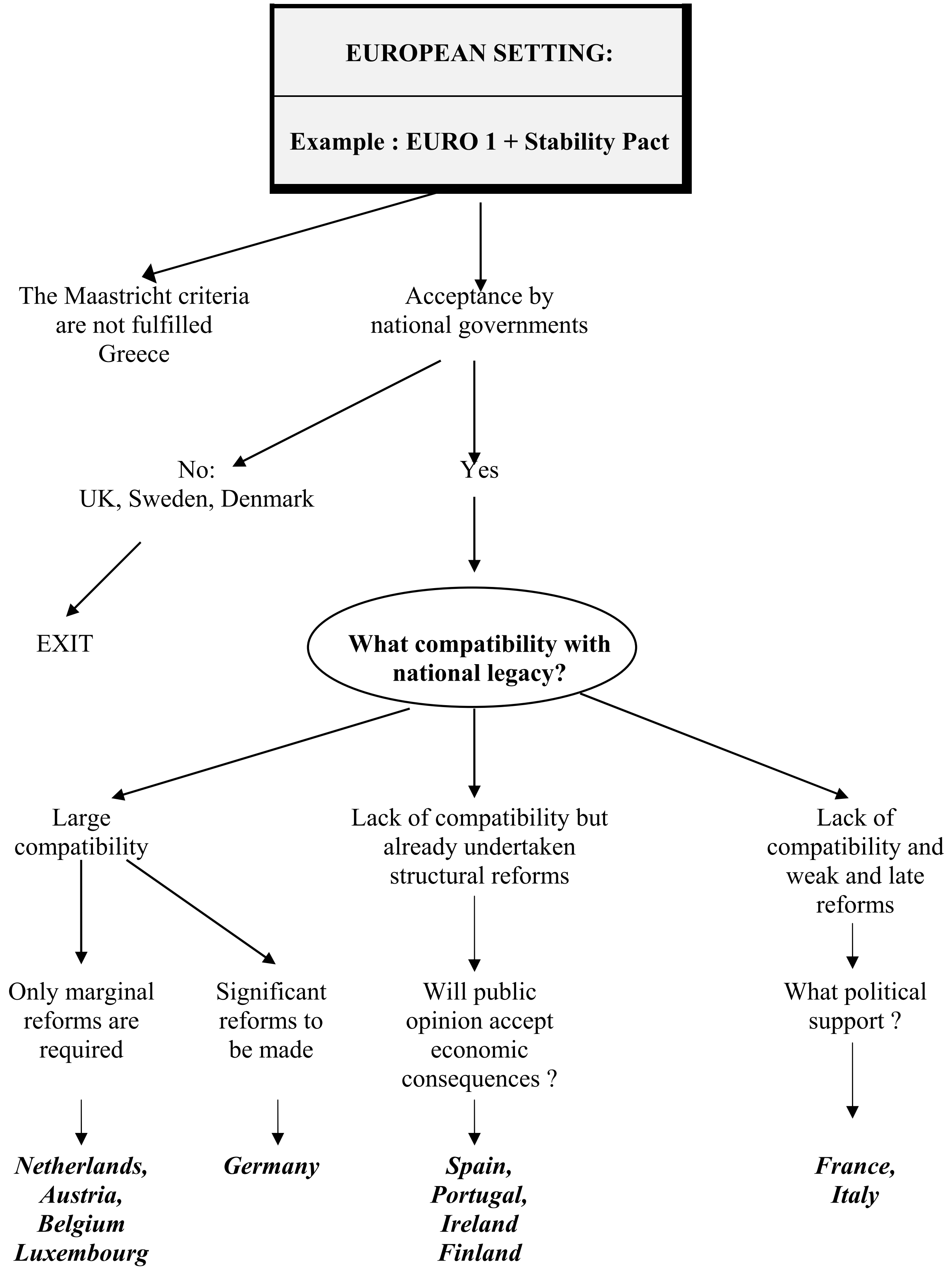
Combining the orientations of the common monetary policy with the induced innovations concerning other economic and political European institutions delivers a lot of scenarios, more or less coherent and promising (in theory no less than 3 x 6 = 18 configurations). But the story is not complete since it does not take into account the political and economic process of adjustment within each member-State.

Some societies are able (or know how) to cope with the Euro, others do not.

Actually, the reactions of various European societies to the same European environment is far from homogeneous. The political compromises are not the same, the conceptions of economic policies belong to different traditions, the independence of the Central Bank either is still a controversial issue or is legitimised since decades. The economic specialisation will benefit or not from external exchange rate stability, the post-WW II institutions have been more or less reformed in response to the emerging problems of the Eighties and Nineties, the general feeling of the population is pro or on the contrary anti European. Finally, the national State is perceived as the unique depository of democratic legitimacy or federalist ideas and principles permeate political debates and so on… *For each configuration, the impact of the Euro will be different*. For simplicity sake, an example may help to understand why. Assume that Euro-1 prevails along with a strict enforcement of the stability pact (Figure 16).

- Politicians may first decide that the *costs of the Euro* are far superior to the gains or alternatively that the economic efficiency increases are too modest and problematic to justify the abandon of such an important prerogative as the national currency and monetary policy. *UK, Sweden and Denmark* have taken this option. It reminds that both *voice and exit* are available to the participants to EU.
- At the other extreme, some countries have been very active in the negotiations of the Amsterdam and the Maastricht Treaties, or alternatively, their economic position in Europe (for example the fact that the national prosperity is directly linked to external trade and competitiveness) is not drastically affected or even enhanced by the Euro. Then, *only marginal reforms* are required and no major political issue is at stake. *Netherlands, Austria, Belgium and Luxembourg* seem to belong to this second category. Note in passing that this is not a sufficient reason for public opinion to be enthusiast about the Euro (see supra Table 1). In these countries, voters have rarely been invited to give directly their opinion via a referendum on the Euro.
- *Germany* is still different case. Back to the early Nineties, the Maastricht Treaty could be read as the exporting of German principles and institutions to the rest of Europe. A priori, both the German political system, largely federalist with divided competence among various

FIGURE 16 : A THIRD POLITICAL OPTION : HOW DOES EACH NATION-STATE ADAPT ITS ECONOMIC INSTITUTIONS TO THE NEW EUROPEAN SETTING ?

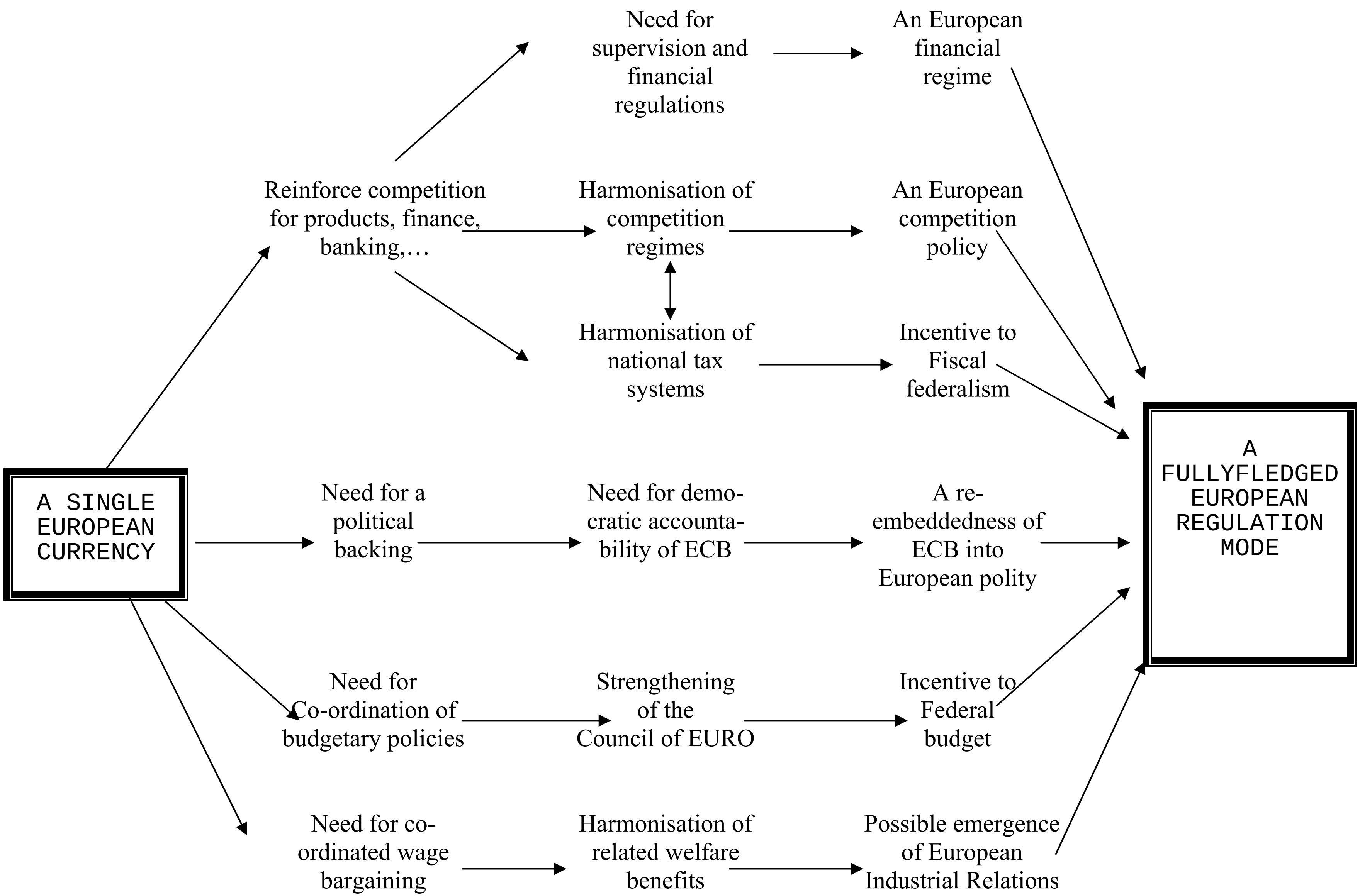


public authorities at different level and the economic specialisation governed by external competitiveness should imply few adaptations to the Euro. In fact, the situation is a little more complex since the slow growth period has dug public deficits, hindered the dynamics of innovation and eroded the non price competitiveness of many manufacturing sectors. Therefore, structural reforms have to be implemented, the more so the more independent from German evolution the European monetary policy will be…and the stronger the Euro.

- *France and Italy* are facing the same problems, which nevertheless are much more acute, and their solutions is made specially difficult, given the political legacy about the role of the State, the style of macroeconomic adjustments and the polarisation of social conflicts. The French society is the more challenged by the splitting of the various attributes of the State and their devolution to supra-national bodies (ECB, competition enforcement by the European Commission, European Court of Justice,…). Furthermore, the *"anomie"* of French Industrial Relations make wage coordination in accordance with the signal of ECB quite *problematic*. Italy has proved a remarkable ability to reform some of its domestic institutions in order to be admitted into the Euro club…But it is not sure that, on a permanent basis, the Italian society may bear the constraints generated by the Amsterdam Treaty, in the absence of *new and still more drastic reforms*.
- Last but not least, some countries have used the perspective of integration into EU as a leverage for creating new institutions and public interventions and promote domestic radical reforms, which might have been less well accepted in the absence of the European project, symbol of political democracy and economic modernisation. With of course variants, *Spain, Portugal, Ireland and Finland* belong to this last category. There is no better evidence about the potential role of Euro in reforming institutions and transforming *the economic and political geography of Europe*. This could be a message of hope for countries such as Poland, Hungary and other Eastern European countries.

In the long run, the political and social capability to reform past domestic institutional compromises and innovate in institution building may delineate new dividing lines in European negotiations about the reforms of procedures and rules. Thus a new series of scenarios can be generated by considering the evolution of "régulation" modes heterogeneity and its impact upon coalition formation in the process of European Treaties revision. The Euro will neither follow the smooth trajectory of a rocket launched in direction of Mars, nor will it lead to the Keynesian paradise or alternatively to the Hobbesian hell. It simply opens to a rich variety of socio-political configurations, most of them still to be invented under the strong necessity brought by possible severe crises.

FIGURE 17 : THE FUNCTIONALIST VISION : THE EUROPEANISATION OF NATIONAL REGULATION MODES IS UNDERWAY.



A largely open future, a lot of surprises to come!

Many conflicting visions can be mobilised to capture some of the consequences of the Euro. The Europeanists would argue that the founding fathers have always intentionally created structural disequilibria in order to get the required common institutions created. Historians would insist upon the long run trends governing contemporary Europe, whereas some social scientists would borrow to technological innovation analysis the concept of path dependence. Still others, inspired by Schumpeter, and why not Popper, would insist upon the radical unpredictability of this unprecedented innovation.

The Functionalist vision of Europe: charms and limits.

Paraphrasing a famous but now largely forgotten social thinker, each society is only entitled to solve the problems and challenges it is presently facing. Therefore, configurations which are considered as totally irrelevant on January 1st, 1999 may become self evident and totally legitimate if the circumstances are fulfilled. For instance, who would have dared to forecast the Keynesian revolution and the post-WW II Golden Age in the middle of the financial crisis and depression of the inter-war? Therefore, a Functionalist approach focuses on the structural problems generated by the Euro and proposes solutions, able to form a coherent system. May be, some day the events will make possible the implementation of the architecture which has been thought and designed in anticipation to these emerging problems (Figure 17).

Imagine that each economic and political actor *fully and rationally* take into account the implementation of the Euro. Then a series of structural changes should take place, quite in accordance with what an outsider theoretician would consider as necessary:

- Business associations and employees unions will learn that an opportunist strategy will finally deliver poor results for both sides. Then, why not *coordinate wage formation*, reform the welfare system in accordance with the new inequalities generated by European integration and possibly the shift in production paradigms?
- Will not all the Ministers of Finance perceive that free riding is quite dangerous for the overall credibility of the Euro and long run sustainability of the national public debt? Therefore, they will eagerly search for solutions and discuss the relative merits of alternative methods for *coordinating national budgetary policies*. They may even think about creating a

federal budget in order to deal with asymmetric shocks and provide a minimum solidarity across member-States.

- Will not the European Central Banker realise that the long run legitimacy of the formal independence of monetary policy can only be backed by a clear *accountability* with respect to the European/national Parliaments? In any case, will not informal lobbies be formed around ECB in order to provide a *feedback* about the consequences of a common policy on quite diversified interests groups and regions?
- Will not the threat of institutional regime and tax system shopping induce Ministers of Finance of the EU to harmonise their domestic systems and other Ministers to try to work out *mutually compatible* legislation or even common one? Will not citizens and firms use more and more the European Court of Justice in order to alleviate major discrepancy between legal systems and thus promote the emergence of a fully-fledged *European judiciary system*?
- These converging forces will therefore push the European community towards *a quasi federal system*, with clear dividing lines between European and national responsibilities for a whole spectrum of competencies: taxation, competition laws, financial regulation, citizen rights, public spending and why not even welfare, which for the time being, remains the core of the legitimacy of many European Nation-States.

This Functionalist vision has the merit to *convert structural constraints into active political projects* but it is not without severe limits. First it underestimates strongly the conflict of interests and the opportunistic behaviours which prevent the creation of many public goods, however desirable they might be for the society. Second, this vision is highly optimistic with respect to the complexity of the feed-backs between the European policy arena, the economic forces and constraints, and the transformations of the domestic political agenda. Finally it might well be a rather simplistic vision of the rationale of political action and its relations with the economy.

A path dependence of Euro.

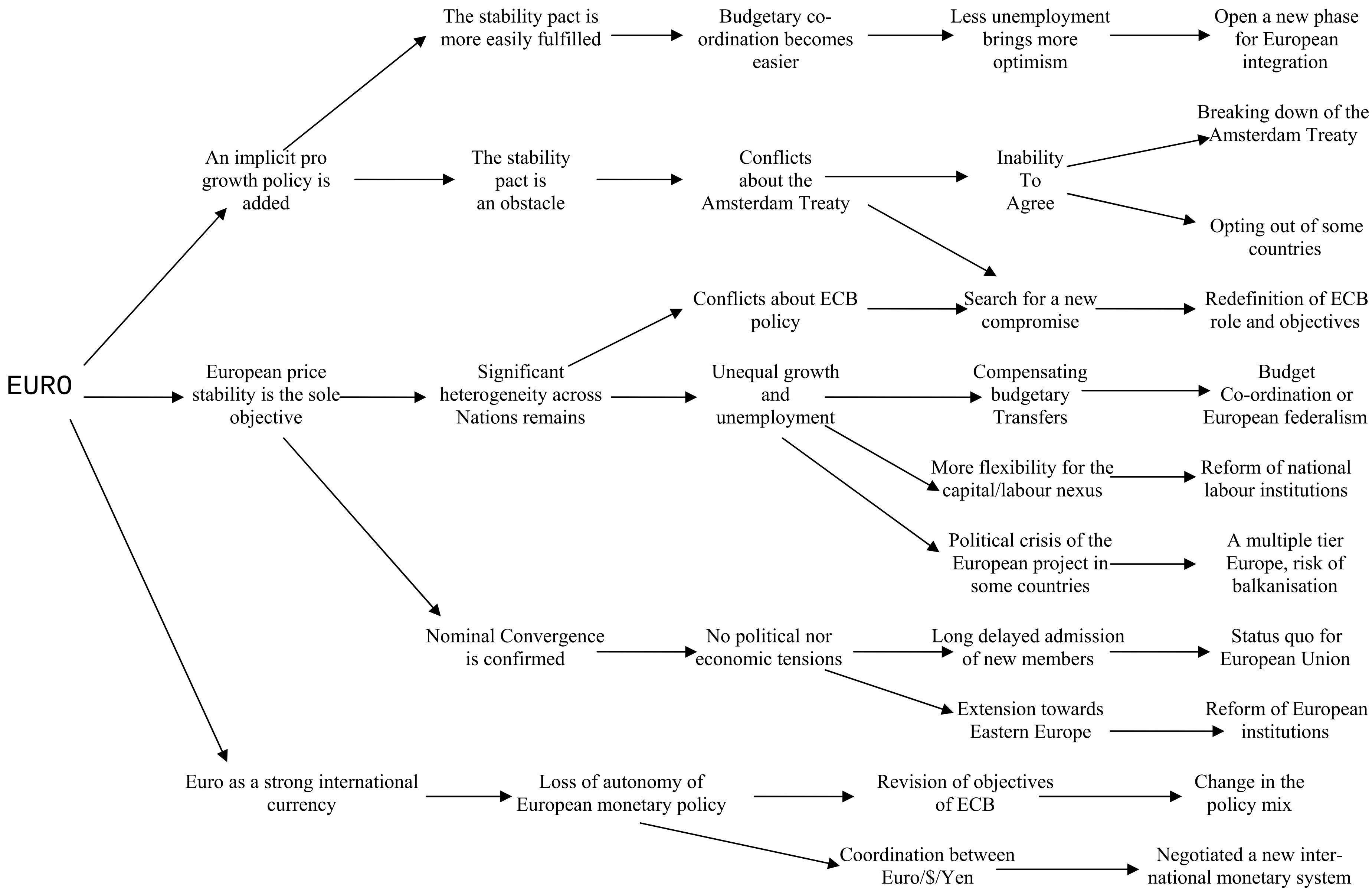
A second vision takes a much more *contingent* approach of institutions building. Frequently, the global context determines largely the success or the failure of a given reform or proposal. Could the Euro have been decided without the collapse of the Berlin wall? Will not the macroeconomic evolutions observed after January 1st 1999 contribute to frame the perceptions of the Euro, for the better or for the worse? Will European leaders size the opportunity of major conflicts and financial/economic crises to make definite advances in European integration? Or on the contrary will they follow the assessment of financial markets, however volatile they might be? In this world, seemingly minor or unrelated events and decisions may exert a long lasting influence, with a strong hysteresis i.e. the inability to implement again a decision which has been discarded earlier. In a sense, one of the better arguments in favour of the Maastricht and then Amsterdam Treaties, however imperfect and unsatisfactory they might be, is precisely that they *could not be negotiated again*, given quite changed contexts. Actually, diverging forces constantly erode any multinational agreement among a large number of countries…specially on such difficult issues as the Euro.

By contrast with the Functionalist vision which concludes to the *convergence towards a coherent system* able to solve, once for all, all the structural problems, the path dependence approach perceive a complete tree of futures, which gets new branches at each strategic decision point. *The divergence of a system submitted to permanent disequilibria* is the vision put forward by this second approach. The first decisive step will be the strategic choice taken by ECB about its objectives. Then, both other European bodies and national authorities will take decisions, thus opening a large spectrum of evolutions, among which some examples are worthwhile commenting (Figure 18).

- Many evidences tend to suggest that the *European Bank* will privilege price stability as its first and may be exclusive objective. But immediately, two scenarios are possible. According to the first, again the more likely, a significant heterogeneity continues to prevail in national "regulation" modes, because their transformations is a matter of several decades and not one or two years. Then, conflicts about the conduct of the ECB are highly probable, because some countries can adjust easily, while others experience more difficulties than during the second phase of convergence towards the Euro. These conflicts may find contrasted solutions. First, national budgetary policies can be *coordinated* in order to build a counterweight to the common monetary policy and complete it. The task is not so easy, but can be achieved from a purely theoretical point of view. Second, *drastic reforms of national institutions* can be undertaken by the countries which experience a larger unemployment than the rest of Europe. Again it is not simple but this can be done, and has been done, by some governments.

- But two other more extreme configurations may emerge from the conflict between the common European policy and the diversity of national economic institutions. A major

FIGURE 18 : A PATH DEPENDENCE APPROACH : JANUARY 1999 OPENS A SERIES OF FUTURES



political crisis may end up into the *breaking down* of the compromise embedded into the Amsterdam Treaty, since conflicting interpretations and interests could find no new point of agreement. This is a third possible outcome, with a positive probability, but not very high if Europe as a whole grows at a sufficiently fast rate. A fourth configuration would on the contrary derive from the feeling that the joint monetary policy will not be accepted in the long term, if there is no solidarity among nations and regions. Therefore, in accordance with the Functionalist vision, governments would accept the creation of a European *tax system and budget*, of the minimum size required in order to fulfil both solidarity and insurance objectives (Tondl 1997). But this evolution is far from being automatic: conflicts create *opportunities* for progressing in the European integration, but they open simultaneously the possibility of a *disruption* of the past achievements.

- If the ECB signals clearly that its permanent objective will be price stability in Europe, if all other economic actors accept as credible this statement, then price and wage formation would be transformed accordingly and nominal convergence would be fulfilled in the very first quarters or years of the ECB. A large fraction of political frictions would disappear, whereas the current EU configuration with fifteen countries would evolve towards the new division of labour which is implicit to the Euro. If on the contrary, the reiterated demands of admission of new members are accepted by the current EU, a reform of European institutions is highly likely, since a new source of heterogeneity is introduced again into the system. According to the first scenario, the Amsterdam Treaty will represent the *zenith of the European integration process* launched two decades ago. According to the second, it would be a first step in the direction of a *totally new configuration*.
- But some analysts think that the Euro, willingly or unwillingly, is bound to be a strong currency (Bergsten 1997). First of all the ECB should build its credibility by pursuing a tight monetary policy. Second, international portfolio investors will shift a part of their holdings out of Dollars into the Euros. Third, some extra-European countries may wish to switch a part of their reserves into Euro. Fourth, the Asian financial crises may trigger a “flight to quality”, which would benefit to the Euro at the detriment of the Yen. The Europeans would then loose the autonomy of their monetary policy, which would be quite costly in terms of macroeconomic stabilisation and legitimacy of the EMU itself. Again two different solutions could be given to this discrepancy between expectations and effective achievements. Either, *pressure groups* would ally in order to influence the *ECB policy*, since the strong Euro would be quite detrimental both to industrialists and unionists, only the financial system receiving benefits from this strategy. Or the very fact that three major currencies would now have an

hegemonic role would induce new negotiations about the building of *a new International Monetary System*. Actually, the Federal Reserve Board, the Bank of Japan and the European Central Bank cannot simultaneously pursue an independent exchange rate policy, because only two exchange rates are independent, confronted to three decision variables controlled by the Central Banks!

- *De facto*, but not *de jure*, the ECB may realise that the EU, after the 1st January 1999, is a rather close economy, as the American and Japanese ones are. Simultaneously, a debate between the Keynesians and the monetarists may lead to a compromise, i.e. the inclusion of *growth* as a second (and may be secondary) objective of the Central Bank. Last but not least, the ECB monetary council may end up understanding that a faster growth helps in alleviating budgetary deficits, promotes productivity dynamism and does not necessarily trigger nominal wage demands, given the relative large pool of unemployed workers, including medium or high skilled ones. Again this initial step opens two different avenues. On one side, the smooth handling of European monetary policy and budgetary coordination may bring a wave of optimism, itself a pre-condition for a new phase of European institution building. One could even contemplate, that after one or two decades, the idea of a *Federal European State* would be accepted by a large number of politicians and citizens, precisely because the implementation of the Euro would have delivered unexpectedly good economic and social results. But there is another dark side. Some governments, allied with some fundamentalist monetarists may persist in thinking that money should be neutral and has no relation with growth or job creation. A major political and ideological conflict could take place. It could even exacerbate *a nationalist backlash* against the loss of autonomy and sovereignty of the National State. Here are all the ingredients for a breaking-down of the Amsterdam Treaty and more generally the very idea of European integration. Some American analysts even think that the EU is so faraway from an optimal currency area that the single currency could lead to war (Feldstein 1997)!

This gives a clear idea about *the diversity of possible futures* (see the last column of Figure 18). From the emergence of a follower to the decaying Bretton-Woods International System to wars among European States. From a new European Federal State, to the balkanisation of countries and regions according to their ability or not to remain competitive under a common currency regime. From a victory of Monetarism in its most dogmatic variant (the ECB more royalist than the *"Budesbank"*!) to the emergence of a Keynesianism at the continental level...and so on.

Radical innovations may open many other possible worlds.

This map, however complex it might seem, is a drastic simplification with respect to the evolutions which should take place in the next century. Basically, the analysis has taken for granted all the present institutions and concepts, without considering that political frictions, contradictions between social demands and economic adjustments, or some major financial and economic crises may lead to *radical innovations in the very basic concepts and tools of European integration*. For instance, consider the scenarios elaborated by social scientists just after the Second World War, when a Common Market for steel and coal was launched in order to prevent the repetition of Franco-German wars. Was anybody able to forecast that the success of this initiative would be extended to the agricultural sector, then by the Treaty of Rome to all manufactured goods? That after a quarter century, the success would lead to the Single Market which would then be extended free trade to the services? Some years later, would come the effective launching of a European common currency, quite an innovation indeed with respect to two century long history.

Nowadays analysts should therefore be very modest, because radical innovations cannot, by definition, be analysed as incremental ones. Just two examples. Why not Brussels transformed into the head quarters of the executive branch of a European Federal State, emerging after two or three decades of acute conflicts? Could not the primacy of monetary integration over the slow process of real convergence gives an opportunity to an international wave…of ultra-nationalist or extreme right movements, which could eventually take the power and organise the balkanisation of Europe, according to the process which led to the decomposition of the former Yugoslavia?

If radical innovation emerge more likely in the context of cognitive dissonance and acute conflicts between a priori totally contradictory rationales, then the next century will be rich of many such institutional innovations! The Euro, by imposing a clear unifying logic of the European space, will have been part of this process….But of course, not necessarily the only source of such surprising evolutions.

Ultimately, the Euro will tell more about economics and political science than economics and political science can currently tell about the Euro!

Conclusion

This essay has tentatively proposed a framework in order to understand the *unexpected fallout of the European Monetary Union*. The literature on the issue is huge indeed and the reader may ask: why to add a paper more? At least for three reasons:

- The vast majority of analyses quite rightly use already existing theoretical tools in order to forecast the consequences of the Euro. Each theory and model teach about one aspect or another of this process. But unfortunately, many authors, by specialisation, tend to take *the detail for the whole picture*, since they imagine that such a multi-dimensional innovation can be captured by formalising one or two features, not necessarily the more important, but the ones that the pet theory of the author is able to deal with. The results are generally quite precise but partial and highly dependent from underlying structural evolutions which are not even described or mentioned. By contrast, this essay has described the *spill-over* from one aspect of the Euro to another, with a clear concern for the *structural compatibility* of the Euro with existing national political and economic institutions. The theoretical interpretation borrows both to the recent advances of "régulation" theory (Boyer and Saillard 1995) in terms of hierarchy among institutional forms and to the Comparative Institutional Analysis (Aoki 1996), which stresses the complementarity of economic institutions.
- Similarly, the rational expectations school has popularised the idea that economic agents can perfectly anticipate the consequences of any change in economic policy. Otherwise, the economic system is assumed to be *stationary* and thus all economic agents end up with a *perfectly knowledge* of the functioning of this system and become as learned in economics as theoreticians are. When this framework is applied to the Euro, the issue is only about the time required by individual agents to compute…or may to learn the rational response to this new environment. These models describe macroeconomic adjustments over several periods but they are not really dynamic in the sense of the endogenous transformations of a system which take place under the flow of permanent innovations. Actually *nobody knows* if there is a viable configuration out the implementation of the Amsterdam Treaty, many American analysts for instance have expressed severe doubts. Therefore, this essay has proposed a *dynamic approach*, which takes fully into account the disequilibria and conflicts which are generated by the EMU. *History matters* and is more than the arrow of time taken into account by econometric models estimated over past time series.

- A third difference is related to the general conception about economic institutions. For a large majority of the economic profession, at least until the last decade, *the market is considered as the canonical and quasi unique form* of adjustment mechanism, the only are able to describe the interactions which occur within a fully decentralised economy. Nearly by definition any other organisation, specially public bodies, brings inefficiency into a system which should be governed exclusively by markets. Under some conditions, don't have they the property to deliver equilibria which are Pareto efficient? These conditions have been proven to be quite restrictive indeed (Boyer 1996) and on the contrary, the firm, the association, the community, and even the State may solve coordination problems and deliver benefits that the market is unable to perform nor deliver (Hollignsworth and Boyer 1997). Consequently this essay takes a full account of the fact that the *Euro will not operate in a pure market economy but within nationally embedded capitalisms*: the outcomes are likely to be at odds with those forecast by neo-classical models. But of course this makes the whole analysis difficult and some cases cumbersome by comparison with the elegance…and the irrelevance (or limited relevance) of most theoretical works about the Euro.

Business cycle synchronisation does not mean structural convergence.

Since May 1998, quite all observers take seriously the issue of Euro, even if most were surprised by the fact that no less than eleven countries could comply with the convergence criteria. Looking carefully at the national business cycles has nevertheless brought back some basic questions (Peet 1998). One could always exert such a pressure upon a spring that it is reduced to a minimal size…but as soon as the pressure is relaxed, the spring pops out! *Mutatis mutandis*, the same story could be told about the convergence of the eleven members of the Euro. Of course, all governments wanted to be part of the first wave of the EMU and to avoid the political cost related to the recognition of their inability to comply with the Amsterdam Treaty. Therefore, these governments have taken short run decisions and sometimes structural reforms in order to be ready at the date scheduled by the Treaty.

But what will happen next? Will the inflation rates be more heterogeneous than they have been in 1997 and early 1998? Will not the underlying diversity in "régulation" modes imply a permanent lack of synchronisation of national business cycles? The financial and economic press has voiced such a concern during the Summer 1998 (Les Echos 1998). According to the most recent forecast available, two striking features emerge (Figure 19).

FIGURE 19 : WILL NATIONAL BUSINESS CYCLE BE SYNCHRONISED ?

Figure 19.1 : A next convergence of growth rates

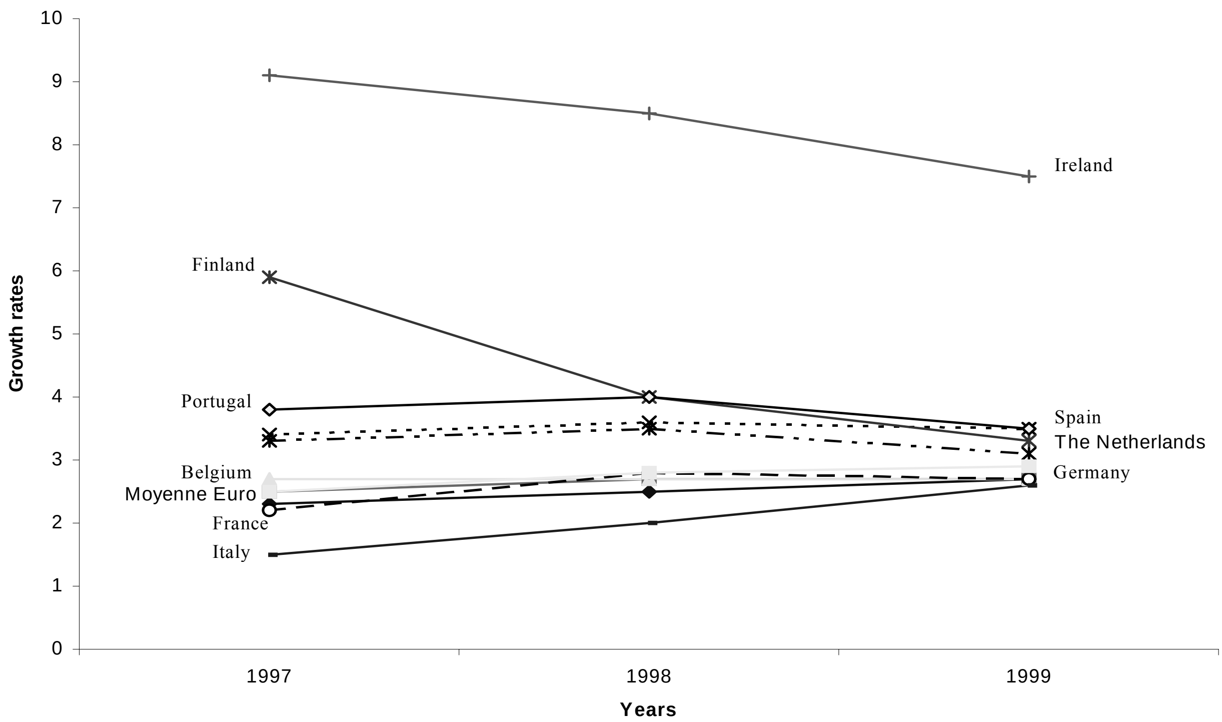
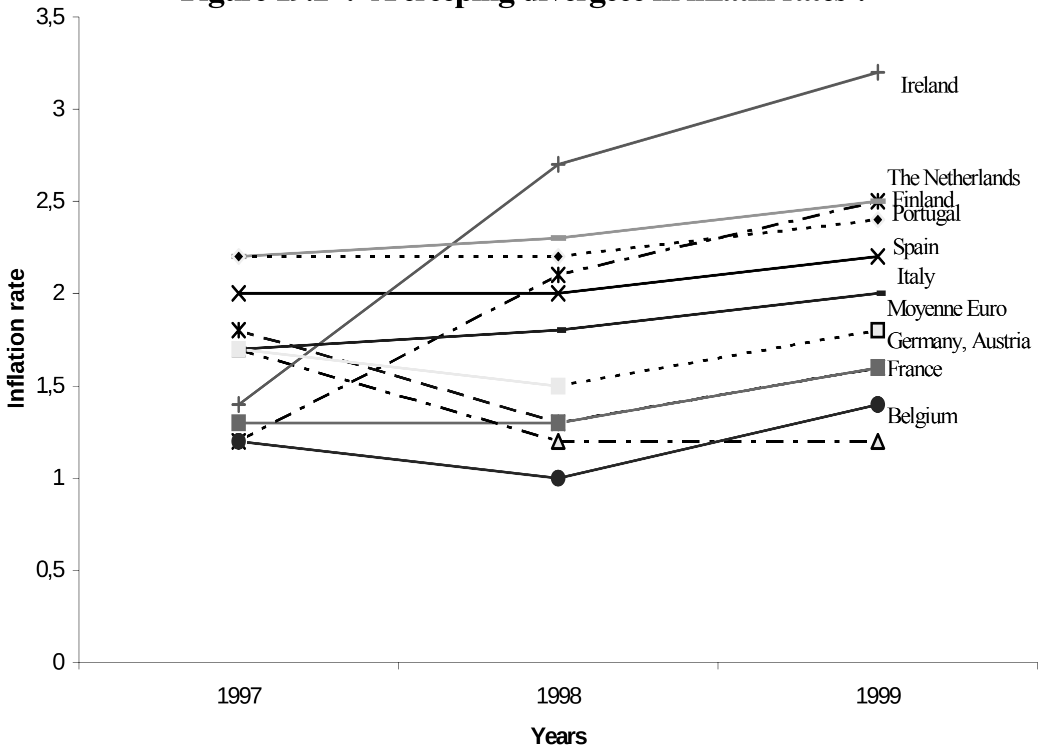


Figure 19.2 : A creeping divergece in infatin rates ?



- Surprisingly or not, the year *1997* exhibits *a minimal discrepancy of inflation rates*, which differed rather modestly: the less inflationary countries were France, Finland (1.1 %) and Austria (1.3 %), the more inflationary were Portugal and Netherlands (2.2 %). But since then, the discrepancy has increased specially due to the high growth observed in Ireland and Finland, and the inflation has decelerated in Belgium too. But the more noticeable observation is that in 1999 again *the discrepancy is far more important than in 1997* (Figure 19 – 1). The inflation rates range from 1.2 % in Belgium to 3.2 % in Ireland, a significant gap with respect to the European Monetary Policy. But of course, these are only previsions and the monetary council of the ECB might precisely have a restrictive policy in order to curb down the inflationary pressures observed in booming countries. But the growth of other members will be negatively affected too, whereas their inflation is already quite low.
- Quite on the contrary, the advent of the Euro seems to induce *a real convergence*. Actually the discrepancy in growth rate would be decreasing from 1997 to 1999 according to the last forecast. Again, this is surprising since the EMU was supposed to be about nominal convergence, not necessarily real evolutions. But it is precisely the contrary that observers anticipate for the first year of the Euro. But again, the monetary and budgetary policies may take into account this discrepancy and try to correct it.

Nevertheless, these short run difficulties in the implementation of the Euro (monetary policy should be more permissive for a majority of members, but more restrictive for a minority) point out a real *structural problem*, which has been at the core of the present essay. Synchronised or not, the eleven Euro members do not enjoy the same social, political and economic “régulation”. Therefore, the same monetary policy (or alternatively competition enforcement or labour law) will not have the same impact. From a pure technical point of view, the channels of monetary policy differ quite significantly across Europe. For instance in UK, an increase in interest rates has a much more important impact over real economic activity, due to the structure and the organisation of the mortgage financial markets, whereas such a large influence is not present in Germany or in France (Dornbush & *alii* 1998). The mere adjustment to the new rules of the game set by the ECB will therefore raise, quite different problems for each national financial system. Of course, the difficulties are still more challenging for the tax systems, welfare financing and labour market institutions reforms. *This heterogeneity across nations could persist over several decades* and pose acute political problems, both in Frankfurt and in Brussels, but also in each national capital. The Euro will be viable only if the national “régulation” modes are finally made coherent and no so heterogeneous.

TABLE 10 : THE SEVEN PARADOXES OF EUROPEAN INTEGRATION : AN INSTITUTIONALIST AND POLITICAL INTERPRETATION.

paradox	interpretation
1. From a *political vision* of Europe promoted by economic integration to an *economy pushed* and reluctant political economy.	1. National governments have agreed to *inter-governmentalism* and used Europe as an excuse to justify sometimes necessary but unpopular reforms at the national level. This is supposed to preserve power and legitimacy within each National-States.
2. EMU and the Maastricht Treaty : an *unprecedented constructivist* project at the very epoch of free market ideology and powerful and regarding financial markets.	2. The constructivism is limited to money and intends to warrant and « wire » an indirect but complete *redesign of other institutional forms* in most cases in the direction of freer markets.
3. Whereas the Single Act has actually delivered far less positive outcomes than forecast by experts, the EMU has been presented quite optimistically to public opinion : a *lot of benefits, no or few costs.*	3. In the absence of clear accord upon the constitution of an European Polity, the economist approach to EMU tries to bring a *functionalist vision* of institutions building, required for the viability of EURO.
4. Largely *pro-European elite* confronted with rather *reluctant people*. Within the same party, significant cleavages between pro and anti a strict implementation of the Maastricht Treaty and stability pact.	4. Even if ideologically in favour of Europe, grass and root people fear to loose economically from EURO : *no solidaristic pact* at the European level, nor at the national one. The more mobile agents gain, the most immobile may loose.
5. The countries which are expected to incur the *most drastic structural changes* and costs associated to EMU, do benefit from the most important *popular support* to EURO. Conversely, serious doubts are expressed by the public opinion in core countries.	5. The adhesion to EMU is a *political move* in favour of national modernisation and/or democracy. The economic costs come in second rank, polity is first, according to a lexicographical ordering. The core countries fear to loose the coherence of their national institutional architecture and some part of their autonomy. New members use Europe as leverage ofr modernisation and democratisation. The support to the Maastricht Treaty is still a matter of *domestic politics*.
6. Whereas the stated objective of EMU is to *integrate Europe*, the implementation of pure economic criteria to join EURO may lead to a two tier Europe : the division between Ins and outs may create a major instability within in Europe (competitive devaluation at the margin of Euro, rise of North/South, Centre/periphery oppositions, balkanisation of some Nation-States).	6. The Maastricht Treaty expresses a benign neglect for the *political foundations* of EURO and favours an economist vision (a currency should minimise transaction costs). Both monetary theory and history contradict this vision. Pure economic forces and uncertain and conflicting political strategies may disintegrate the whole European architecture.
7. Once upon the time, *politicians* used to govern, whereas *markets* were allocating resources. Nowadays they have traded places : financial markets ask for structural reforms and governments are concerned by resources allocation within the public and private sectors	7. The modern « rentiers » (pension funds, large investors,...) have acquired a significant leverage over indebted governments. The financial-political configuration would remind the *pre 1914 situation...*if the *wage-earners* were not the majority of the population, with long term insertion and inter-temporal rights (public pensions).

This structural and institutional analysis brings a series of interesting results concerning some *paradoxes of the European integration*. It may explain why the implementation of the Euro is so frequently associated with a plea in favour of *labour market flexibility*. Furthermore, it brings *some complexity* into the debate between the *pro and anti Maastricht*. Last but not least, this essay provides some hints about what should be on top of the agenda of *the next European negotiations* in order to adapt institutions and procedures to the new context of the 21st century.

The seven paradoxes revisited: the economy/polity dialectics.

The introduction had stressed the inability of conventional neo-classical theory to explain some basic stylised facts about European integration. Now, a better integration of political and economic factors allows some interpretations of the paradoxes which pop out when a mono-causal analysis is applied to the EMU (Table 10).

- Why do most governments and the European Commission have presented the EMU as a purely *economicist project* aiming at transaction cost reduction and exchange rate uncertainty removal? Mainly because European integration has been realised by *inter-governmentalism* and not at all by a clear agreement about the constitution of a supra-national State. Furthermore, often structural reforms, which would have been blocked by social opposition in the domestic political arena, have been presented as constraints imposed by the Euro. But of course this strategy cannot last for ever.
- Why did the Werner's plan for EMU failed in the Seventies, whereas the EMU was actually launched at the end of the Nineties, in the context of *free market ideologies* and a huge distrust about the ability of governments to have any positive influence upon macroeconomic activity? Such a *daring "constructivism"* is quite at odds with contemporary beliefs. It is precisely because the *full deregulation of finance* had so severely restricted the autonomy of European national States, that this proposal was timely in the Nineties. Still more, the seemingly neutrality of monetary management makes more necessary a complete reform of the post-WW II economic institutions. For some governments it is a method for making free market economics more palatable and acceptable by a reluctant public opinion.
- Why did European officials present such a *bright picture* about the consequences of the Euro, assumed to deliver positive and large economic gains? In the absence of a European polity, given the conflicting political traditions of various European societies, this was the

only method to build support, and *prevent any hot political conflict*. If the welfare of any economy and individuals is increased, it would not be difficult to work out political compromise in order to share the benefits of the Euro! Furthermore, a degree of functionalism has always been present in the European integration process and this kind of optimism has often been helpful and crucial.

- Why are *social and economic elite* in favour of Euro and on the contrary the most *modest social groups* generally against? Even when an intensive pro European propaganda has been pursued by governments, most citizens perceive that the EMU will have some costs for the lower social groups. Why? First, the last two decades have experienced an erosion of solidarity within most European societies. Second, the absence of a European welfare State is clearly perceived by people. *This asymmetry in the European construction* gives a premium to nationalist and/or nostalgic movements which defend previous forms of solidarity, via the domestic welfare systems.
- Why *Southern Europe* is so enthusiastic about the Euro, in spite of large adaptation costs, whereas *Northern Europe* is rather reluctant, even if its basic institutions are nearly in tune with the EMU? For the first group, monetary integration means economic modernisation and political democratisation. Polity comes first, economy second. For the second group, these achievements have been obtained since a long time. Thus the EMU is basically considered as a domestic issue, around which political oppositions are redeployed. *The same treaty*, Maastricht or Amsterdam, *but quite contrasted visions*.
- Will not the *voluntarism* deployed in the implementation of the EMU have adverse political effects such as *splitting the European countries* between *INs* and *OUTs*? Within each domestic society, will not the Euro exacerbate political and social divisions, giving again a premium to nationalistic ideologies? The *benign neglect for the political foundations* of the Euro do jeopardise the economic viability of the European integration. Pure economic forces could well disintegrate the European social space, in the absence of a clear principle of solidarity, brought by inter-governmental political agreement.
- Conventional wisdom teaches that *politicians should govern and markets should allocate scarce resources. The last decade suggests the opposite division of labour*: the financial community assesses every day the relevance and sustainability of governments' projects and conversely governments are proud of their rational and sound management of economic resources. Basically, modern *"rentiers"* (pension funds, large institutional investors, mutual funds,…) exert their hegemony by promoting financial stability, high rate of returns on invested capital and they discipline accordingly industrial firms as well as

governments. In many countries, the wage-earners seem to be out of the political game, even if they represent a majority of the population.

The merit of an institutional and structural analysis is to give some general interpretation of such diverse stylised facts, starting from the same premises. Of course, the explanations are far from complete, but there is necessary trade off between the precision of a theory and the extension of its explanatory power.

Labour market flexibility is not a fatality.

Another conventional recommendation is challenged by this essay. Clearly, the historical and institutional analyses of the mutual relationships between the monetary regime and labour market institutions suggest that the *Euro seals a new configuration*, in which the objective of price stability has to be embedded into the *inner structure of the wage labour nexus*. But, the motto according which *"the Euro is not viable if labour market are not highly flexible"* corresponds to one only of the seven strategies available to firms, unionists and governments. More institutionalised mechanisms for wage coordination might be more efficient than a myriad of decentralised local labour markets. Of course, when the bargaining power of workers is eroded by capital mobility and high unemployment, the decentralisation of wage bargaining at the level of firms is quite easy and does not require any radical institutional innovation. But the outcome is not necessarily as satisfactory it should be according to pure neo-classical theory: rising inequalities, insufficient investment in education and training, inefficient organisational choices in response to large wage. By contrast, other solutions, more difficult to implement, may deliver much better results (Table 11).

- *Companyism* is different from pure labour market flexibility, since the labour contract organises an internal market, via promotion and seniority and the long run compromise about implicit employment stability is enhancing commitment, reducing monitoring costs, promoting incremental innovations and of course reducing social conflicts. This model is not specific to Japan (Boyer 1998), it can resist to financial liberalisation…and furthermore it is already implemented within some large European multinationals. But of course, this kind of labour contract is not universal and it is often complemented by more contingent contract, and more defensive flexibility.
- *Meso-corporatism* extends wage coordination outside the large firms towards all the firms belonging to the same sector. One may contemplate to rejuvenate collective bargaining at the European level when economic activity is highly concentrated and business associations

TABLE 11 : WHAT REFORM OF INDUSTRIAL RELATIONS IN ORDER TO COPE WITH EUROPEAN MONETARY POLICY ?

OUTCOMES CONFIGURATIONS	ADVANTAGES	SHORT COMINGS	LIKELIHOOD
1. EURO CORPORATISM : ***collective bargaining at the European level*, taking for given the ECB policy**	• Ideal solution for providing a structural compatibility with the new monetary regime. • Transposition to Europe of the German configuration.	• Few or no actors to negotiate such an Euro corporatism. • Heterogeneity of union conception across Europe	Very small probability
2. XENO-CORPORATISM: **Collective bargaining within *European multinationals* i.e. *xeno-corporatism***	• Building up of an European solidarity among workers. • Extends the 1994 directive about information within European multinationals.	• Limited scope and possible increase in labour contracts heterogeneity. (Domestic/multinational firm) • Unequal power of social partners : capital is more mobile than workers.	Emerging but rather limited
3. NESTED INDUSTRIAL RELATIONS : ***A multiple tier negotiation* and nested industrial relations systems.** • **European level : price expectations** • **National level : welfare** • **Firm/Sector : profit sharing**	• reconciles European macroeconomic constraints with national, sectors and firms' heterogeneity. • Coherent with the « distributed power » of the collective actors at various levels.	• Very complex formula which requires innovative nested bargaining. • Uncertainty about the leading levels and forces : Europe or local firms.	Possible but rather difficult
4. NEO-NATIONAL CORPORATISM **For each country, business and labour work out a new *national social pact*, taking into account the ECB policy**	• National institutions and laws already exist in order to work out such a compromise. • Provides an opportunity to negotiate a series of pro-employment labour reform.	• Business may prefers fully decentralised industrial relations to the renewal of a neo-national corporatism. • The level of unemployment gives a weak bargaining power to unions.	Significant (already took place in Spain, Italy,...)
5. MESO-CORPORATISM **At the European level, *sectoral collective bargaining***	• Takes into account the unequal competitiveness of sectors • Emerging European forces able to propitiate such a negotiation.	• A larger heterogeneity of wages across sectors. • How to deal with rather sheltered domestic sectors ?	Could happen only within a limited number of sectors (car, chemicals, transports)
6. COMPANYISM : **Negotiation at the firm level only (*micro-corporatism)***	• Should allow a better trade-off between wage and employment. • Fits to the trend towards decentralisation of wage bargaining observed since the mid 80's.	• If low workers mobility, widening of income differentials. • For some configurations, unemployment and inflationary spill-over may coexist (UK in the 80's).	Rather high one, a rather likely scenario
7. FLEXIBLE LABOUR MARKETS **Building more competitive labour markets (*the free market solution*)**	• In theory, should deliver full employment. • Does not require any collective agency • Follow the current free market attraction raised by the American job creation machine.	• Modern micro theories of the labour contract cast some doubts about the attainability of full employment. • Strong unions may block such a path. • What to do it if free market is not popular (France ?)	Significant even if less evident than contemplated by free marketers

and unions have already cross-border coordinating procedures. Of course, wage differentials across sectors may vary, as well as they do during the business cycle, but at least a significant degree of coordination is reached. It has been argued convincingly that this is a feature which benefits to employment under the Euro regime.

- *National neo-corporatism* is a third option which has frequently be used in Southern Europe (Italy, Spain, Portugal). If social partners share the objective of European integration and the preservation of national competitiveness, they may agree rather easily to work out wage systems, welfare organisations and even tax systems which are *structurally compatible* with the Euro. But of course, if unions are divided and the European integration a controversial issues, such a deal cannot be struck. The degree of coordination is higher than previously, a feature which in theory allows better macroeconomic results, as soon as the bargaining power is nearly balanced.
- *Nested Industrial Relations* define a much more elaborated system in which the three different levels of European integration are concerned. At the continental level, business and unions have to fully take into account the signals of the ECB, specially the targeted European inflation rate. Then, at the national level, a principle of solidarity can be embedded into a welfare system which would actually fight against the most urgent contemporary inequalities, since it is highly unlikely that such a system could emerge in Brussels. At the lower level, the sector or the firm, profit sharing may be a solution to create commitment and furthermore to shift the trade off to employment stability from real wage increases. Even if the balance between these three components is difficult to adjust, conceptually this configuration is quite adapted to the *nestedness of the contemporary "régulation" modes* in Europe.
- *Xeno-corporatism* is another avenue which is explored within European multinationals which operate in a large number of member-States. Internally to the firm, a negotiation with all the national/local unions may take place and work out a compromise between wage equality and the preservation of the relative competitiveness of each plant. Nevertheless, if the wage levels and welfare systems are highly unequal, for example between the core and periphery of Europe, then strong conflicts may occur among unionists themselves: the wage equalisation asked by high wage workers in favour of their low wage colleagues, would be blocked by them because it would kill the profitability of employment in the plants of the periphery. Not to speak about the large inequality between the large firms employees and the small and medium size firms workers.
- *Euro corporatism* would achieve the *more complete coordination*, in tune with the integration of markets and the common monetary policy. If all national business associations

could merge into a single European one, if the myriad of employees unions could do the same whatever their past and present ideological and national oppositions, then could be created at the European level the collective agreements which had been promoting Fordism at the domestic level. Theoretically ideal, this solution is currently blocked by a huge organisational gap. Industrial Relations are not significantly structured by European issues…but this situation could be transformed in the very long run.

More generally, the specificity of the restructuring of past national institutional arrangements will end up playing a crucial role in the European trajectory under the Euro. Thus, many scenarios are opened according to the *strategic choices of the ECB* about its long term objectives, the ability to develop *accountability and countervailing European institutions*, and *the transformations of national "régulation" modes*.

Neither hell…nor paradise, or the art of muddling through.

Another major conclusion of this essay is to challenge the frequent and superficial opposition between pro and anti-Euro. For the first group, all economic and political actors will learn to take into account the functional constraints inherent to the Euro and will decide collectively to design and implement *a completely coherent system*. Wonderful dream indeed! Faraway from a Machiavellian vision of polity. For the second group, the Euro is no less than a *free market ideology in disguise*, with horrific results in terms of growth, employment, inequalities, and even citizens' rights. Both visions oversimplify a complex interaction process between the forging a new European political arena, the transformation of national institutions under Euro and the feed-backs of these two transformations into the national political arena.

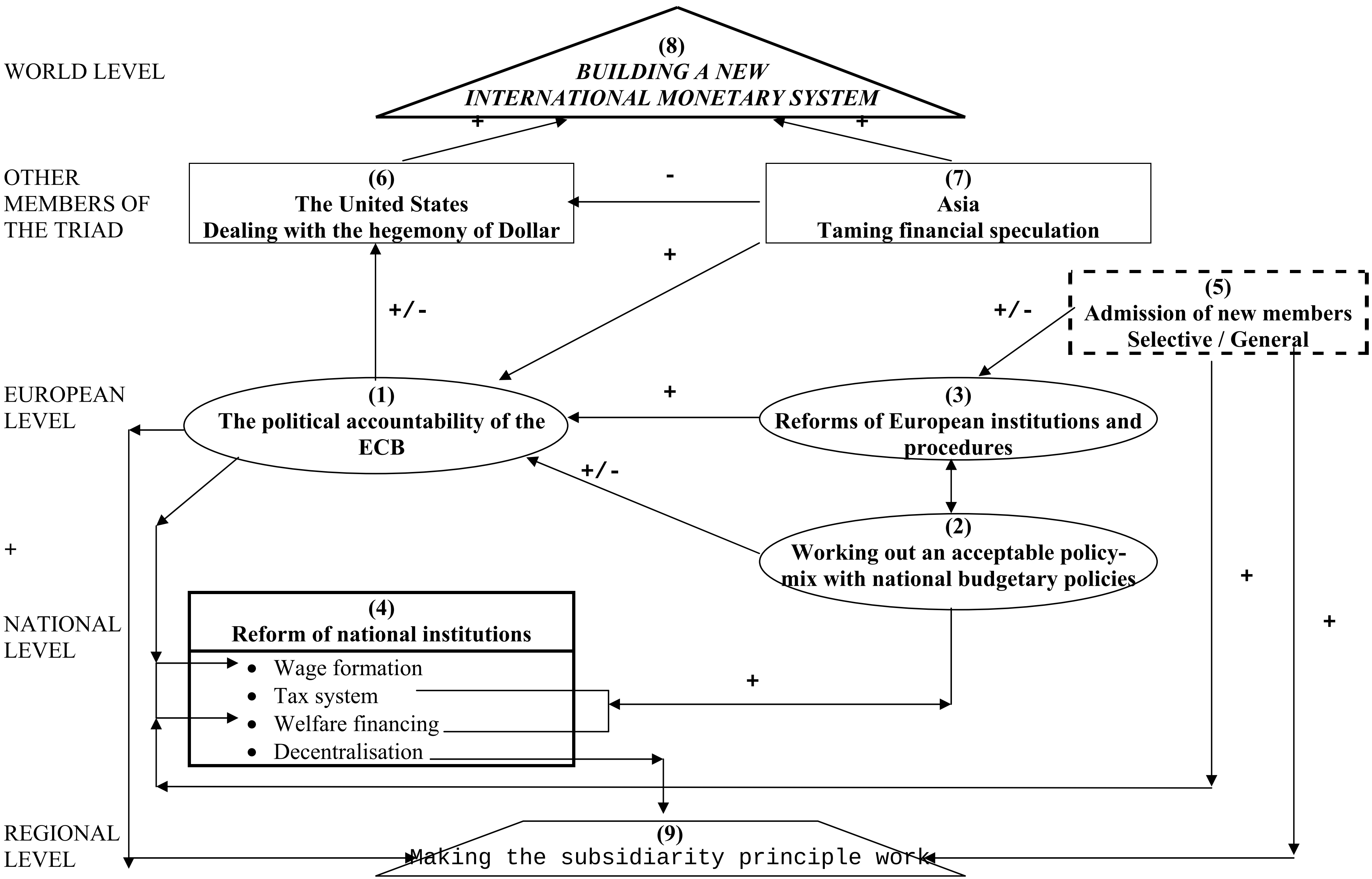
These interactions are so rich that a pure combinatory approach delivers more than hundred scenarios more or less coherent, unequally appealing and sustainable in the long run. Not to speak about the *induced radical innovation* about domestic and European institutions which will quite likely take place in response to strong political conflicts, contradictions between economic and political rationales and may be severe structural crises, coming from the bursting out of a major systemic instability of the global financial markets.

Preparing the next reform of European institutions.

A final conclusion is that the current configuration has no reason to be stable and therefore that unions, associations, political parties, governments, administrations, experts and academics should seriously think about the next phase of European negotiations. The present essay puts on top of the agenda at least nine issues analytically distinct but actually closely inter-related with respect to the final architecture of Europe (Figure 20). Nevertheless, it is important to mention the main issues at stake.

- Since the European Central Bank will never be fully legitimised and credible without a clear accountability, it is essential to think about *the embeddedness of European monetary policy into the national and hopefully European political arena*.
- The excessive deficit procedure is not a real coordinating procedure among national budgetary policies. Therefore, it is essential that *a better policy-mix* should be aimed at, by creating more or less challenging *coordinating procedures*, not to speak about a minimalist fiscal federalism, for the time being faraway from the objectives of the governments.
- The *institutions and procedures* for taking decisions at the European level have become obsolete and inefficient. They cannot be reformed and rejuvenated without a clear recognition of the *political project implicit to the Euro* and accordingly the development of a fully-fledged political arena. Both on European issues at the national level and at the European level for the most strategic common decisions.
- It would be daring to assume that the national institutional architecture inherited from the Golden Age could persist unchanged into the 21st century. The *Euro makes more urgent reforms* which should be undertaken under the pressures of the production paradigm shift and the new configuration of the international division of labour. But this does not mean a return to a mythical state of pure and perfect competition is a fatality. A whole spectrum of alternative solutions already exist and new ones will created under the pressures created by the Euro.
- *The admission of new member States should be carefully assessed and designed*. On one side, it is an opportunity to completely redesign obsolete European institutions, but on the other side, it brings back such an heterogeneity that any common ambitious policy will be difficult to achieve during one or two decades, i. e. the time required to forge a minimal compatibility with the core of European integration. Many *flexible and progressive associations* have to be worked out.

FIGURE 20 : THE NEXT REFORMS OF EUROPEAN INSTITUTIONS: A STRUCTURAL ANALYSIS.



- *Euro as a world currency* may create as many problems for the international system that it solves at the continental level. The American, Japanese and European monetary policies cannot try to be simultaneously autonomous, without creating major structural instability. The objective of the Euro as a strong reserve currency deserves too a careful analysis.
- The financial Asian crises show that *a little of speculation is good for financial markets stability but that too much of it may destroy them* and provoke major economic depressions. The fate of the Japanese financial crisis will strongly interfere with the final status of Euro and the willingness of EU to accept a *complete financial mobility* as a fatality…or not!
- European authorities should be ready to make proposals in order to *redesign a complete international system* in which public authorities will keep a strong monitoring on the rules of the game, for finance, trade, foreign investment, intellectual property rights and innovation.
- In order to foster a lively political debate across Europe, but also in order to cope with the contemporary sources of competitiveness, *the subsidiarity principle, so essential to European integration, should actually be put at work* and prevent an ultra-nationalist back lash, always possible as soon as the success of integration will falter. Padaroxically, subsidiarity might well be *one* of solution to the long run viability of the Euro.

*

*   *

The history of the Euro has not ended with the Amsterdam Treaty, it just began…the future lasts long! Europe will be transformed and so will economics and other social sciences.

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