HOW WILL EUROPEAN MONETARY UNION CHANGE THE GLOBAL FINANCIAL ARCHITECTURE?

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Many people have taken, or at least sold, the view that EMU will make an emerging market of Europe. The economies of scale associated with a continent-wide domestic market and, perhaps even more important, the creation of a truly continental capital market are being presented as increasing the rate of return on capital in euroland, drawing capital in from the rest of the world, not least the United States, and appreciating the euro. This story is told not only by investment banks with an interest in promoting euroland capital markets but by economists of distinction and influence such as Robert Mundell. It would be nice to believe it. Unfortunately, euroland is shaping up to be a disaster for its member countries and also for the liberal, free-market capitalist world order.

The internal disaster scenario is by now well known: once any country other than the politically important ones (Germany and France, and around them the satellites of the inner core) falls into recession, it will face the equivalent of a liquidity trap, so that attempts to reverse rising budget deficits in the downturn exacerbate recession and create a downward spiral from which there is no escape unaided. When this happens, the country concerned will be faced with a risk of sovereign default. What about leaving euroland? Well, all the citizens and companies will be indebted in euros (or third currencies). If the euro is associated with expanded cross-border financial transactions within euroland, then secession by a country in trouble will result in financial havoc, since by construction that country's new currency will depreciate against the euro in the circumstances hypothesized. To avoid the alternatives of sovereign default and widespread private sector bankruptcy, the European Central Bank (ECB) would have to bail the weak countries out via a sharp depreciation of the euro, creating unnecessary inflation in the rest of the area.

The single currency is thus a dangerously irresponsible venture. The key institution of a potentially successful monetary union is not the central bank but the Treasury. Euroland does not possess a Treasury. The looming crisis may end up forcing the creation of one, but as the result of deliberated deception of voters and through the holding of a financial gun to the heads of the peripheral countries by the dominant Franco-German axis: acquiesce in the creation of a Franco-German political condominium in Europe, or go bankrupt.

It is very much a mistake to see EMU as a liberalizing force that will produce an economic renaissance in Europe similar to the rebirth of the American, British and New Zealand economies, and to a more limited extent those of Canada and Australia, over the past two decades. The Anglo-Saxon revival has owed much to a political willingness to favor entrepreneurs over rent-

seekers. New Zealand is the most spectacular example of this, Britain the first and most symbolic (the Thatcher government's summary abolition of exchange controls in October 1979 was a marvelous portent of what was to come in the Anglo-Saxon world), and the United States the most important. One of the most important architects of the American economic revival, to whom due homage should be paid, was Michael Milken. He put the fear of God, of shareholders and of corporate raiders into boardrooms across the United States: "sharpen up your performance or you are out" was the salutary message. And the financial revolution he helped unleash made it possible, along with reduced personal taxes, for small-town garage companies to become world-beaters.

Does the spirit of Milken live in euroland? EMU, fervently supported by established multinationals and by the German universal banks, will be used as an instrument for strengthening the grip of established entities. The ethos of euroland is corporatist (that is why, for instance, it has always been supported by such interventionists as the former British Prime Minister, Edward Heath, who has never made any attempt to hide his distaste for capitalism and for free markets, not to mention the ineffable Jacques Delors), and that is why the blueprints for EMU can be found, almost word for word, in the plans of the fascists of the 1930s and 1940s.

Exactly which entities will run euroland is, of course, a matter of dispute. The French technocrats think they will. In contrast, former Bundesbank President Karl-Otto Pöhl has reportedly said that, "EMU will not be run by the German government; but it will be run by German firms." If Pöhl has a historical blueprint in mind, it is undoubtedly not that of the 1930s and 1940s, but rather the period between the dismissal of Bismarck and the outbreak of World War I, when the same arguments as now (the need for economies of scale for giant, cartelized German firms in a continent-wide market, and the supposed consequent offsetting need for a sovereignty superseding "the empty shell of the nation state") were used to justify both Weltpolitik and the ambition of Mitteleuropa. The forthcoming battle between Ecole Nationale d'Administration and Deutsche Bank will be a mighty one--unless they find a mutually profitable accommodation.

What of euroland's impact on the world as whole? It is perhaps an interesting academic exercise to speculate about whether or not the world monetary order would be improved or worsened by the emergence of a second United States, to be called Europe, and a second dollar, to be called the euro (more whimsically, one might call the new dollar the dolly, after the celebrated sheep). It is easy to predict that in this hypothetical new world, the euro, the currency of a liberal, Anglo-Saxon capitalist democracy, would rapidly come to share the reserve currency role of the dollar. Unfortunately, this academic exercise has no relevance to the question of what difference the real-world euro will make. First, Anglo-Saxon capitalism has no chance of being established in euroland. Euroland is simply not a clone of the United States. Indeed, a major part of the reason for its creation is a desire to make the United States a clone of Europe, not the other way around. Everyone should take note of the joint declaration early last year by socialist members of the French and German parliaments (when the declaration was issued, they held power in neither country; now, they hold power in both). EMU was necessary, they wrote, so

that Europe would have the weight to change the world social and economic model. Mitterrand realized in 1983 that "socialism in one country" was not possible. Instead, he set about creating the structures that, via monetary union, would, he hoped, make "corporatism in one continent" feasible.

But if the creation of the euro is indeed the prelude to a return to corporatist-socialist policies in Europe, inevitably reducing the anticipated real rate of return on capital in euroland, how will the currency avoid the need for a sharp real depreciation if there is not to be a severe recession forcing output below even its lowered trend path? The euro-strategists foresee a threefold defense.

First, they say, the very creation of the euro as an international currency will lead to inflows into euroland, as central banks in the rest of the world switch into euros and the transactions demand for euros rises as companies begin to invoice in the new currency. A fall in the real exchange (a worsening of the terms of trade) would normally accompany a set of structural measures that depress the rate of return in capital. This real depreciation, moreover, would have to go beyond the depreciation of the notional long-run equilibrium real rate: the initial negative shock to domestic demand, particularly investment, would be likely, as in France in 1981, to be greater than the reduction in short-run potential output. To offset this, real interest rates would have to fall relative to the world level, and for this to happen, the real depreciation of the euro would have to overshoot. However, if the euro succeeds in achieving the status of a reserve currency, eating into the dollar's international role, the flows into euroland will allow the real interest rate on euros to fall without a depreciation of the currency. Indeed, the euro may even draw capital out of the United States to such an extent, goes the European wishful thinking, openly expressed, that there is a U.S. recession severe enough to force U.S. acquiescence in European plans for a new, corporatist-socialist, world order. As one prominent French politician/banker put it, "The euro is our monetary force de frappe."

That argument is tenuous. The international reserve role of a currency is a reflection not just of its size, but of the economic vigor of the underlying economy, the political stability of the underlying polity, and the willingness and ability to project international influence and military strength of the underlying sovereignty.

How does euroland shape up in these respects?

The likely prospects for Eurobond's trend growth, given the corporatist-socialist agenda, are miserable. To make things worse, the almost inevitable financial crisis of the euroland periphery in the first half of the next decade will lead to extreme euro weakness. At all events, euroland will not have a vigorous underlying economy. Nor will its underlying polity be stable--in fact, it does not exist. Given all this, it is unlikely that euroland will be willing or able to project international influence and military force for the next few years, at least. Both France and Germany want to create a military superpower, and Germany very definitely wants a get a finger on the French nuclear trigger by calling it the WEU deterrent. And Germany also wants Britain

in, on the LBJ principle: better to have a nuclear power on the inside pissing out than on the outside pissing in. But none of this is going to make an as-yet-non-existent country a world superpower--not until the euroland financial crisis allows France and Germany to railroad everyone else into an informal condominium, and perhaps not even then.

In sum, while there will undoubtedly be some precautionary switching out of dollars into euros, the conditions for this move to be rapid and very large are simply not yet in place. It is far from clear that this switching effect will even compensate for the factors tending to produce a real depreciation of the euro, and it seems highly unlikely that the aim of forcing the United States to its knees economically will be achieved in a hurry. But this does not mean that either the U.S. authorities or international investors can afford to be complacent about the impact of the euro.

For the second line of defense against potential capital flight from Europe as a result of EMU should make everyone worry. Article 73(f) of the Maastricht treaty was inserted specifically to guard against capital flight. It stipulates that capital controls, affecting all EU countries, not just euroland members, can be imposed by a qualified majority vote in the Ecofin, “Where, in exceptional circumstances, movements of capital to or from third countries cause, or threaten to cause, serious difficulties for the operation of economic and monetary union.” No one is suggesting that controls will be introduced at the drop of a hat (after all, this threat had ideally to kept under wraps, away from the world’s notice, if the so-greatly-desired international reserve currency status of the euro and the equally strongly-held ambition to get London’s financial center in the power of the euro authorities were not to be gravely jeopardized). But the euroland financial crisis is likely, when it comes, to prompt the imposition of controls. The French authorities have been stating very firmly to the other EU countries that article 73(f) is not dead letter. It is there to be used when circumstances warrant.

The threat to capital flows posed by 73(f) is, it has to be admitted, not an imminent one. But the euroenthusiasts’ third line of defense against the sanction of the international capital market is much more immediately worrying. Both the French government and the German SPD have argued in favor of something resembling an international exchange-rate mechanism, to be buttressed by some form of “regulation” of capital flows. Such ideas are enormously attractive to European corporatist-socialists, for several reasons. First, the setting up of such a mechanism would allow the euroland politicians, under article 109 of the Maastricht treaty, to issue guidelines to the ECB, or even put in place a formal system of limits and intervention obligations, thus establishing political control over the new central bank. Second, the ego of international bureaucrats would be satisfied: they, not financial markets, would be “Masters of the Universe.” Third, and by far most important, a system of targeted exchange rates and capital controls would mean the de facto reimposition of current account constraints. Current account constraints are synonymous with international policy conflict, which would have to be “solved” by “coordination”, not just of monetary policies, but of fiscal, and, most disturbingly of all, structural policies.

The mechanism would be used, if the United States were gulled into accepting it, by the Europeans to enjoin, for instance, the United States to raise taxes or increase domestic regulation and intervention. One control--preventing insufficient flexibility of the exchange rate--creates distortions and conflicts that very rapidly lead to the imposition of new controls, creating new distortions and inefficiencies, requiring more controls, and so on. In these conditions, the optimism, the acceptance of bygones-are-bygones and of a winner-takes all society, the mainsprings of the U.S. renaissance, would be dried up. The rate of return in the United States and the rest of the world would be forced down in parallel with that in Europe.

In the world as whole, a return to inflexible exchange rates, capital controls, more interventionism and reduced rates of return would be accompanied by reduced financial market discipline on governments, so budget deficits would begin to climb again and inflation would creep back up (gold would recover some of its lost attributes as a good--perhaps the only available--inflation hedge; but good news for the gold market would be little consolation in the overall scheme of things).

But surely, one might think, the United States would never accept such obviously damaging ideas. The problem is that an unholy alliance could be formed between the left (those who find the prospect of more interventionism attractive) and part of the right (those who yearn for a return to Bretton Woods, fixed exchange rates, and U.S. world leadership). The left would have their ambitions fulfilled by falling in with European ideas, but the right would find that the world has moved on since Bretton Woods. In particular, while under the Bretton Woods system a U.S. current account deficit was the source of liquidity in the international monetary system as whole, in the system that Jospin and the SPD appear to have in mind, the U.S. current account deficit would be seen as a symptom of U.S. misbehavior. In this new system, the US would not be able to exercise leadership, for better or for worse, but would end up subjecting itself to foreign interference in its domestic economic affairs. But illusions reign.... Just as one should not forget that Nixon imposed wage and price controls, so also one should not forget that Harry Dexter White proposed, during the Bretton Woods negotiations, the creation of an international agency responsible for overseeing the national budgetary and monetary policies of the members, including the United States. The Congress wisely threw that out, thus ensuring that the Pax Americana was allowed to pursue its beneficent course. But bureaucrats are constantly prey to the temptations of such grand ideas. When analysis goes wrong, as it has done persistently in recent years, prescription and policy will also go wrong.