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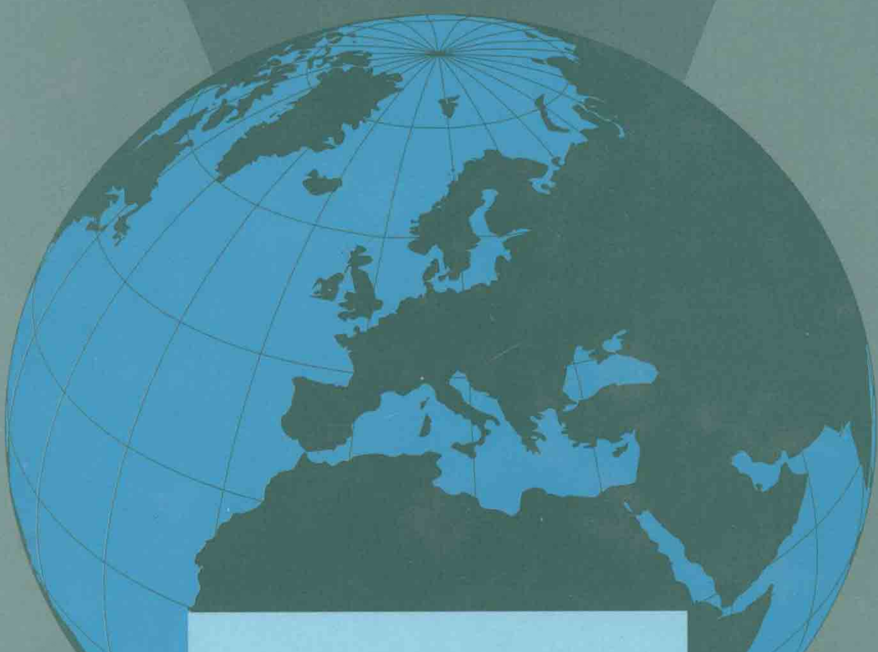
THE EUROPEAN MONETARY UNION IN A PUBLIC CHOICE PERSPECTIVE

JENNIFER C. MARTIN-DAS



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The European Monetary Union in a Public Choice Perspective

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List of abbreviations

ADA	Americans for Democratic Action
OE	Austria
B	Belgium
BTO	Brussels Treaty Organization
CEEC	Committee for European Economic Cooperation
CAP	Common Agricultural Policy
CFSP	Common Foreign and Security Policy
CLM	Community Loan Mechanism
ECOFIN	Council of Economics and Finance Ministers
CM	Council of Ministers
COPA	European Farmers' Union
COREPER	Council of Permanent Representatives
DK	Denmark
ECA	Economic Cooperation Administration
EAEC	European Atomic Energy Community
ECB	European Central Bank
ECSC	European Coal and Steel Community
EC	European Community
ECU	European Currency Unit
EEA	European Economic Area
EEC	European Economic Community
EFTA	European Free Trade Association
EMA	European Monetary Agreement
EMCF	European Monetary Cooperative Fund
EMI	European Monetary Institute
EMS	European Monetary System
EMU	European Monetary Union
EPU	European Payments Union
EPU	European Political Union
ERM	Exchange Rate Mechanism
ERP	European Recovery Program
ESCB	European System of Central Banks
EU	European Union
EUA	European Unit of Account

EDP	Excessive Deficit Procedure
FOMC	Federal Open Market Committee
FRS	Federal Reserve System
FI	Finland
F	France
GMU	German Monetary Union
G	Germany
H	Greece
GDP	Gross Domestic Product
GNP	Gross National Product
GSP	Growth and Stability Pact
HICP	Harmonized Index of Consumer Prices
IGC	Inter-governmental Conference
IEPA	Intra-European Payments Association
EI	Ireland
IT	Italy
JHA	Justice and Home Affairs
LMU	Latin Monetary Union
L	Luxembourg
MTFA	Medium-term Financial Assistance system
MEP	Member of European Parliament
NATO	North Atlantic Treaty Organization
NL	Netherlands
OCA	Optimum Currency Area
OECD	Organization for Economic Cooperation and Development
OEEC	Organization for European Economic Cooperation
PO	Portugal
PR	Proportional Representation
QMV	Qualified Majority Vote
RoP	Rules of Procedure
SCU	Scandinavian Currency Union
STMS	Short-term Monetary Support system
SEA	Single European Act
ES	Spain
SW	Sweden
TEU	Treaty on European Union
UK	United Kingdom
VAT	Value Added Tax
VSTF	Very Short-term Financing

Preface

This book provides an analysis of the European Union institutions that participate in the policy-making process of the European monetary union. It employs concepts from the public choice literature to model the political marketplace of the EMU at the EU level. It examines the interaction between the European Council, Council of Ministers, European Commission, European Parliament and the European Central Bank. It notes the principal–agent relationship between the EU governing institutions and the supranational monetary authority, the ECB.

Following a review of optimum currency area theory, this book presents the empirical evidence on the suitability of EU countries for membership in a single currency arrangement. Economic heterogeneities and limited adjustment mechanisms shed strong doubt on the suitability of a common monetary policy. Fiscal limits on national debt constitute a further constraint on regional adjustment policy.

Differences in national monetary and fiscal policy preferences following economic shocks may lead to divergent policy demands within EU institutions. The win-set framework demonstrates how one or more countries may become disaffected by policy decisions along these dimensions in the presence of less than unanimous decision rules. Subsequent pressures upon representatives of disaffected national constituencies may lead to the withdrawal of such countries from the single currency arrangement and a return to sovereign currency systems.

This book is an outgrowth from my dissertation at George Mason University. I would like to thank my dissertation advisor, Dr. Charles K. Rowley, for his encouragement, support and guidance throughout the preparation of this book. I would also like to thank the members of my dissertation committee, Dr. Willem Thorbecke of the Economics Department at George Mason and Dr. Francesco Parisi of the George Mason School of Law. I owe a special debt of gratitude to Dr. Walter E. Williams, Professor and Chairman of the Department of Economics at George Mason, who kindly arranged financial support throughout my graduate study and encouraged me throughout the program. Generous financial support throughout my graduate study was provided by the Lynde and Harry Bradley Foundation and the George Mason Economics Department. Finally, I would like to express my gratitude to The Locke Institute for its invaluable assistance in the preparation of this book.

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Von Hagen, Jürgen and Manfred J.M. Neumann (1994), 'Real Exchange Rates Within and Between Currency Areas: How Far Away is EMU?', *The Review of Economics and Statistics*, **76** (2), 236–44 (Table 1, p. 238).

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1. Introduction

The European Monetary Union (EMU) stands as one of the most important economic issues of the new millennium. For many European policy-makers, this project marks the pinnacle of the move towards European economic and political integration since the end of World War II. The success of this monetary arrangement depends upon the ability of European Union (EU)-level institutions to satisfy the monetary and fiscal policy demands of sufficient numbers of national constituents, interest groups and multinational corporations.

This book provides an analysis of the EU institutions that participate in the policy-making process of the EMU. Using concepts from the public choice literature, it examines the European Council, Council of Ministers, European Commission, European Parliament and the European Central Bank (ECB). It notes the potential principal–agent relationship between the EU-governing institutions and the supranational monetary authority, the European Central Bank.

Following a review of optimum currency area theory, the book presents the empirical evidence on the suitability of EU countries for membership in a single currency arrangement. Economic heterogeneities and limited adjustment mechanisms shed strong doubt on the suitability of a common monetary policy. Fiscal limits on national debt constitute a further constraint on regional adjustment policy.

Economic shocks may lead to divergent monetary and fiscal policy preferences among EU constituents. In response, domestic demanders of policy call on their national representatives to promote and secure policies favorable to their interests within the decision framework of the EU. Spatial models demonstrate how one or more country may become disaffected by policy decisions along these dimensions in the presence of less than unanimous decision rules. Subsequent pressures upon representatives of disaffected domestic constituencies may lead to the withdrawal of such countries from the single currency arrangement and a return to sovereign currency systems.

Chapter 2 provides a brief survey of Western European efforts at economic and political integration since the beginning of the nineteenth century. During this period, a number of customs and monetary unions formed and subsequently disbanded. The disintegration of these unions resulted from economic circumstances that drove national governments to undertake divergent policies.

Chapter 3 provides a brief survey of Western European efforts at economic and political integration since the end of World War II. The chapter concentrates on the affiliations and institutions that serve as the predecessors of the EU. The motivations for the integration that took place over this period were twofold: participating countries first sought to promote economic development and growth in the war-torn economies of the region; second, they sought to promote political cooperation in order to prevent further violent conflicts. The EMU evolved from the continued efforts at economic and political integration after the war.

Chapter 4 provides a theoretical overview of issues relevant to the creation and operation of currency unions drawing from the optimum currency area theory literature. Foremost among the criteria that define an optimum currency area is the suitability of a single monetary policy response to economic disturbances for the participating regions, particularly following economic disturbances. Whether or not a single monetary policy is suitable for one or more regional economies depends upon the similarity of economic disturbances and the operation of sufficient adjustment mechanisms. Adjustment mechanisms include, but are not limited to, real exchange rate flexibility, factor and output market flexibility, wage and price flexibility, industrial and portfolio diversification, economic openness and fiscal policy.

The institutional framework of a currency union also plays an important role in determining the success of single currency areas. The introduction of a currency union may include the transfer of monetary policy to a new central institution. This transfer implies that individual regions no longer retain authority over monetary and exchange rate policy. Fiscal policy may also be subject to constraints because of participation in a currency union.

Chapter 5 presents an overview of the issues relevant to the proposed EMU from optimum currency area theory and related empirical results. The consensus in the literature holds that the EU does not comprise an optimum currency area. In comparison with the US and Canadian currency unions, the EU does not possess the available adjustment mechanisms to respond sufficiently to economic disturbances.

The chapter also considers the motivations for and costs of participation in EMU, as well as the three-stage transition to EMU. Motivations are economic and political. Economic motivations include the goal of price stability, reduced exchange rate uncertainty and cost savings from a reduction in intra-EU currency conversions. Political motivations include the advancement of a political union within Western Europe, access to wider credit markets in a single currency and pecuniary transfers from the EU. The costs of participation in EMU stem from the constraints that participation in the currency union places on national monetary, exchange rate and fiscal policy.

Chapter 6 examines the implications of EMU for monetary and fiscal policy and institutions. Participation in the EMU implies that countries surrender monetary and exchange rate policy to the ECB. The latter directs the European System of Central Banks (ESCB), which includes the central banks of the participating countries. These banks serve as the national agents of the ECB. The EU possesses no central fiscal authority. Countries retain fiscal powers but face limits on the size of domestic debt levels and possible penalties for violation of these levels in accordance with the Growth and Stability Pact (GSP).

Chapter 7 introduces the rational choice approach to institutional analysis of actors within the political marketplace. These actors consist of policy brokers, demanders, and suppliers. These actors interact with each other in the political marketplace in a manner analogous to the consumers and producers of the commercial marketplace. Policy brokers differ from the producers of the commercial marketplace because they do not necessarily create new wealth by producing goods and services from various factor inputs. Rather, they affect transfers of existing wealth among different constituencies. The Council of Ministers, European Commission and European Parliament act as policy brokers at the EU level. Voters and interest groups act as policy demanders and suppliers. Members of the European Commission may also demand policies from the Council and Parliament.

Chapter 8 examines the role of the Council of Ministers, Commission and Parliament in monetary policy determination. Agenda power and decision rules play a limited role in the determination of monetary policy. The European Council, in particular, plays a decisive role in major policy matters. This body consists of national representatives that are responsible to domestic constituencies at the ballot box. The Treaty on European Union (TEU) holds the Commission and ECB accountable to the Council. The Parliament plays a very limited role in actual policy-making. For these reasons, the European Council may direct monetary policy within the EU.

Chapter 9 discusses economic shocks in the context of the EMU. A number of studies attempt to empirically determine whether regions of the EU are subject to asymmetric shocks. Differences in factor market regulations and industrial diversity affect the extent to which regions face asymmetric disturbances. Empirical evidence illustrates the existence of economic heterogeneity within the EU. Rigidities in national labor markets may increase the costs of adjustment to shocks to regional economies.

Chapter 10 presents a win-set model of the possible political implications of asymmetric macroeconomic shocks to the EMU. Empirical evidence indicates that national constituent support for elected politicians and for EU participation depends positively on the performance of the domestic economy. Based on majority rule, this model suggests that two or more countries may introduce changes in monetary and fiscal policy away from the *status quo*. Countries disaffected by such a European Council policy response, particularly in the face of a shock, but also alternatively because of an exogenous shift in tastes, may withdraw from the arrangement. Such withdrawal highlights the fact that no regime of fixed exchange rates is irrevocable.

2. European economic and monetary integration, prior to the creation of the European Communities

2.1 INTRODUCTION

The historical path to a European monetary union stretches back in time to early efforts at integration long before World Wars I and II. In the face of economic and technological development, as well as recurrent political and territorial conflicts, the integration of countries appeared as an alternative that would enable greater wealth creation and accumulation to participating countries. Advocates of integration boasted such potential benefits as access to larger markets, reduced barriers to trade, the avoidance of internal armed conflict, the provision of a stronger defense against common external enemies and greater negotiating power *vis-à-vis* other polities.

This chapter provides a historical overview of early efforts at European economic and monetary integration prior to the creation of the European Communities during the 1950s. Section 2 briefly reviews early attempts at integration in Europe prior to 1870. Section 3 reviews early attempts at monetary integration in Europe during the nineteenth century. Section 4 reviews European economic and political relations from 1870–1914. Section 5 reviews the economic and political situation in Western Europe from the beginning of World War I through the end of World War 11. Section 6 reviews the economic and political situation in Western Europe from 1945–52. The final section concludes with a review of the trends in European economic and monetary integration from a political economy perspective.

2.2 EARLY ATTEMPTS AT ECONOMIC INTEGRATION: 1800–1870

Calls for integration dot the history of the European continent. The Greeks (600–200 BC) raised perhaps the earliest suggestion of European integration. In the thirteenth century, the merchants of the Hanseatic League called for an enlarged economic sphere to realize greater returns from exchange from access to larger and more diverse markets and to eliminate profit-reducing barriers to trade. Religious thinkers of the Middle Ages (11–13th centuries) called for the integration of the states of Europe under the common bond of Christianity. Similarly thinkers of the Enlightenment (14–15th centuries) advanced the case for an integrated Europe on the basis of shared humanitarian ideals.

2.2.1 Economic Thought and Integration

Until the 1700s, mercantilist thought dominated international policy and economic affairs. Mercantilism saw nation states as competitors with each other in a struggle to amass wealth. The goal of national policy was to attain economic self-sufficiency. Countries sought to acquire gold in order to finance national defense and domestic expenditures. Trade barriers sought to promote exports and discourage imports. Protectionism, as advocated by mercantilists, was the order of the day.

Calls for integration began to challenge the mercantilist orthodoxy from the late eighteenth century. Pollard (1981, 12–14) identifies two approaches that characterize these renewed discussions of European integration. The first approach illustrates the case of integration motivated by economic interests. This economic approach emphasizes the potential for increased material wealth through the exploitation of advances in communications (postal and telegraph services), production (factory machines) and transportation (steam engines) technologies, newly built domestic infrastructure (railroads, roads and ports), and recently introduced standardized units of measurement (the Imperial and Metric systems) and timetables (Overturf 1986, 5). Integration would promote the dispersion and exchange of technical knowledge, widen the spectrum. of exchange, and lead to increased specialization.

The second approach illustrates the case of integration motivated by shared cultural heritage and common political concerns. Cultural motivations include a shared religious experience (Christianity) and common social and intellectual traditions. Political motivations include integrated transportation and infrastructure networks, prevention of military conflict in order to avoid the destructive effects of war and defense against common external enemies in order to retain existing sovereign arrangements. In 1693, William Penn prepared an essay providing for an assembly of representatives from across Europe to promote political cooperation and prevent further military conflict. Penn wrote this essay in light of the destructive effects of the Thirty Years' War (1618–48). Advocates of this approach included Abbé de Saint Pierre, Jean-Jacques Rousseau and Jeremy Bentham. The latter thinkers specifically promoted the creation of a European assembly and suggested a standing army.

Increasing developments in economic activities and relationships during the nineteenth century provided the motivation and opportunity for European inte-