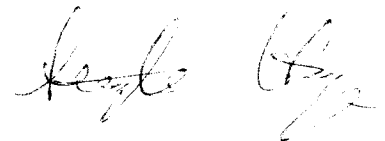


# Honor's Thesis

## **Economic Cohesion to Create Strong Convergence for the EMU**

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## Introduction

Not long ago I happened to see a television commercial in which a man from the Boeing company said, "One man can do only little things." He then showed a design for an airplane and said, "But, many people can do a lot of things." A moment later, we are shown thousands of people working together to produce a large aircraft. I think that this is a very meaningful television commercial. The reason behind this belief is that this commercial sends a very important message to us. When we discuss the European Monetary Union (EMU), it must be true that millions of people in the European Community (EC) could jointly create a better economic condition. However, if the EMU failed to bring people and members of the EC together, it would create an incentive for self-destruction to the EC. EMU could not create better economic conditions without adequate support from people and members of the EC, just as an airplane could not be made with fewer people. The Maastricht Treaty in 1992 designed a set of economic standards, that is, the convergence criteria. Members of the EC have to meet these standards in order to join the EMU. The convergence criteria turns out to encourage higher competition among members and non-members of the EC. This higher competition, instead of bringing members together, seems to create a separation between them. However, it is extremely vital to bring members of the EC together so that those people could create an airplane named "EMU" in this coming new era. In this thesis, I plan to discuss the major benefits

of the EMU and how it will be established. In addition, I would like to argue about the difficulties associated with the convergence criteria. At the same time, I will discuss economic cohesion as a means to help create the airplane "EMU".

## Background

Examining history explains how the image of the European Monetary Union strongly emerged to build a better future economy in the European Community. In particular, let's look at the success of German economy in the 1980's. It was during this period that many other members of the EC successfully managed their monetary policies and improved the economy. The European Monetary System (EMS), which was created in 1979, has supported members of the EC in many different ways. The EMS instituted a set of rules to limit exchange rate fluctuations and established a system known as the Exchange Rate Mechanism (ERM). This ERM promoted a stability of the exchange rate since most member countries in the EC were required to maintain their exchange rates within 2.25 percent of central rates between their currency and each of the other members' currencies. When an exchange rate between two members' currencies moves to a threshold of divergence, both central banks are required to prevent the exchange rate from moving outside that range. In addition, the ERM provided members permission for a realignment of their central rates. When a country cannot keep the exchange rate within 2.25 percent of a central rate, the ERM permits that

country to realign the central rate. The ERM has enhanced the European Monetary System and helped stabilize the economy of member countries in the 1980's.

The success of the German economy also helped stabilize other members' economies during the 1980's. The reason for Germany's success is that her central bank, the Bundesbank, has effectively conducted a tight monetary policy. The German mark had become a notably stable currency and created a deutsche mark zone. In the deutsche mark zone, other members of the EC had pegged their currencies to the mark and achieved anti-inflationary economies. They simultaneously established the German style monetary credibility. Jeremiah Riemer, the author of the article "The ECU as the 'Mark' of Unity: Europe between Monetary Integration and Monetary Union," says, "by 1987 it began to look as though realignments were a thing of the past. It was at this point that discussions began about turning the European Monetary System into a true monetary union, in which exchange rates would be irrevocably fixed and national currencies would eventually disappear in favor of a single European currency." (Social Education, p185) As he mentions, the image of the EMU first appeared in the late 1980's. The EMU would create a single European currency and a single market. At the same time, it would establish a fixed exchange regime.

### **Benefits of the EMU**

The EMU consists of three salient features. Those are the single currency, the single market, and the fixed exchange rate regime. Members believe that the

EMU will bring substantial benefits to the EC as a whole. There are two economic thoughts that can elucidate how these salient features of the EMU could bring benefits to member countries. The first one is a theory of an optimum currency area, and the second is an issue of a fixed exchange rate system. According to the text International Economics written by Dominick Salvatore, a theory of an optimum currency area is defined as "a group of nations whose national currencies are linked through permanently fixed exchange rates and the conditions that would make such an area optimum. The currencies of member nations could then float jointly with respect to the currencies of non-member nations." (p615-616) This definition includes an important key to comprehend how the optimal currency area works. This key is the theory that an optimum currency area works when an exchange rate is permanently fixed. The reason behind this thought is that the permanently fixed exchange rate eliminates impacts of the exchange-rate fluctuations. The elimination of these impacts has crucial influences to the optimum currency area and to the future economy of the EC.

The theory of an optimum currency area can help explain how the EMU could be a benefit to members of the European Community. First, the optimum currency area eliminates the uncertainty that arises when exchange rates fluctuate over time. The elimination of this uncertainty encourages people to trade and invest more in the EC. Hence, it leads to specialization in various sectors of the economy. Second, the optimum currency area creates an enormously large market in the EC. John Templeman, the author of the article "One Big Currency -

And One Big Job Ahead," gives us a good measure on how large the market would be. He discusses, "With the EC boasting 340 million consumers and a gross national product of \$8.5 trillion, the new European currency unit, or ECU, has the potential to become a strong rival to the dollar in international finance and trade." (Businessweek, p4). The optimum currency area would enlarge both capital and goods' markets, and enhance economies of scale in various sectors of member countries. Third, if the EMU introduces a single European currency to be used among members of the EC, the optimum currency area will eliminate costs associated with exchanging currencies. Salvatore discusses, "The European Commission estimated that the creation of a single currency and elimination of the costs involved in exchanging currencies in the EEC would save from \$18 to \$26 billion a year." (International Economics, p619) The elimination of the costs is advantageous to traders and travelers. Precisely, the elimination will facilitate imports and exports of capital, goods, and services. In addition, that will encourage people to travel more among member countries of the EC. Lastly, the optimum currency area promotes price stability. Price stability, in turn, allows members to attain an anti-inflationary economy and establish monetary credibility. These are the four major benefits of the EMU that attribute to the optimum currency area. Likewise it is essential for members of the EC to have the permanently fixed exchange rate. This is because elimination of the impacts which is caused by the exchange-rate fluctuations enhances the optimum currency area.

We have discussed that a fixed exchange rate mechanism eliminates impacts of the exchange rate fluctuations. The elimination of the impacts is one of the most vital features of the EMU. At the same time, the elimination fundamentally augments those four major benefits of the EMU. When we compare the European Monetary System (EMS) to the EMU, we know that the EMS does not eliminate the impacts of the fluctuations, it only limits them. This was one of our discussions earlier. In the article "Why Economic and Monetary Union is an Important Objective for Europe," Neils Thygesen states, "The main aim of the [EMS] was to reduce the impacts of exchange rate fluctuations within the EC, not to eliminate them." (SAIS Review, p19). The EMU, which replaces the EMS, will get rid of those impacts because of the mechanism based on the fixed exchange rate. Now there is an important question we must consider. This is the question of how the fixed exchange rate mechanism eliminates the impacts. There is an economic tool which will help resolve this question. This tool is the price adjustment mechanism. The price adjustment mechanism holds a unique role between an internal and an external balance, and effectively eliminates those impacts. This unique role is the fact that, under fixed exchange rates, the external balance determines the internal balance. It is vital to understand this role under the fixed exchange rate mechanism, in order to show how the price adjustment mechanism removes the impacts caused by the exchange rate fluctuations.

However, to truly understand how the price adjustment mechanism works, we need to apply economic theory. This is the quantity theory of money which is

described with a simple equation and four variables. These four variables are a nation's money supply  $\{M\}$ , a velocity of money circulation  $\{V\}$ , a general price index  $\{P\}$ , and a physical output  $\{Q\}$ . The equation consists of these four variables, and it is expressed as  $MV = PQ$ . When a country retains an equilibrium of internal balance, we know that  $\{MV\}$  is equal to  $\{PQ\}$ . This equation implicitly tells us that whether a country holds an internal balance depends upon the balance between  $\{MV\}$  and  $\{PQ\}$ . I have briefly mentioned before that an external balance determines an internal balance under the fixed exchange rate mechanism. This correlation gives us an important clue for how the fixed exchange rate mechanism gets rid of the impacts of those fluctuations. Let us begin with an example. If, for instance, Italy experienced a situation where her exports exceeded her imports, she would move away from an equilibrium of the external balance. Italy would enjoy expansion of her economy because of the net inpayment of Lira. The current money supply  $\{M_0\}$  in Italy would substantially increase and yield an inflationary tendency. At this point, holding everything else constant,  $\{MV\}$  is not equal to  $\{PQ\}$  since the increased money supply  $\{M_1\}$  makes  $\{MV\}$  greater. Italy would move away from an equilibrium of the internal balance. However, Italy's exports will become less attractive to foreigners as the current price level  $\{P_0\}$  gets higher. The increased money supplies necessarily make a new higher price level  $\{P_1\}$  in the economy. Italy's exports will eventually decline until she moves back to the equilibrium of the external balance. As Italy reaches the external balance, she can bring her economy back to the equilibrium of the



internal balance. When the price adjustment mechanism is effective, the external balance leads the economy to the equilibrium of the internal balance. Thus, the external balance determines the internal balance under the fixed exchange rate mechanism. As we learned from this example, it is important to remember that the price index  $\{P\}$  is automatically adjusted by the country's external balance. In addition, the price index influences the volume of exports. The price adjustment mechanism detects a deficit and a surplus of the external balance, and gets rid of them both. Since a country moves back to the equilibrium of the external balance as well as the internal balance, we can see that the impacts of the exchange rate fluctuations are eliminated by the price adjustment mechanism. The fixed exchange rate regime, which is one of the salient features of the EMU, benefits the members with the elimination of those impacts.

### **Establishment of the EMU**

We have discussed so far how the idea of the EMU has emerged, and what benefits the EMU will provide to members of the EC. The EMU may replace the EMS by the end of the 20th Century. However, an unsolved question remains in our discussion. The question is how to establish the EMU. To begin with an answer to this question, we need to introduce a man; Jacques Delors, who is the president of the EC commission. It was President Delors who first took an initiative in establishing the EMU. President Delors and his committee prepared a blueprint for the EMU. The blueprint is known as a Delors Report, which contains

the issue of how to establish the EMU. The Delors Report presents a concept which leads members to the EMU. The concept is called "Gradualism". It gives us a strategy based on a sequence of concrete and pragmatic stages. According to an article "The Transition to the European Monetary Union", Alberto Giovannini gives us a center notion of the Delors Report. He mentions,

"The main feature of the Delors Report is the concept of gradualism: integration is to be achieved over time in order to adapt the economies and policy making processes to monetary union. The transition will be accomplished in stages by removing barriers to the integration of goods and financial markets while simultaneously strengthening policy coordination and progressively building up the institutions that will manage the new European Money." (Essays in International Finance, p1-2)

The concept of Gradualism seems to give us an outline of how the EMU could be established. However, gradualism hardly gives us a concrete means of how to establish the EMU. Giovannini criticizes that, "Gradualism might lead to weak economic convergence that will make the transition more difficult to accomplish ." (Essays in International Finance, P2) If a strong economic convergence is a key to accomplish the transition, the concept of gradualism might lead to a failure of the establishment. The question of how to establish the EMU, which will take us to a further discussion.

Although the concept of gradualism does not give us a practical means on how to achieve the EMU, it does contain a few positive aspects for the accomplishment. Gradualism supports members of the EC who share different political, economic and administrative structures. In this respect, members of the EC could coordinate policies at their own individual pace for the accomplishment

of EMU. The Delors Report introduced the concrete and pragmatic stages leading to the EMU. The concept of gradualism encourages members to make the EMU step by step through these stages.

Delors Report created three stages, each of which adopts different objectives to make the transition possible. It is not the concept of gradualism, but these three stages that give us a concrete image on how to achieve the EMU. Let us briefly demonstrate how the transition to the EMU will take place in those three stages. First, stage one which began in July of 1990 adopted a few objectives. These were to remove restrictions for better capital movements, liberalize financial and goods' markets, and enlarge memberships in the exchange rate mechanism. The second stage began on the 1st. of January in 1994. The goal in stage two was to encourage member countries to attain convergence criteria which were determined at Maastricht treaty. In addition, the creation of the European Monetary Institute (EMI) is an important goal in this stage. The reason is that the EMI will be the future European Central Bank. The third stage, which will begin by the year 1999, has three major objectives. The first objective is to accept the permanently fixed exchange rates within members of the EMU. The second is to create a single European currency. The third objective is to get the European Central Bank to handle the single currency and authorize monetary policies in the European Monetary Union. The actual transition to the EMU will take place in the stage three. At the same time, the establishment of the EMU will be completed in this stage.

As we have discussed earlier in the quotation from Giovannini, a weak economic convergence would make the transition more difficult to accomplish. If a strong economic convergence is a necessary condition to establish the EMU, members of the EC must make the strong economic convergence before the transition. In this respect, stage two is the most crucial period since the attainment of convergence criteria has a powerful influence on the future economic convergence. The attainability of the EMU would heavily depend on whether this second stage could fix the strong economic convergence. That is to say, the stage two plays a vital role for enhancement of the economic convergence and for the establishment of the EMU.

The stage two plays the vital role for the creation of the strong economic convergence. For this reason, one of the most important goals in the stage two is to get member countries to satisfy the convergence criteria. According to the article "Choosing union: monetary politics and Maastricht," the author Wayne Sandhilts gives us the specification on the convergence criteria as following:

- (1) a rate of inflation in the consumer price index no more than one and one half percentage points higher than the average of the three states with the best performance in price stability;
- (2) interest rates on long term government bonds no more than two percentage points higher than the average of the three countries with the lowest rates;
- (3) a central government budget deficit no greater than 3 percent of gross domestic product;
- (4) a public debt of no more than 60 percent of GDP;

- (5) a national currency that has remained within the narrow (2.25 percent ) fluctuation margins of the ERM for the previous two years and has not been devalued against any other member state currency over the same period. (p18)

The convergence criteria specifies the five qualifications for the economy which a nation needs to satisfy to join the EMU. J. Mawson, in his article "Cohesion, Convergence and Economic and Monetary Union in Europe," supports the convergence criteria for the creation of the strong economic convergence within the EC. He remarks, "It is argued ( and enshrined in the Maastricht Treaty) that unless the various indicators of nominal convergence - interest rates, inflation rates, public debt and the stability of the exchange rate are broadly harmonized within the EC, the monetary union would not be sustainable." (Regional Studies, p150) It is clear that the convergence criteria imposes a crucial task upon members of the EC. They must make huge efforts to satisfy the convergence criteria. The strong economic convergence makes the transition more possible, and creates the sustainable EMU. The ultimate goal in stage two is to create this strong economic convergence. It is certainly true that the second stage plays a vital role for the establishment of the EMU.

### **Economic Turmoil of German Unification**

Members of the EC must strive to satisfy the convergence criteria. The convergence criteria is one of the most important objectives in stage two and a key to the creation of a strong economic convergence. Hence, it is necessary for

members of the EC to achieve that goal. In order to establish the EMU and make it sustainable, we know that the EC needs the strong economic convergence as a whole. However, we must discuss whether it is sufficient for members to only achieve the goal of convergence criteria. The reason this discussion is necessary is that German unification in 1990 triggered many negative changes in the European economy. It even created new concerns on whether members could establish the EMU. Riemer argues, "The politics and economics of German unification, however, created new tensions in the relationship between a now united Germany and those countries who had come to see the Deutsche mark as the anchor currency of the European Monetary System." (Social Education, p185)

Members of the EC attained a relatively stable economy by the late 1980's because they pegged their currencies to the German mark under the EMS. In a sense, the other members of the EMS imported a low inflation rate from Germany as the Bundesbank successfully operated a tight monetary policy. After German unification, however, the tight monetary policy became a negative influence to the economy of Germany and other members of the EC. Let us carefully observe how German unification triggered negative impacts to the European economy, and created new tensions in the relationship between Germany and other members.

Bundesbank, after the unification, persisted with a tight monetary policy under an inflationary pressure. According to the article "The United States in the World Economy", the council of economic advisers gives us a statistic of the German interest rate. It states, "As a result [of unification] German short term

interest rates, which had been rising since 1988, continued to rise reaching nearly 10 percent by the summer of 1992." (Economic Report of the President, p224)

The high interest rate in Germany triggered an economic turmoil in the European Community. Members of the EC suffered from both a high unemployment and a high interest rate.

The following two figures visually explain how a tight monetary policy of the Bundesbank caused the high unemployment and the interest rate. First of all, figure 1 represents a IS-LM model which shows a relationship between an aggregate output level  $\{Y\}$  and an interest rate  $\{i\}$ . Figure 2 reflects a nation's money market which shows a relationship between a money supply  $\{M_s\}$  and a money demand  $\{M_d\}$ . Assuming that Germany, before the unification, was operating her economy at point A, then the level of aggregate output was primarily  $\{Y_0\}$ , and  $\{i_0\}$  for the interest rate. Bundesbank targeted on the nation's money

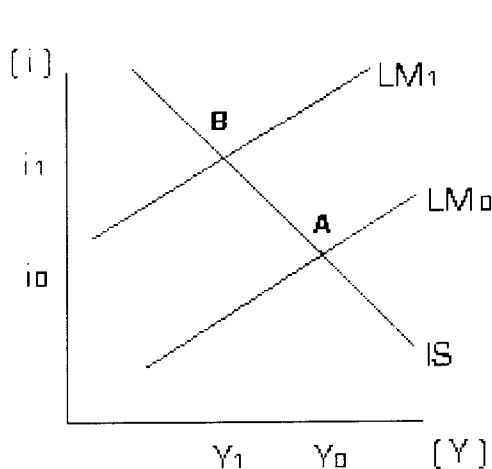


Figure 1

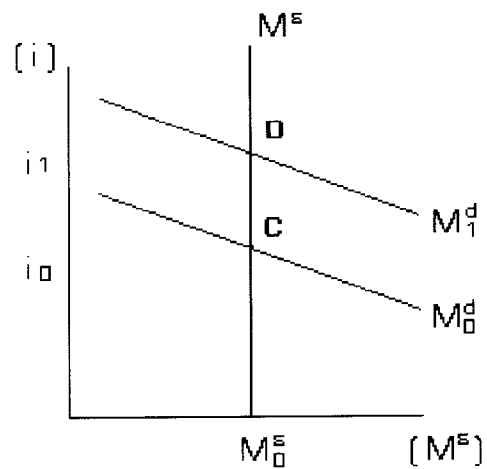


Figure 2

supply in order to keep the economy from inflation. Hence, Bundesbank operated a tight monetary policy. In addition, the money market in Germany was initially balanced at point C. The money demand, however, was substantially increased after the unification, when the East and West Germany accepted deutsche mark as a common currency in July 1990. The money demand curve shifted upward and created a new level of money demand  $\{M_d\}_1$ . At the same time, the increased money demand shifted the LM curve to  $\{LM_1\}$ . (See Figs. 1 and 2.) The German economy reached point B in the IS-LM model and point D in the money market since the Bundesbank, even after the unification, persisted the tight monetary policy. This policy augmented the interest rate even more. As a result, the interest rate was increased to  $\{i_1\}$ , and the level of the aggregate output was dramatically dropped to  $\{Y_1\}$ . Thereby, it led to the increase in the rate of unemployment.

The increased interest rate in Germany triggered an interest arbitrage through a capital market. People in the EC sought to earn higher return and invested in short term capital in Germany. As a result, members experienced a diminishing in the supply of funds and increasing in the interest rate. This occurrence decreased investment, and essentially yielded higher unemployment in other members of the EC. The United Kingdom, Finland and Italy experienced big recessions. They decided to allow their currencies to float, and left the exchange rate mechanism. In addition, Sweden, Portugal, and Ireland devalued their currencies. The economic turmoil triggered by German unification, instead of



making a tight relationship among members, caused a collision among them. German unification simultaneously created some difficulties in attaining the convergence criteria. In the article "How Europe can come together without colliding," William Glasgall argues, "With much of the region battling recession and the high interest rates resulting from Germany's lavish spending on its eastern half, should the European Community continue pressing ahead to create a single currency and central bank as early as 1997?" (Businessweek, p38) We have discussed that the EC needs the strong economic convergence to establish the EMU and make it sustainable. In addition we have mentioned that members of the EC must strive to satisfy the convergence criteria for the strong economic convergence. After the German unification, the EMS seemed to fall apart. It is still necessary for members to achieve the convergence criteria. However, it is not sufficient to achieve only the convergence criteria for establishing the strong economic convergence. This is because German unification caused the economic collision among members and made it difficult to achieve the strong economic convergence.

Lorenzo Bini Smaghi, the author of the book Adjustment and Growth in the European Monetary Union, observes the situation after German unification and points out, "The situation has progressively changed and is bound to change even more during stage two because:

- (1) the other large countries of the Community have joined the European Monetary System and are expected to adopt the narrow fluctuation margins, as Italy did in 1990;

- (2) Germany is no longer the best performer in the Community in terms of price performance, and it is not likely to recapture its primacy in the short term;
- (3) the Bundesbank's credibility is still the highest but that of the central banks of several other countries has improved;
- (4) With full capital mobility and German unification monetary conditions have become less stable in Germany." ( Torres and Givazzi, p29)

Members of the EC used to peg their currencies to the deutsche mark, and could stabilize the economy. German unification, however, has changed the systematic way of stabilizing other members' economies since the deutsche mark zone was collapsed, and Germany is no longer the leader who offers the best price stability. A number of large countries in the EC joined the European Monetary System. They adopted the convergence criteria in order to establish the EMU. It has become very competitive to satisfy the convergence criteria among members of the EC. As the EMS is braking apart, members face the problem of how to create the strong economic convergence in the second stage. Smaghi mentions, "In more general terms, as the performances of the member countries converge, the maintenance of price stability does not necessarily require all countries to adopt the same monetary policy stance all the time." (Adjustment and Growth in the European Monetary Union, p29) Smaghi implies in this context that the member countries do not have to pursue the policies imposed by a country with a stable economy. He rather encourages the member countries to persist with their own monetary policies to attain the convergence criteria.

## Difficulties with Policy Convergence

According to our discussion, it is apparent that German unification has negatively influenced the economy of member countries in the EMS. At the same time, it caused the economic turmoil in the EC and tore apart the European Monetary System. Smaghi argued that the member countries, instead of depending on the deutsche mark, could persist with their own monetary policies to satisfy the convergence criteria. Although German unification created a condition where members have difficulties in attaining the convergence criteria, it is still difficult to satisfy these criteria if members only depend on the monetary policies. This is because there are some inevitable conflicts which exist among goals of monetary policies, and hinder members in attaining the convergence criteria. In order to examine this reasoning, let us begin by looking at the goals of monetary policies and observe how these conflicts make it more difficult for members to attain the convergence criteria.

There are six goals that the monetary policy can target. These are,

- (1) high employment;
- (2) economic growth;
- (3) price stability;
- (4) interest rate stability;
- (5) stability in financial markets;
- (6) stability in the foreign exchange markets.

When we look at both the goal of (1) high employment and (2) economic growth, we realize that there is a link between the two. If a country has a high rate of employment, this condition indicates that workers and resources in this country are efficiently utilized at a given level of technology. This efficient utilization of

resources encourages economic growth. Thus, a country with a high rate of employment can likely attain the goal of economic growth. After all, both the goal of high employment and the goal of economic growth are compatible to the monetary policies.

Next, when a country faces inflationary pressure, this country needs to conduct a monetary policy which aims for the goal of price stability. For example, when Bundesbank operated a tight monetary policy after German unification, it worked so as to keep the German economy away from inflation. The tight monetary, which targeted on the money supply of the deutsche mark, helped the German economy for price stability. To the contrary, this tight monetary policy led the German economy to a high interest rate. In order to achieve the goal of interest rate stability, a country needs to operate monetary policies that can directly influence a level of interest rate. As a country aims for interest rate stability, a policy which targets on money supply is completely inconsistent. Hence, a country needs monetary policies that encourage the central bank to engage in the open market operations, or to alter discount rate and reserve requirements. The goal of interest rate stability opposes with the goal of price stability because these two goals need two incompatible monetary policies. On the other hand, the goal of interest rate stability is compatible with the goal of stability in financial markets. As we learned from the example of German unification, the financial markets in Germany were destabilized when the German interest rate soared. When the interest rate is not stable, an interest arbitrage

takes over the financial market and destabilizes the market under uncertainty. Thus, interest stability is an important condition for the goal of stability in the financial market. The stability in foreign exchange markets is heavily dependent upon movements in the value of a national currency. Hence, both the price and the interest rate stability are vital for the stability in foreign exchange markets. This is because the change, in both interest rate and price level, alters the value of the national currency and makes it difficult to achieve the goal of stability in foreign exchange markets.

We have briefly discussed that there are some conflicts among goals of monetary policies. In the book Money, Banking, and Financial Markets, Frederic S. Mishkin mentions, "The goal of price stability often conflicts with the goal of interest rate stability and high employment in the short run." (p443) We can agree with Mishkin because the goal of price stability and the goal of interest rate stability require two different policies which are incompatible to each other. In addition the goal of price stability also conflicts with the goal of high employment. As we have observed from the German unification, a tight monetary policy created a high rate of unemployment. Mishkin is right that there are incompatibilities which exist among goals of price stability, interest rate stability, and high employment.

When members of the EC employ monetary policies and try to attain the convergence criteria, the conflicts among the goals of the monetary policy makes it more difficult for members to achieve. We know that the goal for price stability

is incompatible with both the goal of interest rate stability and high employment. As we keep these incompatibilities in mind, we can come to realize that there are some difficulties associated with the convergence criteria. More specifically, when a country pursues the first criterion of low inflation, she will experience some difficulties of satisfying the second criterion of interest rate stability. In addition, the country will experience an increase in unemployment as she moves toward the third criterion of budget deficit reduction and the first criterion of low inflation. In the article "Adjustment Under Fixed Exchange Rates: Application to The European Monetary Union," A. Steven Englander and Thomas Egedo analyzes, " - - - in the absence of structural reform, some countries may experience higher unemployment in moving towards the low inflation rates and modest deficit levels that are prerequisites for entering EMU" (Economic Department Working Papers No.117, p2)

In fact, many countries in the EC has been experiencing relatively high rates of unemployment as they move closer to the specific condition described by the convergence criteria. The matter of high unemployment rates is becoming one of the most serious issues among members of the EC in stage two. When we look at a statistic of unemployment rates for March 1994, we can observe the high rate of unemployment in member countries of the EC. According to this statistic used in the article "Voting together, pulling apart?" (The Economist, June 4th, p49), Luxembourg attained the lowest unemployment rate of 3.2%. Other member's unemployment rates were following: Portugal (6.1%), Germany (9.0%), Greece,

Britain, and Belgium (10.0%), Denmark (10.5%), Holland (10.7%), France (11.2%), and Italy (11.3%). Spain reached the highest unemployment rate of 22.9%. As we recognize from this statistic, there are eight countries in the EC which reached an unemployment rate greater than 10.0 percent. As Englander and Egedo mentioned that countries may experience high unemployment as they adopt a lower rate of inflation and government deficit of the convergence criteria. In order to solve the problem of high unemployment, it is necessary to analyze how the unemployment is formed in an economy.

An economic notion of automatic stabilizers helps resolve how unemployment is formed in an economy. This notion of automatic stabilizers explains the fact that a number of government programs automatically increase their income transfers to families when the unemployment rises, and the aggregate income falls. An important question comes to mind, namely, how the government finances the income transfers in the situation of an increase in unemployment and the falling aggregate income. The following function;  $T = tY$ , can resolve this question. Robert E. Hall, the author of the book Macro Economics, discusses, "the tax rate  $\{ t \}$  actually falls when income  $\{ Y \}$  falls, and rises when income rises." (p392) This is very significant rule that we need to remember. What he literally means is that Government tax receipts  $\{ T \}$  decreases as both income  $\{ Y \}$  and tax rate  $\{ t \}$  falls during a recession. To the contrary, the government tax receipts  $\{ T \}$  increases as both income and the tax rate  $\{ t \}$  rise during an expansion. Hall additionally mentions, "The automatic stabilizers exacerbate the

swing of the deficit during a recession." (Macro Economics, p393) He points out that the government deficit rises during recession. His thought, then leads us to a crucial point. That is the fact that the government deficit is cyclically related to the unemployment rate. Thus, an economic recession with a tight monetary policy leads to high unemployment rates and government deficits. If, however, the government chose to reduce its deficit in order to satisfy the third criterion, the government would have to cut back its expenses. In this scenario, the government would augment the rate of unemployment because the reduction in government expenses reduces the number of government related jobs. This consequence explains how unemployment is formed when a country moves toward the low inflation rate and the moderate deficit without any structural reforms.

When members of the EC move toward the goal of satisfying the convergence criteria, the incompatibilities among monetary policies make it more difficult for them to achieve. If a country choose the convergence criteria as the first priority, we have found that it is inevitable to create the high unemployment without any structural reforms. As the rate of high unemployment is getting bigger for satisfying the convergence criteria, the reduction of the unemployment seems to be a vital condition for the creation of strong economic convergence. Otherwise, people in the EC, instead of helping each other, would be torn apart from each other. We must consider that the condition of less unemployment in



the EC is also a necessary goal for members to create strong economic convergence.

### **Economic Cohesion for the EMU**

We have mentioned that the reduction of unemployment is also an important objective in stage two that can lead to the creation of strong economic convergence. In order to reduce unemployment, the structural flexibility and the labor market flexibility are the two necessary conditions. However, relatively small countries in the EC do not have this structural flexibility. At the same time, we can perceive that members of the EC do not have such a labor market flexibility. Charles R. Bean, the author of the article "Economic and Monetary Union in Europe," gives us an appropriate reason to support this perception. He argues, "- - European labor mobility is so much lower, because of linguistic and cultural heterogeneity" (Journal of Economic Perspectives, p49) This linguistic and cultural heterogeneity is a burden that a labor market in the EC cannot be flexible as a whole. Thereby, the unemployment rates in the member countries tend to persist in their economies.

We need to discuss another issue which is related to a high rate of unemployment. That is the issue of regional disparities. This issue is becoming a serious matter in the EC at the same time with the issue of high unemployment rates. The reason for this is that a small country tends to have more economic damages associated with a high unemployment rate. On the other hand, a large

country can prevent the economic damages at a minimum level since this country has more structural flexibility. It is this small country that becomes so vulnerable after the harsh competition for attaining the convergence criteria. Mawson mentions, " - - - much of the work on the Single Market suggests that the more prosperous core regions of the Community have most to gain, while the peripheral countries and regions will be vulnerable to more intense competition." ("Policy Review Section", p151) He also analyzes, "Indeed, in the transition towards the EMU, which will impose a greater burden of adjustment of nominal macro economic variables (inflation, interest rates, public debt) on many of the least favored parts of the EC, the risks of aggravating existing regional disparities are considerable." (p151) We can observe that this intense competition, for satisfying the convergence criteria, gives small countries the two major concerns of both high unemployment rates and risks associated with the regional disparities. The issue of the regional disparities and high rate of unemployment are both critical issues for small countries in the EC.

According to Mawson, "In many less favored regions, the persistence of problems suggests that the cumulative effect of disadvantage, rather than insufficiently open markets, is the main reason for a lack of competitiveness. If so, market liberalization may well exacerbate the difficulties of less favored regions by intensifying competitiveness pressures. (p151-152) This market liberalization, which was established in the first stage of the Delors Report, simply encouraged severe competition among the members to achieve the convergence criteria. As a

result, the market liberalization created regional disparities. We have mentioned that the creation of strong economic convergence is an ultimate goal in order to establish the EMU and make it sustainable. When people and countries in the EC eager to bring some economic benefits to the EMU as a whole, it is essential to eliminate the regional disparities, and to reduce unemployment rates. Mawson also argues, "Equally, if parts of the Community economy lack the infrastructure, the skilled labor or the access to technology and finance enjoyed by the more prosperous regions, their lack of competitiveness might limit the gains from integration by inhibiting their contribution to Community growth." (p152) This is an important point that the regional disparities, which are caused by a lack of competitiveness, could limit potential gains to the EMU. Mawson's quotations gives us a new objective in stage two of how to create the strong economic convergence and achieve the EMU.

This objective is an achieving economic cohesion among members of the EC. Mawson discusses the objective of achieving this economic cohesion for a challenge to policy makers. Mawson analyzes that there are three policies that help achieve the economic cohesion among the members. These policies are;

- (1) assisting the productive base of less favored regions in order to improve their capacity to compete;
- (2) transfers of income to redistribute some of the net benefits of integration;
- (3) a slowing down of the pace of integration in order to ease the costs of transition (p152)

We then need to examine whether or not these policies are applicable to members of the EC. According to Mawson's discussion, he observes, "in most nation states, disparities in welfare are mitigated by fiscal transfers (inter-regionally, as a result of fiscal federalism, or between individuals as a result of the tax and benefit system). No such built in stabilizers exist in the EC, and with only a tiny budget (1.2% of Community GDP) there is very limited room for maneuver in achieving any redistribution. (p152) In fact, it is necessary for prosperous countries of the EC to support a structural fund for a cohesion program, so that poor members of the EC could receive some benefits from the integration of the EMU. At the same time, the market liberalization can minimize economic damages to the small countries in the EC. Charles R. Bean, the author of the article "Economic and Monetary Union in Europe," states, "The Structural Funds serve two main objectives; to promote development in the less developed regions; and to help areas affected by industrial decline and high unemployment." (Journal of Economic Perspectives, p50) However, there is one problem that remains in our discussion. That is a question of who is going to finance such a structural fund. The matter of the regional disparities, which exists in the EC, would remain unsolved as long as prosperous members of the EC refuse financing in order to help small EC members.

## Conclusion

As we have discussed earlier, the image of the EMU first appeared in the

late 1980's. This is mainly attributed to the rising economies in the European countries. At the same time, the success of the German economy and the EMS played an important role to stabilize members' economies during the 1980's. However, the German economy in 1990 triggered an economic turmoil in the EC. It was the German unification that caused a negative influence to other members' economies. Although the EMS seemed to have brought members together to establish a better economic environment, the increasing interest rate in Germany, after the unification, tore members apart. The EMU, which imposes three salient features; a single currency, a single market, and the fixed exchange regime, is believed to bring substantial benefits to the EC as a whole. However, the matter of how to establish the EMU seems to remain unsettled.

In order to establish the EMU and make it sustainable, members must create a strong economic convergence. The attainability of the EMU would heavily depend on whether the second stage, which began in January of 1994, could inspire this strong economic convergence. Stage two plays a vital role for the enhancement of the economic convergence and for the establishment of the EMU. It is argued that members need to satisfy the convergence criteria in order to create the strong economic convergence. It is necessary for them to do so. However, it is not sufficient to only achieve the goal of these criteria. This is because German unification caused the economic collision among members and made it more difficult to achieve the strong economic convergence. In addition, the convergence criteria turns out to encourage higher competition among

members and non-members of the EC. This higher competition, instead of bringing members together, seems to create a separation between them.

The issue of a higher unemployment rate among members and the regional disparities are another critical matters. As members move toward the goal of satisfying the convergence criteria, it seems inevitable to experience an increasing unemployment rate. This is because there are conflicting goals among monetary policies. At the same time, relatively small countries in the EC have been suffering from the regional disparities due to a lack of the structural flexibility. As Mawson pointed out earlier the regional disparities, which are caused by a lack of competitiveness, could limit potential gains to the EMU. In order to create the strong economic convergence and gain full potential benefits from the EMU, countries in the EC must have the economic cohesion. This economic cohesion can solve the matter of regional disparities and high unemployment, and is another vital objective in stage two. It is necessary for prosperous countries to support a structural fund for a cohesion program so that poor members of the EC could receive some benefits from the integration of the EMU. This structural fund can enhance development in the less developed regions and support areas affected by industrial decline and high unemployment.

After all, it is extremely vital to bring members of the EC together so that those people in the community can all contribute to create the airplane "EMU". Simultaneously, they can all prosper from the EMU. Hence, the EMU could bring benefits to everyone in the European Community. The economic cohesion, which

helps to create the strong convergence among people and members in the community, must be attained during the second stage in order to establish the EMU.

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