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The political economy of EMU: rethinking the effects of monetary integration on Europe

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The Political Economy of EMU
Rethinking the effects of monetary integration on Europe

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Abstract

How will EMU influence the European political economy? This paper argues that most of the likely alternatives are unsustainable for at least some of the EMU member-states. As a result, the Stability Pact imposed by the Kohl government and the Bundesbank is likely to be rejected by other member-states. Additionally, EMU will most likely also have an effect on the relations within the German political economy, by unsettling the basic compromise between employers and labour unions that was at the basis of German export successes in recent decades.

Zusammenfassung

Wie wird die europäische Währungsunion die europäische politische Ökonomie beeinflussen? Aus Sicht der vorliegenden Arbeit sind die meisten der sich abzeichnenden Alternativen zumindest für einige der potentiellen Mitgliedsstaaten der EWU politisch nicht tragbar. Die Wahrscheinlichkeit ist groß, daß solche Vereinbarungen, darunter auch der vom ehemaligen Finanzminister Waigel eingebrachte Stabilitätspakt, von den Mitgliedern der EWU abgelehnt wird. Andererseits wird eine neu ausgehandelte Währungsunion wahrscheinlich ernsthafte Folgen für das Kräftegleichgewicht innerhalb der deutschen politischen Ökonomie haben und könnte die grundsätzlichen Verständigungen von Arbeit und Kapital, die die Exporterfolge der deutschen Wirtschaft in den letzten Jahren ermöglichten, zu Fall bringen.

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1. Introduction

The decision to develop a common European currency - taken some years ago by the triumvirate of Kohl, Mitterrand and Delors - was a political one, and not without inspiration. Like other inspiring political decisions, however, - the parity of the Ost Mark with the DM was another - it was taken without having thought through at all fully the economic consequences. The last two years, preoccupied by the struggle of different countries to meet the Maastricht conditions, have focused less on the question of how EMU would in fact operate than on how to get there. But as 1999 draws closer, so the concrete implications for economic management of a functioning EMU become clearer. As they do, the ideas, indeed the fundamental economic goals, that led France, many pro-Europeans in the UK and important parts of Swedish opinion, to support EMU, appear in sharp contrast to the way the operation of EMU is seen in Germany and the Netherlands. This article will look at a number of alternative ways in which EMU will operate, each of which carries serious problems for some at least of the participants. In particular it will be suggested that the restrictive conditions under which the German government has presumed it will operate (the European Central Bank working in a similar way to the Bundesbank and the substantial limitations on deficit borrowing implied by the Stability pact) are unlikely to be politically sustainable once the EMU has been set up. If this is correct, what is pertinent to the longer-term operation of the EMU will result from its renegotiation at some future date: the last part of the article speculates on the possible outcomes.

The differences which are now coming to light between what might loosely be called the French and German views reflect four related sets of underlying difficulties: First, whatever is the exchange regime within an area, monetary and fiscal policy within that area have to be consistent: the debate on EMU has been concerned until recently solely with monetary and exchange rate policy; only now are major differences over fiscal policy emerging. Second, the operation of the European Central Bank (ECB) may turn out to mimic the Bundesbank, de facto targeting and being prepared to punish strategic actors in the German inflationary process, or it may operate in a more flexible manner on the lines of the American Federal Reserve Board: the *mere fact* of siting the ECB in Frankfurt seems as irrelevant in guaranteeing a Bundesbank-style ECB as the location of the United Nations in New York for adoption of pro-American policies. Third, - and explaining why the first two difficulties matter - the basic preferences and the basic macro-economic methodologies of potential participants with respect to inflation and unemployment differ: France - and the UK under a Labour government - both want to use macro-policy to lower unemployment at the expense of some inflation; and the economic policy-making establishments in both countries have long moved to what is called New Keynesianism - as has that of the US; Germany and the Netherlands share neither

preferences nor policies. Less generally appreciated, fourth, the possibility of nailing down national fiscal policies in the form of precise contractual treaty obligations is quite limited; short of *de facto* depriving national governments of their capacity to use fiscal policy for aggregate demand management - which is what the Stability Pact negotiated at the instigation of the previous German government is designed to do - the complexity of fiscal policy makes prior control unfeasible. A similar point can be made about specifying the future operation of the ECB. Moreover, we shall argue, even a binding treaty obligation would be in practical terms very difficult to enforce.

That there are difficulties should surprise no economic historian. There are virtually no examples of successful monetary union between sovereign national states - leave aside small states such as Luxembourg. Germany and France as the prime movers behind EMU share the desire to use the common currency to tie their two economies irrevocably together. The German side wishes to do this while preserving the credibility of the DM, seeing the Euro as the phoenix rising from its ashes. The French side by contrast wants the ashes to remain ashes; it wishes to have a major say in European macro-economic policy-making, both through regaining control of fiscal policy and by using the European Central bank to change what it sees as the deflationary stance of the Bundesbank. The French and German goals are contradictory. Financial markets value the DM because of the independence of the Bundesbank from political influence; the current fall in value of the DM in part reflects the change in market perceptions as market participants reassess how EMU will work.

There are several different fiscal and monetary arrangements under which EMU may initially operate. Each set of arrangements carries tensions for some or all of the members. Section 3 of the article will set out the four most likely initial fiscal and monetary arrangements, and will explain the tensions to which each will probably lead. This section is based on an overview of recent work in economic analysis of the problems of monetary union, provided in section 2. The tensions discussed in section 3 will probably lead to the political unsustainability of the initial fiscal and monetary arrangements. Section 4 examines the consequences of this unsustainability, and suggests that the original agreement will be renegotiated and a regime more favourable to the French and UK position - involving some degree of fiscal co-ordination between member governments - may result. The analysis in sections 3 and 4 also suggest that the bargaining environment of German industrial relations may change. Initially this will be to the advantage of major unions, yet over time it is likely to further an employer-led de- and reconstruction of the system.

2. EMU: managing cost and demand shocks

In the literature on common currency areas, there is widespread agreement on one clear benefit: the saving on transactions costs (notably the cost of exchange itself and the cost of insuring against relative movements in exchange rates, interest rates and inflation rates in the future). This positive effect is extremely strong for local economic units - no one would propose that a small town should have its own currency; but it is seen as relatively limited for the reasonably large economies which would be members of EMU. A second argument - which politicians often use in support of EMU - is that it will increase the equilibrium rate of growth in the EU and reduce that of unemployment. Interestingly, despite its prima facie plausibility, there is simply no basis for this in economic theory.

The most important questions surrounding EMU therefore deals with an entirely different issue which has been somewhat neglected up until now: how will a common currency affect so-called supply (i.e. cost) and/or demand shocks. National governments can deal with shocks through monetary and/or fiscal policy; or they can rely on market forces to return the economy to equilibrium. An important distinction in the common currency literature is between ”symmetric” and ”asymmetric” shocks. Symmetric shocks are defined as those which affect all the economies in the area in broadly the same way; they will be discussed below. Asymmetric shocks, by contrast, are uncorrelated or negatively correlated across individual economies.

Asymmetric shocks:

Under what circumstances can governments rely on market forces to restore equilibrium in a world of asymmetric shocks, or to minimise their occurrence? A *first* mechanism relies on rational expectations and perfect competition: With rational expectations and common knowledge among economic actors of the equilibrium of the economy, adjustment is instantaneous whether the shock is a cost or a demand shock; it takes the form of price changes. Without rational expectations, the more rapidly price changes can clear markets and equilibrium price expectations can form, (i.e. the more perfect is competition), the less important will cost or demand shocks be. Empirical evidence is certainly not dismissive of price effects in labour and product markets, but there is little support for rational expectations and/or perfect competition. A *second* mechanism, which rather clearly operates across different states in the US, is that of labour mobility: labour moves from states with higher to those with lower unemployment, thus mitigating asymmetric demand shocks. But the empirical evidence suggests that these movements are very weak across EU member states. A *third* mechanism, and empirically more important, concerns linkages between wage-setting systems in different economies. It has been suggested that some Northern European wage-setting systems are beginning to look towards German wage outcomes as in effect the exogenous inflation generator in

the EU. If such a trend develops asymmetric cost shocks --themselves often the result of developments in wage-setting systems-- would be diminished. The tentative conclusion is: (a) Asymmetric cost shocks may become less important as wage bargaining systems in different member states become more integrated - they then become part of symmetric cost shocks; (b) There is no obvious reason why asymmetric demand shocks should become less important; and it is clear that reliance on market forces to cope with asymmetric shocks would be ill-advised, since efficient market forces simply do not exist in the EU.

What then can be said of the capacity of monetary and fiscal policy to minimise the adverse effect of asymmetric shocks?

(1) In principle, if an economy adjusts slowly to cost shocks (such as, say, an increase in nominal wages which increases the real exchange rate and unemployment in the medium term above their equilibrium values), an equivalent depreciation of the currency can restore equilibrium quickly. Monetary policy is the instrument required to bring this about, (though it may not be sufficient). The main loss of capacity, therefore, in entering a common currency is the use of the exchange rate to diminish asymmetric cost shocks. This may as suggested above, decline as a problem as wage systems become more integrated.

(2) Demand shocks can be reversed by fiscal or monetary policy. Within EMU, interest rates will effectively be set across all member states, so that national governments would only have fiscal policy to rely on. Fiscal policy does not necessarily have to operate at national government level in order to diminish asymmetric demand shocks. In the US, the mechanism of ”fiscal federalism” is of more importance than the independent fiscal policies of individual states. Fiscal federalism refers to the fact that the flow of taxes to Washington and of benefits and other payments from Washington acts as an automatic stabiliser, thus reducing the need for fiscal independence of individual states. It is therefore of central importance to the debate on EMU that *no such fiscal federalist mechanism exists via Brussels* (or only to a trivial degree). This means that for the EMU to be consistent with minimising asymmetric demand shocks, individual member states *must* retain an independent counter-cyclical fiscal capacity. Note that, even if wage bargaining systems are aligned across EMU members, that would only reduce cost shocks but not demand shocks.

The Stability Pact does not permit member governments to run public deficits above 3% of GDP, unless GDP has fallen by 2% or more in the previous year. It is exceptionally rare for GDP to fall by 2%, while (at least over the past 15 years) public deficits normally rise above 3% in a recession. In other words, the Pact removes the capacity to pursue an independent counter-cyclical fiscal capacity: a member economy would therefore be exposing itself to great potential risks that a downturn in economic activity would be both magnified and maintained over a long period of time if the Pact were to operate.

The Stability Pact is by no means the only possible fiscal arrangement under EMU. A second possibility is that members have fiscal discretion. Note, however, that, *in the absence of EMU,* governments still cannot do what they want fiscally. This is because both foreign exchange and bond markets assess government policy when a country has its own currency. Markets may penalise governments severely with falling bond prices (rising interest rates) or a fall in the exchange rate. Thus governments who want the fiscal capacity to counter asymmetric demand shocks may well be better off within EMU than outside it if they have fiscal discretion in EMU - since there are no market reactions to fear; and worse off within EMU with the Stability Pact. We shall see in the next sub-section that fiscal discretion can lead to problems.

Symmetric shocks:

Symmetric shocks - which may be either demand shocks or cost shocks or both together - are those which affect many members of a potential common currency area in a similar way. These shocks can either be external or internal. In the case of EMU, external shocks could for instance be a sharp rise or fall in the value of the dollar against the Euro, or a significant increase or decrease in the growth rate of the rest of the world. Internal shocks are most likely to come from the German leading role in inflation-setting, or - because of Germany's central role in aggregate demand determination in Western Europe - from aggregate demand fluctuations in Germany. Leaving aside how fiscal and monetary policy might work in a common currency, the fact of the common currency per se is likely to amplify internal shocks, since national governments cannot use monetary policy to damp them. The cost and demand linkages within Western Europe, moreover, will also amplify the second order effects of external symmetric shocks.

Given that symmetric shocks are likely to be somewhat stronger in the presence than in the absence of EMU, the nature of fiscal and monetary policy under EMU becomes of critical importance.

(1) Monetary policy and symmetric shocks: By definition monetary policy within EMU cannot differentiate between conditions in member states (short of allowing interest subsidies etc., which are ruled out by EU rules). A key question is therefore how the ECB will respond to EMU-wide inflationary pressures and monetary movements and changes in the $/Euro rate. The EMI and the financial press have turned this into a debate about whether the ECB should adopt the supposed Bundesbank practice of monetary targeting or the Bank of England's supposed practice of inflation-targeting. In fact, neither the Bundesbank nor the Bank of England follow such simple policies: as the pronouncements and actions of the Bundesbank make plain it is highly aware of inflationary developments, particularly as concerns wage-setting; it pays also great attention to the public sector deficit and public spending. The real debate is

about whether the ECB will behave broadly like the Bundesbank or like the American Federal Reserve Board. The difference is this: The Bundesbank punishes inflationary behaviour and fiscal looseness severely, and adopts only weak stimulation in response to low inflation. The Fed is more even-handed, pushing up interest rates in response to inflationary signs, but bringing them down again as inflation subsides or as cyclical weaknesses appear.

This difference between the behaviour of the Bundesbank and the Federal Reserve Board is, in my view, ultimately a consequence of the differences between the wage-bargaining environment - indeed the income distribution system more generally - that the Bundesbank has to face compared to the Fed. The Bundesbank faces powerful unions in both the public and private sector, who have in turn their own constituents with well-entrenched power bases, as well as many other groups with entrenched positions and with claims on resources; substantial conflicts of interest among all these claimants on resources; Germany is not a consensus based society as it often seen from outside: it is a society which reaches tough compromises over resource distribution after often prolonged institutional bargaining processes between those with institutionally entrenched positions. It is of central importance for the maintenance of a stable inflation environment in an economy organised as Germany that there is a sufficiently powerful external constraint on this process: the bargainers must not be able to "fudge" the process. In the US, by contrast, resource allocation is by market forces. If inflation results, the Fed raises interest rates; and when inflation falls, interest rates are reduced. Because actors are not strategic, nothing is to be gained in the American environment by adopting the Bundesbank's "punishment phase" of drawing out the process of relaxation of interest rates.

The consequence of a Bundesbank-type ECB is not necessarily deflationary on balance. In the past, in Germany, the effect has probably been beneficial: First, key strategic actors, notably IG Metall, have most of the time responded with wage restraint to the threat strategy of the Bundesbank, so that inflation has remained low and unemployment has not been adversely affected. Second, expansionary exogenous shocks - the American boom of the early 1980s and the reunification boom - have generated expansion during periods of otherwise slow growth. Neither of these factors can be relied upon with the ECB. Inflation generated by non-strategic actors may trigger punishment strategies; and the likelihood of external reflationary shocks seems lower now than 15 years ago. Thus a Bundesbank-type ECB seems likely to lead to a generally deflationary environment, and not provide a monetary policy at the EMU level capable of dealing with symmetric systemic shocks.

But a contrary danger arises from a Fed-type ECB. For in that case strategic actors will be less constrained in their behaviour. Anyone who argues today that IG Metall is constrained by fear of the Bundesbank's reaction to wage increases must necessarily accept that a less punishing ECB will lead IG Metall or other strategic

actors to behave in a less constrained way. Of course, IG Metall will always be constrained by fear of loss of international competitiveness within EMU if it pushes unit labour costs above those of other members. The point here is just that if German strategic actors are additionally constrained by fear of the Bundesbank, they will be to that degree less constrained with a Fed-type ECB.

(2) Fiscal policy: The European budget is negligible at around 1% of EU GDP, so that there is no real possibility of an independent budget using community-wide taxes and expenditures. Any counter-cyclical fiscal policy available to deal with symmetric demand shocks would have to come from co-ordinated or uncoordinated national fiscal policy responses. If the German interpretation of the Stability Pact comes into operation with EMU, national counter-cyclical fiscal policy will be virtually unavailable. System-wide deflationary demand shocks would be likely to lead to long periods of low activity. Most potential members of EMU are currently struggling to keep public sector deficits down to 3%; if they join EMU with deficits of around that level, a system-wide deflationary shock would push their public deficits automatically above 3% as unemployment benefit payments rose and tax revenues fell; thus they would have to engage in further *cutting back* of government expenditures - unless the system-wide shock was so severe as to lead to the rare event of national GDP actually falling --the necessary condition, under the Stability Pact, for governments to run deficits above 3%. Even a monetary policy which was highly sensitive counter-cyclically would likely only moderate this tendency. The concern on the part of the French government is therefore understandable.

Why then has the German government desired such a rigorous mechanism? There is a very good reason. In the absence of a Stability Pact mechanism, national governments within EMU would be significantly less constrained in running fiscal deficits than they would be outside EMU. The reasons for this are straightforward. Outside EMU fiscal policy is judged by the financial and foreign exchange markets. If these markets believe a government is resorting to deficit financing, and the government in question (or its central bank) does not have a reputation for strict anti-inflation policies, they will infer that inflation will increase, which brings with it the likelihood of higher interest rates and/or depreciation. Since something like rational expectations operates in these markets, both bond prices and the currency will be marked down simultaneously. Governments are therefore nervous about using fiscal policy for expansionary purposes. It is for this reason that Keynesian policies are less effective nowadays; leaving aside market reactions, Keynesian measures retain substantial efficacy in medium and large economies at least in the short and medium run.

Once inside EMU, however, financial markets have much less bite. Since national currencies will have given way to the Euro, the reaction of foreign exchange markets is no longer of relevance. And since individual governments no longer have control over monetary policy interest rates are basically set across EMU: given the lack of exchange rate risk, and perfect financial markets, arbitrage would eliminate

national differences in rates. (There are two qualifications which can in principle reintroduce a market constraint. The first, to which we will return later as it is potentially a serious issue, is the possibility that a country might leave the EMU. The second is a standard qualification: above a certain level of debt in relation to taxable resources, markets begin to fear that a borrower might default. Studies done on US states suggest that states are in effect rationed out of the market when their debt to state-GDP exceeds a level of about 10%. This is because, at state level, both businesses and individuals and hence the tax base are responsive to relative tax burdens. In the case of potential EMU members, however, the likelihood of market rationing because of default risk is a long way off at any rate in the foreseeable future.) In addition, in an area in which exchange rates cannot change, the effect of domestic expansion on inflation is more limited than under floating rates.

The consequence, at least in principle, is a Prisoner's Dilemma game. All the member states may be concerned about a low rate of inflation. Assume the common monetary policy of EMU produces a low region-wide inflation rate. If in addition, perhaps because of an overly high level of unemployment, members are also interested in lower unemployment, then the temptation for members to use their fiscal freedom to reduce unemployment or more generally to raise government spending or reduce taxation will be substantial for some or all member states. But it may be that the consequence of unrestricted fiscal expansion will be an increase in the region-wide inflation rate to unacceptable levels. This, in essence, is the case for a Stability Pact, embodying a real and perhaps treaty-based commitment to fiscal retrenchment.

However, an opposite Prisoner's Dilemma --in which individual countries cut back too much on public expenditure-- arises if a tough Stability Pact is in place. This is explained in the next section. And it is this Prisoner's Dilemma which, I will suggest, may lead to the political unsustainability of the arrangements which are likely to accompany EMU.

(3) Outside EMU: Despite these disadvantages, potential members still see membership (at least under the right conditions) as advantageous. This is because outside EMU individual governments are exposed to the judgement of financial and exchange markets. But at the end of the day the advantage of being inside or outside will depend on the fiscal and monetary arrangements and the extent to which they are explicitly or informally renegotiable after EMU has been set up.

3. EMU fiscal and monetary arrangements: political sustainability and implications for industrial relations in Germany

In this section, we use the previous discussion on the economics of EMU to discuss how EMU may work in practice and how the environment of the collective bargaining system in Germany will be affected. Doing so will allow to bring political considerations back into the centre of the argument.

What follows assumes that long-term equilibrium issues can be put on one side, on the grounds since it almost impossible to give correct assessments of their development and the critical economic question then become how shocks are dealt with under different arrangements governing fiscal and monetary policy. It is argued here that different arrangements have very different implications for the environment of German industrial relations. Moreover, not all the different fiscal and monetary arrangements are politically sustainable. The consequences for the organisation of EMU and for German industrial relations of this political unsustainability will be discussed in the concluding section.

Although in practice there are many ways in which both monetary and fiscal policy might work under EMU, two broad divisions can be made in each case. These are shown in Table 1. The horizontal axis shows two styles of behaviour of the ECB. In the right hand column it mimics the Bundesbank in both targeting wage-setting institutions and being unresponsive to deflationary symmetric shocks: in other words, the ECB only reduces interest rates slowly, even when inflation is under control. In the left hand column the ECB responds to low inflation with interest reductions and to high inflation with interest increases. The vertical axis distinguishes fiscal arrangements. The upper row is the case of the Stability Pact in which national governments lose fiscal autonomy de facto; the lower row is the case of national governments having no restrictions on their ability to run public sector deficits.

We can now look at each box (I to IV) in turn to see the implications for the German industrial relations system:

Case I: Bundesbank-style ECB; Stability Pact

These monetary/fiscal arrangements reproduce the current German system. That is to say, the ECB will implicitly target key actors in the German bargaining system, and be prepared to punish inflationary behaviour severely. Acting in the same direction, a strict interpretation of the Stability Pact will restrict government borrowing. This scenario corresponds to the conditions under which the Bundesbank and the Ministry of Finance are prepared to support EMU.

Table 1: Alternative monetary and fiscal arrangements

ECB style	ECB functions like Bundesbank	ECB functions like Fed
Fiscal Policy Stability Pact: no fiscal discretion	I. *Maintain and aggravate symmetric deflationary shocks (as well as asymmetric); deflationary Prisoners' Dilemma.*	II. *Monetary flexibility to counter deflationary fiscal policy; low interest rates and tight budgets; possible deflationary Prisoners' Dilemma.*
Fiscal discretion for each member	III. *Monetary tightness to counter expansionary fiscal policies; high interest rates, high deficits; inflationary Prisoners' dilemma; asymmetric shocks less important.*	IV. *Monetary flexibility; fiscal policy unclear; asymmetric demand and symmetric shocks soluble; some danger of expansion; possible inflationary Prisoners' Dilemma.*

This pattern of monetary/fiscal arrangements implies no change in the industrial relations environment. Export sector unions will remain constrained by the ECB's mimicking of the Bundesbank; public sector unions will remain constrained by a continuation of the need to keep the public sector deficit under 3%. In both sectors these pressures will reflect corresponding pressures on employers. Exporting companies will live under the fear of high exchange rates; and public sector employers will be under tight expenditure constraints.

This scenario is likely to lead to a period of perhaps prolonged recession in Europe. When EMU is set up, most members will have barely attained a public sector deficit of 3%. This means that --if the literal interpretation of the Stability Pact (as it was proposed by former Finance minister Waigel and the Bundesbank) is maintained-- *any* deflationary shock, symmetric or asymmetric, will push deficits of one or members above 3% (as unemployment benefits and other social security expenditures mount and as tax receipts fall). This exposes member governments to great danger: for an initial deflationary shock will require governments to destabilise the situation further by cutting-back public expenditures or raising taxation; and such an anti-stabilising macro management response amplifies the initial deflationary shock, leading to a vicious circle of declining activity. Hence individually-rational governments will respond ex-ante by trying to reduce their public deficits to less than 3%, in order to be able to engage in stabilising behaviour in the event of exogenous shocks. But, while this is individually rational, it is not collectively rational: for the sum of the individual retrenchments is a symmetric deflationary shock through the

EMU system. This the deflationary Prisoners' Dilemma: if others do not retrench it pays an individual member to retrench; if others do retrench, individual members have to retrench; thus all retrench, when ideally all should not have retrenched. (It is thus exactly opposite in effect to the inflationary Prisoners' Dilemma which worries the Bundesbank.)

It is of course possible that this scenario --comfortable to those who value low inflation almost independently of unemployment-- may be reversed by positive demand shocks. But it is not easy to see where they will come from. The idea that businesses will respond with an investment-led boom as a result of the confidence factor induced by EMU is wishful thinking; in so far as there is agreed econometric evidence, it is that investment responds to growth in demand when profitability is suitably high. Nor is there any reason to believe that recovery will come from abroad: the EMU problem is that Germany's main export markets are in Western Europe.

Political sustainability: This case leaves France and a Labour government in the UK in a highly exposed situation. Poor economic performance, and persistent attempts by government to cut back on government expenditure, will be laid at the door of EMU, and its domination by Germany. What the French government (nowadays) sees as the central gain from the sacrifices needed to join EMU - namely regaining some measure of control over macro-economic management - will not materialise in this case. The real likelihood exists that an anti-EMU majority will form politically on the centre-right (Seguin in France; the Conservatives in the UK); and it will divide the centre-left in both countries. It is not difficult to imagine similar movements in Italy. As developed in the next section, political sustainability here is low.

Case II: Fed-style ECB; Stability Pact

Case I assumes a Bundesbank-style ECB. But the requirement of the new ECB, that it will concern itself with European-wide inflation, makes it likely that it will not adopt an approach of targeting strategic actors in the German system and "punishing" inflationary behaviour severely by responding only slowly as inflation falls. The Bundesbank hope that it will provide the model for the ECB seems founded on two questionable assumptions: First, the presence of the ECB in Frankfurt; but Frankfurt seems as irrelevant to the ECB's operations as New York to the UN's. Second, the culture of central bankers. Doubtless the five members of the executive committee of the ECB will be concerned to keep European inflation low. But there is no single central bank tradition; the Bundesbank tradition is a rather extreme one. Moreover governments appoint central bank governors, and in some countries - not Germany - can influence the governor. The idea that the French government will have no influence on the position of the Governor of the Bank of France sitting on the Executive Committee of the ECB is politically naive to anyone with knowledge of how

the elite French state network operates. In any case, if there are strong populist anti-EMU pressures within France, Italy and the UK (if all three are members of EMU in a few years time) because of a deflationary situation in Europe, and future membership of EMU appears under threat politically, it is difficult not to believe that their ECB representatives will respond.

If the ECB is concerned with European rather than German inflation, then the German collective bargaining environment will change. Export sector unions will no longer have such a strong concern about the reaction of a Bundesbank-type central bank. IG Metall's bargaining power (at least in the short run) will be increased. However, the operation of the Stability Pact will put pressure on governments to adopt restrictive fiscal policies, so this case will be asymmetric between public sector and export sector unions. The public sector unions will operate in a more restricted environment with reduced bargaining power. How much the environment will change in the public sector will depend on the extent to which governments choose or are forced into retrenchment.

The critical question in this case is whether or not member governments will find themselves engaged in the deflationary Prisoner's Dilemma. If the ECB operates a monetary policy sufficiently loose to increase the growth rate for a period of time, allowing unemployment to fall, then public deficits will be automatically reduced. In that case, governments would have no need to adopt restrictive policies, so that the Prisoner's Dilemma problem of overly restrictive fiscal policies would not arise. There is, however, some scepticism among economists about how effective monetary policy can be in Europe, given already low interest rates and depressed business expectations; this scepticism is reinforced by recent Japanese experience in which exceptionally low interest rates have been unsuccessful in stimulating growth. If a Fed-style ECB cannot stimulate enough growth to reduce deficits automatically, then member governments will have an incentive or be forced to adopt restrictive fiscal policies; and the result will be a deflationary vicious circle, as in case I.

Political sustainability: If a deflationary vicious circle develops, the same argument as in Box I applies: namely, these monetary/fiscal arrangements are unlikely to be politically sustainable. We return to what may happen in the next section.

Case III: Bundesbank-type ECB; individual fiscal discretion

It seems unlikely that this box will materialise, because a Bundesbank-type ECB is unlikely and because it is difficult to imagine that the German government would agree to fiscal discretion. If it does, the industrial relations environment in Germany will not change greatly as far as the export sector unions are concerned, since they

will still be bargaining under the shadow of the ECB-Bundesbank, with one potential qualification. The qualification relates to the fact that the federal government will in principle have more fiscal freedom in that it will not have to be concerned about the reactions of either foreign exchange or financial markets to its behaviour. As a result, the government may be able to engage in bargaining with IG Metall over public expenditures, for instance in relation to employment creation or further training. Public sector unions will benefit from more freedom in this box.

This box exemplifies the fears of German policy-makers, not so much from the changed industrial relations environment (which has not been much discussed) as from the likely behaviour of member countries in a position of fiscal freedom with monetary contraction. For it is this case which most lends itself to the prospect of expansionary fiscal free-riding. The argument is this. First of all, the monetary environment will not (automatically) generate expansion. Secondly, individual countries will be free to borrow in order to expand, in the sense that they will not have to face either foreign exchange or financial market reactions. Hence for countries of any size such as the UK or France, where demand leakage is relatively small, the temptation to reflate will be strong. It is sometimes suggested that this will not happen because countries will be aware that the ECB will respond to expansion with restrictive policies. But this suggestion is incorrect: on the contrary, for individual countries the incentive to expand increases with the more deflationary character of monetary policy.

Political sustainability: This box is likely to lead countries to try and renegotiate the rules. This is because, at least after two or three years, there are likely to be high interest rates and rising inflation. In this case the pressure to renegotiate will come from central bankers and finance ministers rather than from electoral forces. Electorates may dislike the high interest rates and increased inflation, but they will not be likely to suffer from attempts to cut social security benefits or rising unemployment. On the other hand, central bankers and finance ministers from all member countries have an incentive in trying to arrive at a better solution. We return to this in the next section.

Case IV: Fed-type ECB and individual fiscal discretion

As with Case III, the likelihood of this case is low; since it is difficult to see the German government accepting fiscal discretion for individual member states. If it nonetheless comes about, it will substantially change the industrial relations environment in Germany. Export sector unions will no longer bargain under the shadow of the Bundesbank and public sector unions will confront employers who can borrow without fear of market reactions. How long such a situation would last for as

far as the private sector unions were concerned before employers developed new strategies to deal with it is a question for the next section.

It is unclear how macro-economic performance would develop. Individual fiscal discretion would limit the impact of persistent asymmetric demand shocks. But there is the danger - similar to case III - of the Prisoner's Dilemma that each member would overuse borrowing to finance expansion; the problem is that (i) the aggregate expansion would be inflationary and would lead to reaction by the ECB in the form of higher interest rates and perhaps a higher Euro/$ exchange rate; and that (ii) this would *increase* the incentive for individual governments to use fiscal policy for expansionary purposes. Thus, as in case III, both interest rates and inflation may end up higher; but the fact that governments retained their borrowing capacity is likely to mean that unemployment would not rise and might fall (though this would depend on the preferences of individual governments).

Political sustainability: This box is not vulnerable to electoral unsustainability. It is more likely, if inflation and interest rates both rise, to lead to attempts by finance ministers and ECB board members to develop patterns of co-ordination.

4. The future shape and reshaping of EMU

The most likely basis on which EMU will be established corresponds to case II in the last section; it is also possible it will be established on the lines of case I. The last section argued that the orthodox interpretation of the Stability Pact is most likely not sustainable. This is because it would be likely to lead to increased unemployment and further pressure on governments to cut back public expenditure. In particular electoral coalitions would build up in France and in the UK (if it was a member), as well as probably Italy, against what would be portrayed as a German-dominated arrangement which imposed restrictive conditions throughout the currency union. The wafer-thin majority for Maastricht in France together with the shift to the Front National; the delicate balance between the centre-left in Italy and an increasingly populist right led by Berlusconi; the Conservative party in the UK almost certainly moving into opposition to EMU: these suggest strongly that governments (even if favourable to EMU) will find continued support for an orthodox interpretation of the Stability Pact impossible to maintain short of electoral suicide. Moreover in all these countries, governments are methodologically New Keynesian, in particular at a European level.

What sort of outcome could such a crisis lead to? A likely outcome is the development of some sort of co-ordinated fiscal policy within the currency area. The reason for this can be seen in terms of bargaining theory. The preference ordering of the UK, French and Italian governments would probably be: (i) co-ordinated fiscal

policy, with some possibility for individual discretion to deal asymmetric demand shocks; (ii) individual fiscal discretion; (iii) leaving the EMU; (iv) an orthodox interpretation of the Stability Pact. For these governments leaving the EMU would be a choice of last resort: while countries can manage in a world of floating exchange rates, the protection from markets which EMU affords is preferable so long as there is the possibility of using fiscal policy within EMU. If the Germans were to insist on the de facto elimination of the borrowing instrument, then domestic policy concerns would probably force the UK, France and Italy to leave EMU. Thus, critically, so long as the German government wants EMU to exist, it would have to yield to demands for some measure of fiscal freedom. As between allowing members individual fiscal freedom and a co-ordinated fiscal policy, the German government would prefer a co-ordinated fiscal policy since it offers some protection from the expansionary fiscal Prisoner's Dilemma.

How much confidence can be placed on the German government wanting to maintain the continuation of EMU under such conditions? It is obviously possible in a crisis of this sort that political forces within Germany would push for the restoration of the D-Mark and the reestablishment of the powers of the Bundesbank. It is unclear how the constitutional court in Karlsruhe would react to a change from a Stability Pact to a co-ordinated fiscal policy. What is clear, however, is that the Bundesbank is in a much weaker position after the setting up of EMU than it is at the moment. Up until 1 January 1999, the Bundesbank had the possibility of disrupting markets - as it did in 1992 - precisely because it was still in charge of interest rate determination; moreover it was able to tacitly threaten the government that it will behave non-co-operatively in many ways in the future. Yet once EMU was set up, the Bundesbank lost its powers to do anything except complain.

It might be objected that members of EMU will be under tightly-drawn treaty obligations; since the treaty does not permit withdrawal from EMU, withdrawal from EMU would be tantamount to withdrawal from the EU. And without the ability to threaten withdrawal from EMU, the bargaining power of members will be limited. Hence, whatever the political problems or desires of EMU member governments, there would be little they could do about it. In my view this objection is wrong. Domestic pressures might make withdrawal from EMU likely in the absence of negotiated change in its operation. It would not be a credible threat on (say) Germany's part to require France to leave the EU; a bargaining situation would develop over redrawing the terms of EMU.

A renegotiation of EMU would be likely to lead to some system of fiscal policy co-ordinated at European level. This would satisfy France, the UK and Italy, as well as Sweden. It would be a less bad alternative for Germany and the Netherlands than individual fiscal discretion. And all member governments would see it as preferable to leaving EMU and facing exposure to international financial markets.

How would this novel fifth situation affect German industrial relations? If the ECB behaved in a Fed-type way and if there was some system of fiscal policy co-ordination, major German unions in both public and private sectors would be in a considerably stronger bargaining situation than they are today. Yet, for IG Metall and IG Chemie, this situation could only continue if they in effect *internalised* the restraint which the Bundesbank currently imposes on them.

IG Metall, in particular, would be in a very difficult strategic situation. On the one hand, there would be no Bundesbank; the German government would be less restricted fiscally than it had been, and hence open to bargaining over the social security system, employment creation and other social policies. European governments would look to IG Metall as wage leader in Germany, implicitly therefore --given the likely convergence of wage systems-- influencing settlements in other countries as well. Its members, finally, would expect to gain from this situation of increased power. On the other, the German manufacturing sector has had comparatively low profitability in the 1990s --at a time when profitability should be increasing in consequence of the need for more R&D expenditure, greater investment in training and retraining within companies, and the fact that companies are facing a riskier and more uncertain environment. The danger for IG Metall is that use of its bargaining power will lead business to try and restructure the bargaining environment.

It would take us too far to speculate on how business might want to do this, but some signs how this could be done are already apparent. As the power of skilled workers has grown in the German export sector, so has their influence in the works councils --up to the point, as is the case today, where works councils increasingly represent the interests of their skilled members over the lower-skilled workers. Since the industry unions still see the semi-skilled workers as their basis, the works councils (and in their wake the local unions, the official local bargaining agents) and the industry unions have slowly started to drift apart over the last ten years or so. Any restructuring attempt by business is likely to start from this latent tension: in order to respond to the pressure imposed by the IG Metall strategies, companies will try to use the leeway between the works councils and the unions to push the latter --at least for a while, as in Sweden-- out of the bargaining system and concentrate on local wage settlements. When the situation has stabilised sufficiently according to business, it might bring the industry unions back in, and revert to the old situation, but with the tables turned this time: wage co-ordination is in their interest as well, after all --but it is hard to see this with the institutional brakes provided by the Bundesbank gone.

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