

By Martin Feldstein

ALTHOUGH THE European Monetary Union will have only a very small effect on the United States economy, it will have major long-term consequences for Europe and for its relations with the United States. Indeed, the combination of European Monetary Union and the end of the cold war creates a significant new challenge for American foreign policy.

Supporters of the euro, the single currency that will be shared by 11 countries, claim many advantages, in addition to the elimination of currency fluctuations. The economic impact, however, is actually likely to be more negative than positive — particularly when it comes to unemployment and inflation.

But politics, not economics, is the real reason the European governments have pursued monetary union. The euro will advance Europe's evolution toward a political union, a United States of Europe.

The euro will immediately shift power from the individual countries to a new single European Central Bank, increasing pressure for continental coordination of tax rules and other economic policies. All of this

The euro may stir up serious conflicts.

will strengthen political institutions like the European Parliament at the expense of the individual member governments. These developments are specifically anticipated in the Maastricht Treaty, which created the European Monetary Union. The treaty calls for an eventual political union that will have responsibility for foreign and defense policies as well as for economic and social policies.

Replacing German marks, French francs and other national currencies with euros will also have a big psychological effect. There is no significant country in the world that does not have its own currency. When Europeans carry euros in their pockets, they are bound to feel that power has shifted from their national capitals to the political institutions in Brussels and Strasbourg.

This shift to a single currency will probably cause higher cyclical unemployment in the future. With the euro, national interest rates and exchange rates will no longer automatically decline to cushion the effects of national or regional declines in demand. Currently, when a country experiences a fall in exports or a decrease in construction or business investment, market forces automatically force its interest rates and exchange rate to decline, which in turn increases demand for its products. That limits the resulting increase in unemployment. And a nation's central bank can take steps to reduce interest rates even further.

With the euro, these adjustments

of national interest and exchange rates can no longer happen. And Europeans, unlike Americans, cannot move to where the jobs are, because of language barriers. Europe's welfare benefits and strong



unions make wages less flexible than those of the United States. And Europe lacks America's national tax system, in which losses in revenue during recessions automatically cushion regional economic downturns.

The long-term outlook for inflation depends on the policies that will be adopted by the new European Central Bank. The current system — in which national governments are virtually forced to follow the lead of the German central bank — has produced very low inflation rates throughout Europe, even though most countries do not share Germany's strong aversion to inflation.

In the new monetary union, Germany will no longer set the standard for Europe. At the European Central Bank, each country will have an equal vote. Higher inflation in the future looks like a good but unfortunate bet.

It is possible, of course, that the monetary union will eventually be abandoned because of its adverse effects on unemployment and inflation. What will happen if unemployment rises rapidly in Spain and the country's public and politicians are frustrated by their inability to adopt an easier monetary policy or to permit a currency decline? The European central bank may listen sympathetically, but it must set monetary policy for the continent as a whole and not for any particular country. At what point would the Spaniards declare that they want out?

The Maastricht Treaty provides no legal way to secede from the monetary union, and many European politicians believe that any country that tries to leave will be punished by being forced out of the free-trade agreement of the European union. In short, whether a country leaves the union or stays, there would be conflict.

High unemployment and monetary policy are not the only likely sources of conflict. On a wide range of other domestic and foreign policy issues, many of the countries using the euro are likely to conclude that European policies are being made by a German-French collusion from which others are effectively excluded. They may come to regret that they sacrificed their national sovereignty without getting in exchange any meaningful say in the decisions that affect their citizens' lives.

Since the end of World War II, the proponents of European political union have dreamed that a federal state would eliminate the conflicts that produced past wars. Unfortunately, the euro and the political union that could follow are more likely to lead to new and magnified conflicts about policy and power sharing. Such conflicts will probably occur not only among the nations in the monetary union but also with the European countries that remain outside, as the union countries try to set rules for all of Europe.

The end of the cold war eliminated what had been the primary reason for European countries to cooperate

with one another and with the United States. The monetary union is likely to create or worsen political conflicts and economic instability in Europe. Moreover, some Europeans will respond to the conflicts by seeking a common enemy as a source of political solidarity.

Since we already hear some Europeans saying that a political union is needed as a counterweight to the global influence of the United States, it's clearly time for Americans to take the euro seriously.

Washington must develop a strategy to reduce the risk of conflict in Europe and to sustain the existing positive relationships between the United States and the individual nations of Europe. □

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Martin Feldstein, an economics professor at Harvard, is president of the National Bureau of Economic Research. He was chairman of the President's Council of Economic Advisers from 1982 to 1984.