1. Introduction

Economic and Monetary Union constitutes a profound change in the economic, social and political spheres of Europe. Inevitably, it has been the subject of intense debate. The single currency, launched in January 1999, has served to concentrate many diverse aspects of the debate around one question: is the euro in the interests of Europe? This book presents a sustained argument that the single currency as *currently implemented* does not promise to deliver enduring economic growth in the European Union. We argue that the economic impact of the euro and its accompanying institutions, the European Central Bank and the Eurosystem, is likely to be deflationary and destabilising; that the political impact is profoundly undemocratic; and that the social consequences are likely to be deleterious. We do not, however, argue that the project of a single European currency is inherently flawed. On the contrary, we propose a Keynesian alternative to the economic policies and institutions that currently surround the euro. In this way, we argue that the broad question is not whether to be ‘for’ or ‘against’ the euro *per se*, as if there were no alternative to the monetarist structures underpinning the euro outside of its abolition. The Keynesian alternative we propose can provide many of the benefits of the single currency as recognised by its proponents, whilst avoiding many of the costs identified by its detractors.

Chapter 2 sets the inception of the euro in the context of the postwar history of the attempts to forge economic and monetary union in Europe. The chapter charts the path towards economic union within Europe in terms of the sporadic attempts to forge monetary integration and ultimately monetary union. When, in the context of deregulated capital markets and the Single European Market, the institutional structure that currently underpins the euro was laid down, neoliberal monetarist ideas were very influential on policy. At the same time the (conservative) Bundesbank was considered a model for the European Central Bank. Thus we stress the historical reasons for the fact that the institutional structure accompanying the euro conforms to what we have elsewhere termed the ‘new monetarism’ (Arestis and Sawyer, 1998b).

Chapter 3 first examines the conditions surrounding the launch of the euro, noting that the fiscal criteria stipulated by the Maastricht Treaty were not, on any strict interpretation, met by many of the countries that entered the single currency. Furthermore, we note that unemployment rates across the eurozone

were both high and divergent and that rates of economic growth across the eurozone diverged. The Optimum Currency Area literature highlights the potential problems such asymmetries cause, yet unemployment and growth rate targets were not a part of the Maastricht criteria. In the context of these difficulties, the chapter considers the fiscal arrangements surrounding the euro in terms of its accompanying institutional structure (the ECB and the Eurosystem) and the fiscal conditions laid down by the Stability and Growth Pact (the 3 per cent limit on national government deficits). We note that the 3 per cent deficit limit effectively curtails discretionary fiscal policy on the part of national governments and, judging by past evidence, is likely to disrupt the operation of automatic stabilisers. Nor can there be any fiscal policy at the EU-wide level, given the relatively small EU budget and the requirement for EU budget balance. Finally, there can be little coordination of monetary and fiscal policy, given the separation of the monetary authorities (ECB and Eurosystem) from the fiscal authorities (national governments). Hence, to the extent that fiscal policy is possible at all, it may well pull in a different direction to monetary policy. Related to the above points, EU-wide regional transfers are of a negligible size relative to the large disparities in unemployment and GDP growth rates noted above. Our Keynesian alternative proposal broadly aims to combat high unemployment and regional asymmetries through an institutional framework of EU-wide fiscal policy; coordination of monetary and fiscal policy at an EU-wide level, and of regional transfers at this level. We propose an alternative to the Stability and Growth Pact along these lines and a revamped European Investment Bank able to promote investment in low-growth regions.

Chapter 4 turns from fiscal issues to the consideration of the monetary and financial arrangements accompanying the euro. Within the Eurosystem, the independent European Central Bank is responsible for setting the eurozone-wide interest rate, whereas the national central banks have regulatory responsibility. The ECB's first responsibility is price stability, which has been defined as Eurozone inflation of no more than 2 per cent over the medium term. We argue that healthy respective rates of GDP growth and of unemployment should be high on the list of policy objectives; the inherent deflationary dangers of the prioritisation of price stability are especially worrying given the aforementioned problems regarding European unemployment and growth rates. In the face of asymmetries of economic performance, and the lack of institutions to cope with them, we argue that a single interest rate cannot be appropriate; it may serve to exacerbate regional differences as policy is suited to an average inappropriate to 'outlier' countries. Furthermore, there are very diverse monetary and financial institutions across Europe, which entail that the influence of interest rate movements will be different across countries, increasing the difficulty of achieving appropriate EU-wide monetary policy. Turning to regulatory matters we note that the lender of last resort function is not built into

the remit of the ECB and Eurosystem. Problems are particularly acute if coordinated action were to be required in the face of financial crises across the zones of control of the national central banks. We argue also that the separation of monetary from fiscal policy may raise problems regarding the monetisation of deficits, which must occur in the normal course of economic growth. A significant worry relates to the destabilising effects of capital movements now unfettered by national currency considerations within the eurozone. Long-term bank-based investment finance is likely to be increasingly replaced by the short-term demands of mobile capital. Our alternative proposals are designed to remedy the weaknesses identified above. The ECB should have full employment and a high rate of economic growth as objectives equal in importance to price stability. It should be responsible for regulation of the financial system and must be required to provide the lender of last resort function. In order to be able to perform these functions, and in view of the highly undemocratic nature of the ECB at present, we propose that the European parliament, and indeed national governments, should exert democratic control over the ECB.

Chapter 5 contributes to one aspect of the empirical work mentioned in Chapter 4. The chapter employs econometric techniques in order to estimate demand for money functions of the eleven countries comprising the eurozone. The results of the estimation lend support to the view that there are significant asymmetries of interest rate elasticity in the demand for money across the eurozone. For Austria, the Netherlands, Finland, Ireland and Luxembourg we find that interest rates do not have any significant effect upon the demand for money at all. For the other countries we find significant but widely differing effects. Furthermore the estimations support the view that the short-run impact of both interest rate and income changes on the demand for money varies widely across the eurozone countries. In terms of the ECB's own theoretical framework (which would appear to incorporate the idea that the stock of money can be controlled and is exogenous to the private sector), whereby monetary targeting is one route towards controlling inflation, these results raise serious problems, for they imply that monetary targeting at an EU-wide level will have very diverse effects across countries such that it may not be possible to reach the chosen target. Given what we would consider to be a more realistic framework (that money is endogenous credit money created within the private sector by the banking system) the result raises serious problems of a different nature, in that it indicates, and estimates quantitatively, one particular channel of monetary policy influence that is highly asymmetric across the eurozone and which is therefore likely to have a destabilising macroeconomic impact upon the area as a whole.

Chapter 6 examines the impact of the euro since its inception in the context of the search for an explanation for its declining external value. We show how the most recent evidence concerning the macroeconomic impact of the euro

lends support to the arguments of the previous chapters and, in so doing, we are able to provide an empirically robust explanation for the fall in value of the euro. In the literature, the steadily weakening euro has often been attributed to the peculiar strength of the US economy, rather than to any inherent difficulties of the imposition of the single currency in Europe. If the eurozone itself is focused upon then this is only to stress the ‘inflexibility’ of European markets (particularly the labour market). We find the widespread notion that labour market inflexibility is at the root of so-called ‘eurosclerosis’ to be an unconvincing argument. Instead we argue that it is not US strength on its own, but this strength in combination with a structural weakness of the eurozone that is *endogenous to the imposition of the euro*, that has caused an outflow of direct investment capital, leading to the exchange rate decline. By ‘structural weakness’ we do not refer to inflexible labour markets but to the situation analysed in previous chapters: the imposition of the single currency, without the appropriate institutions and policy framework, onto a set of economies which are in a divergent state, with low growth and high unemployment. The most recent evidence shows that the divergent state of the eurozone has persisted, and may even have worsened, since this imposition. Thus the argument that the institutional structures underpinning the euro must be replaced by our proposed alternative is well supported by the most recent evidence on the impact of the euro, and goes some way to explaining the instability of the euro exchange rate.

This book is the result of a project on the EMU and the euro funded by the Jerome Levy Economics Institute (Bard College, New York). We are grateful to the Institute and in particular to its Executive President Dimitri Pepedimitriou, for their financial support and encouragement. This was a two year project, 1998–2000. Over this period a number of people contributed to its genesis and development. We are grateful to them. Kevin McCauley was first to join the project and worked with us for a year. He produced the first full draft of Chapter 2, he contributed substantially to Chapter 3, and he put together the data set used in Chapter 5. Andrew Brown succeeded Kevin McCauley in October 1999. In the meantime Iris Biefang-Frisancho Mariscal began work on Chapter 5, to which she made a substantial, indeed a major, contribution along with Andrew Brown. Iris also participated in the preparation of Chapter 6. Andrew Brown made a substantial and major contribution to Chapter 6. In addition, Andrew took responsibility for revising all six chapters and for rearranging a great deal of the material for the book.

We wish to thank Edward Elgar and Dymphna Evans for their encouragement and close collaboration on this and, of course, on many other projects. As always we are grateful to both of them and their staff.