C.D. Howe Institute
Institut C.D. Howe

Communiqué

Embargo: For release *Thursday*, June 25, 1998

New “euro” could lead to calls for international exchange rate coordination, deals on labor and social policy, says C.D. Howe Institute study

The European Economic and Monetary Union (EMU) and the introduction of a single currency — the euro — in 1999 might lead Europe to try to limit the costs of its labor market difficulties through international coordination of exchange rate policy and multilateral agreements on labor and social policy, says a C.D. Howe Institute Commentary released today.

The study, *Birth of a New Currency: The Policy Outlook after Monetary Union in Europe*, was written by David Laidler, an economics professor at the University of Western Ontario and an Adjunct Scholar of the C.D. Howe Institute, and Finn Poschmann, a Policy Analyst at the Institute.

The authors note that long-term high unemployment rates in the European Union (EU) are generally thought to be the result of a highly regulated and inflexible labor market. If those high rates persist, European voters might be tempted to elect politicians who promise either to take fiscal action or to pressure the new European Central Bank (ECB) for exchange rate remedies, rather than to pursue the painful labor market adjustment policies otherwise necessary.

Laidler and Poschmann say that, after 1999, control over monetary policy in the 11- member EMU will be in the hands of an independent ECB and that fiscal policy in those countries may also be constrained by the agreed terms of the union. This could lead to European pressure for international macroeconomic policy coordination, they say, and Canadian policymakers need to be prepared to defend Canada’s interests in any such negotiations.

Laidler and Poschmann explain that the euro’s introduction differs sharply from most currency reforms, where a new currency replaces one discredited by inflation. But the most likely alternative to the euro, the use of the deutschmark as the EU’s common currency, was ruled out by the political need to limit German influence on the continent. The EMU’s architects thus made the euro as much like the deutschmark as possible, while the Maastricht Treaty set strict rules for fiscal policy in the run-up to the EMU and took pains to make the ECB politically independent.

But Laidler and Poschmann point out that adherence to Maastricht’s criteria has not been strict, and post-EMU fiscal policy rules are subject to many exceptions and will be hard to enforce. Political maneuvering over appointing the ECB's first president has also already begun to erode that institution's standing. None of this bodes well for the future, the authors say, as either fiscal laxity in the euro zone or political disagreement over the exchange rate may destabilize the euro.

Canada's interest in these developments stems from the fact that international monetary instability usually affects the Canada-US dollar exchange rate, which could lead to renewed domestic political pressure to peg that rate. In this country, macroeconomic policy coordination has traditionally been debated in the Canada-US context, but the euro's creation broadens the context and may prompt proposals involving the wider international monetary system. Thus, the authors argue, the extra maneuvering room that Canada's policymakers get from having a flexible exchange rate seems more attractive than ever.

* * * * *

The C.D. Howe Institute is Canada's leading independent, nonpartisan, nonprofit economic policy research institution. Its individual and corporate members are drawn from business, labor, agriculture, universities, and the professions.

- 30 -

For further information, contact:

David Laidler (519) 661-3500;
Finn Poschmann;
Maxine King (media relations), C.D. Howe Institute
phone: (416) 865-1904; fax: (416) 865-1866;
e-mail: cdhowe@cdhowe.org; Internet: www.cdhowe.org

Birth of a New Currency: The Policy Outlook after Monetary Union in Europe, C.D. Howe Institute Commentary 110, by David Laidler and Finn Poschmann (C.D. Howe Institute, Toronto, June 1998). 28 pp.; $9.00 (prepaid, plus postage & handling and GST — please contact the Institute for details). ISBN 0-88806-439-X.

Copies are available from: Renouf Publishing Company Limited, 5369 Canotek Road, Ottawa, Ontario K1J 9J3 (stores: 71½ Sparks Street, Ottawa, Ontario; 12 Adelaide Street West, Toronto, Ontario); or directly from the C.D. Howe Institute, 125 Adelaide Street East, Toronto, Ontario M5C 1L7. The full text of this publication will also be available on the Internet.

C.D. Howe Institute
Institut C.D. Howe

Communiqué

Embargo : à diffuser le *jeudi* 25 juin 1998

Le nouvel « euro » pourrait mener à des demandes de coordination internationale des taux de change, et des ententes en matière de politique du travail et de politique sociale, indique une étude de l'Institut C.D. Howe

L'Union économique et monétaire européenne (UEME) et l'introduction en 1999 d'une devise unique — l'euro — pourraient mener l'Europe à essayer de réduire les coûts associés aux difficultés qu'elle éprouve avec son marché du travail par le biais de la coordination internationale d'une politique des taux de change et d'ententes multilatérales en matière de politique du travail et de politique sociale, affirme un Commentaire de l'Institut C.D. Howe publié aujourd'hui.

L'étude, intitulée *Birth of a New Currency: The Policy Outlook after Monetary Union in Europe (Naissance d'une nouvelle devise : perspectives de politiques à la suite de l'union monétaire européenne)*, est rédigée par David Laidler, professeur d'économique à l'Université de Western Ontario et attaché de recherche auprès de l'Institut C.D. Howe, et Finn Poschmann, analyste de politique de l'Institut.

Selon les auteurs, on attribue généralement les taux de chômage à long terme élevés que l'on observe au sein de l'Union européenne à un marché du travail extrêmement réglementé et rigide. Si cette tendance devait se poursuivre, les électeurs européens pourraient être tentés d'élire des politiciens qui promettent de prendre des mesures budgétaires ou d'exercer des pressions sur la nouvelle Banque centrale européenne (BCE) afin qu'elle y remédie par les taux de change, plutôt que d'instituer les politiques difficiles de rectification du marché du travail qui seraient autrement requises.

MM. Laidler et Poschmann indiquent qu'après 1999, le contrôle de la politique monétaire des 11 États membres de l'UEME se retrouvera entre les mains d'une BCE indépendante et que la politique budgétaire de ces pays sera soumise aux restrictions des modalités de l'union. Il pourrait donc se produire des pressions européennes pour une coordination internationale de la politique macroéconomique; les artisans canadiens de la politique devraient par conséquent être prêts à défendre les intérêts du Canada dans le cadre de telles négociations.

Les auteurs expliquent que l'introduction de l'euro se démarque notablement de la plupart des réformes de devises, où une nouvelle monnaie en remplace une autre dont l'inflation a détruit la crédibilité. Mais on a éliminé l'alternative la plus probable à l'euro, soit le deutsche mark comme monnaie commune de l'Union européenne, en raison du besoin politique de limiter l'influence allemande sur le continent. Les architectes de l'UEME ont donc créé le plus de ressemblances possibles entre l'euro et le deutsche mark; par ailleurs, le traité de Maastricht établissait des règles strictes de politique budgétaire menant à l'UEME et se donnait beaucoup de mal pour faire de la BCE un organisme politiquement indépendant.

Cependant, MM. Laidler et Poschmann soulignent que l'on n'a pas adhéré strictement aux critères de Maastricht et que les règles de politique budgétaire qui suivront l'UEME sont assujetties à de nombreuses exceptions et seront difficiles à faire observer. Les manoeuvres politiques qui ont entouré la nomination du premier président de la BCE ont également déjà commencé à saper son statut. Ceci n'augure pas bien pour l'avenir, indiquent les auteurs, car tout relâchement budgétaire dans la zone de l'euro ou tout désaccord politique sur le taux de change pourraient déstabiliser cette devise.

Cette situation présente un intérêt pour le Canada, en ceci que l'instabilité monétaire internationale comporte habituellement des répercussions sur le taux de change entre le dollar américain et le dollar canadien, ce qui pourrait mener à de nouvelles pressions à l'échelle nationale pour établir un taux fixe. Dans ce pays, on débat généralement de la coordination des politiques macroéconomiques dans un contexte Canada-États-Unis, mais la création de l'euro élargit le contexte et pourrait faire appel à des propositions englobant le système monétaire international dans son contexte le plus large. Par conséquent, soutiennent les auteurs, la marge de manœuvre supplémentaire dont disposent les artisans de la politique canadienne grâce à un taux de change flottant présente plus d'intérêt que jamais.

* * * * *

L'Institut C.D. Howe est un organisme indépendant, non-partisan et à but non lucratif, qui joue un rôle prépondérant au Canada en matière de recherche sur la politique économique. Ses membres, individuels et sociétaires, proviennent du milieu des affaires, syndical, agricole, universitaire et professionnel.

- 30 -

Renseignements : David Laidler (519) 661-3500; Finn Poschmann
Maxine King (relations avec les médias), Institut C.D. Howe
téléphone : 416 865-1904, télécopieur : 416 865-1866
courrier électronique : cdhowe@cdhowe.org, Internet : www.cdhowe.org

Birth of a New Currency: The Policy Outlook after Monetary Union in Europe, Commentaire n^o 110 de l'Institut C.D. Howe, par David Laidler et Finn Poschmann, Toronto, Institut C.D. Howe, juin 1998, 28 p., 9,00 $ (les commandes sont payables d'avance, et doivent comprendre les frais d'envoi, ainsi que la TPS — prière de communiquer avec l'Institut à cet effet). ISBN 0-88806-439-X.

On peut se procurer des exemplaires de cet ouvrage auprès des : Éditions Renouf ltée, 5369, chemin Canotek, Ottawa ON K1J 9J3 (librairies : 71½, rue Sparks, Ottawa ON, tél. 613 238-8985 et 12, rue Adelaide ouest, Toronto ON, tél. 416 363-3171), ou encore en s'adressant directement à l'Institut C. D. Howe, 125, rue Adelaide est, Toronto ON M5C 1L7. Le texte intégral de ce document figurera également sur Internet.

Birth of a New Currency

The Policy Outlook after Monetary Union in Europe

by

David Laidler and Finn Poschmann

The decision by the European Union to adopt a single currency — the euro — poses new challenges within and without Europe.

On the euro's takeoff in 1999, the eleven members of the European Economic and Monetary Union (EMU) will have lost direct control over domestic monetary policy; that control will be in the hands of an independent European Central Bank (ECB). Fiscal policy too will be constrained by the agreed terms of the union.

But labor market performance in Europe has long been poor and quick improvement is not in sight: a highly regulated and inflexible labor market is commonly held to blame. If high unemployment rates persist, it is likely that European electorates will come to prefer politicians who promise either to take fiscal action or to pressure the ECB for exchange rate remedies, rather than to pursue the painful labor market adjustment policies otherwise necessary.

If the terms of the EMU and the independence of the ECB do indeed limit action on the fiscal and monetary fronts, pressure will mount for international macroeconomic policy coordination.

Canada's policymakers need to be prepared to participate in negotiations that include a monolithic Europe, a Europe that may seek to limit the costs of its own labor market difficulties by way of international coordination of exchange rate policy and multilateral agreements on labor and social policy. A soaring EMU will therefore involve broader — but possibly less stable — policy horizons.

Main Findings of the Commentary

- The near-term goal of European Economic and Monetary Union (EMU), to adopt a single currency, could have been achieved by simply widening the deutschmark's circulation. Instead, the EMU will undertake an economically risky business — replacing the deutschmark with an untried substitute — with the political goal of limiting German influence in Europe. The euro's introduction therefore differs sharply from most currency reforms, where a new currency replaces one discredited by inflation.
- The EMU's architects, knowing the risks, made the euro as much like the deutschmark as possible. The Maastricht Treaty set strict rules for fiscal policy in the run-up to the EMU and took pains to make the European Central Bank (ECB) politically independent. But adherence to Maastricht's criteria has not been strict, and the Stability and Growth Pact's post-EMU fiscal policy rules are subject to many exceptions and will be hard to enforce. Political maneuvering over appointing the ECB's first president has also begun to erode that institution's standing. None of this bodes well for the future.
- Under the EMU, monetary policy is intended to be beyond politicians' control, while national governments control fiscal policy subject to the Stability and Growth Pact. But Maastricht gives the Council of the European Union — the political heads of member states — substantial policy control over the euro's exchange rate.
- European macroeconomic performance is mediocre, particularly on the employment front, and will remain so without substantial structural reforms. Because European electorates perceive little need for such reforms, their political leaders may lean initially toward traditional (and inappropriate) fiscal fixes and may pressure the ECB to compromise its low-inflation mandate.
- With the euro as the currency of a sizable economic area, international monetary turbulence could ensue. With European politicians controlling exchange rate policy, and given widespread reluctance in Europe to leave that rate to the workings of unregulated international markets, the world will probably feel European pressure to return to a more regulated international monetary system, involving policy coordination among major countries.
- European politicians might instead embrace labor market reform, increasing the euro's chances of a smooth launch. It could then begin competing with the US dollar as an international reserve currency, inducing major shifts in international capital markets. International monetary turbulence could also be created this way.
- Canada will have little influence on these events. But international monetary instability usually affects the Canada–US dollar exchange rate; renewed domestic political pressure to peg that rate is therefore likely.
- In this country, macroeconomic policy coordination has traditionally been debated in the Canada–US context, but the euro's creation broadens the context and may prompt proposals involving the whole international monetary system — as well as, perhaps, for much wider-ranging policy coordination, especially for labor market and social policies. Given these possibilities, the extra maneuvering room that Canada's policymakers obtain from the flexible exchange rate seems more attractive than ever.

Euroskeptics, as the British call them, when discussing the prospects of a successful European Economic and Monetary Union (EMU), often joke about emus' flying abilities. But emus can actually run rather fast, and this EMU now appears capable of takeoff.

Emus also pack a pretty powerful kick, a fact that Canadians should bear in mind over the next few years. Introducing a single European currency — the euro — will have major consequences for the international monetary system, and hence for the economic environment in which Canada must function. As the currency of an economic area roughly the size of the United States, the euro will be of the first order of importance internationally. Whether its introduction goes roughly or smoothly, it will have important effects on, among other things, monetary relations between the United States and Europe, although the form those effects take will depend on how well the EMU works in its early years.

This *Commentary* explores some of the issues involved here. We argue that the institutional framework set up by the European Union (EU) when the Maastricht Treaty was signed the framework within which the new currency is embedded — is probably inadequate in its provisions for coping with the ongoing politics of monetary policy formation within the EU. Specifically, poor European labor market performance will lead national governments to seek fiscal and monetary solutions, placing intense pressure on the European Central Bank (ECB).

Meanwhile, Maastricht leaves politicians with considerably more power over exchange rate policy than over other aspects of monetary policy. The labor market difficulties mentioned above are therefore most likely to direct politicians' attention to the euro's exchange rate against other currencies, generating uncertainty in international financial markets. The most likely consequence of such instability will be European proposals for international monetary policy coordination — and, perhaps, managed or pegged exchange rates among the world's major currencies.

Such an unpleasant outcome is, of course, not certain. This *Commentary* therefore considers some possible consequences of a successful launch of the euro, in which European governments introduce labor market reforms as a matter of urgency so that the pressures just postulated do not in fact build up. In that case, the euro could well emerge as an important international reserve currency, and currency competition could then arise between it and the US dollar. This too might create turbulence on foreign exchange markets, generating by another route incentives for international economic policy coordination.

As in the past, volatility in Canadian-dollar exchange rates, the byproduct of international monetary turbulence, will breathe life into the perennial domestic debate about whether a flexible rate regime is appropriate for this country. But at the same time — and of more basic importance — the euro's introduction will change the debate's international context, no matter how that experiment works out. Proposals for a broader reorganization of the international monetary system, involving a return to managed or even fixed exchange rates among its major currencies, are likely to be on the table. Indeed, if things do go wrong in Europe because of a failure to address labor market problems, attempts might even be made to link international standards for social policy to these issues. Canadian debates about the exchange rate will thus no longer focus on bilateral relations with the United States, but will instead need to consider North America's, and therefore Canada's, place in the international economic order.

The EMU and the Euro

In choosing to adopt the euro, the EU took two distinct decisions about future monetary arrangements: to form a monetary union based on a common currency and to make that currency a new one. While the move toward monetary union *per se* has both an economic and a political rationale, the decision to base that union on a new currency, the euro, rather than on an existing one, was strictly a political matter.

The Economics and Politics of the Euro

The economic case for a common European currency comprises three broad elements.

- It is argued that, within the single market the Europeans are creating, a single means of exchange and unit of account will noticeably reduce transactions costs.[1]
- It is suggested that eliminating national currencies will also eliminate the temptation for member countries' governments to seek temporary, but ultimately harmful for all parties, competitive advantage for local producers by manipulating exchange rates.
- A special benefit will accrue to countries with particularly unhappy fiscal and monetary histories. Abandoning old currencies that are burdened by histories of instability and adopting new ones that are beyond the influence of the political forces that undermined confidence in their predecessors will lead to lower domestic interest rates. This will follow from the complete elimination of currency risk[2] in the context of lending to those countries from capital pools denominated in euros, and from the decline in the currency risk associated with particular national currencies to the level of risk associated with the euro in the context of lending from outside the euro zone. Lower cost of credit and better access to international capital markets will result.

Exploiting the purely economic gains from adopting a new currency cannot, however, be the only important motivation for the move toward an EMU. If it were, participants would not be planning a new currency called the euro. Instead, countries other than Germany would be either preparing to replace their own currencies with the deutschmark or turning their central banks into currency boards and backing local monies 100 percent with deutschmark reserves (an option that amounts to much the same thing in monetary terms).[3]

Using the deutschmark rather than the euro as Europe's money would yield greater savings in transactions costs, because it would spare about 82 million people the trouble of learning to cope with a new unit of account. It would also eliminate competitive devaluations just as effectively. Furthermore, the deutschmark has a 40-year history of stability, and that well-established credibility would be instantly transferred to the monetary system of any country that irrevocably adopted it.

It is nevertheless impossible to contemplate an EMU based on the deutschmark. It would be hard to imagine a more powerful symbol of German hegemony over Europe than this type of arrangement, and avoiding such hegemony has been an important, though seldom-stated, aim of the EU from the outset. The case for monetary union based on a new currency rather than on the deutschmark is that achieving union this way will cut the Bundesbank to size, reducing Germany's power to shape European economic policy.

Why should Germany acquiesce in the deutschmark's demise? The German polity — the west German elite in particular — has an abiding desire for international recognition as a fully European and fully communal society. It is here that political concerns have most clearly trumped arid economic argument.

Moreover, the 1990 run-up to the Maastricht Treaty occurred in the context of the debate on German reunification, a project whose

Box 1: ***Trust, the Monetary System, and Currency Reform***

The social and economic arrangement known as monetary exchange succeeds in the first instance only because mutual trust exists among its participants. Money derives its usefulness from the fact that every individual who accepts it in exchange for goods, services, or other assets takes for granted that everyone else will also accept it.

Mutual trust among the agents who participate in the monetary system, and hence the credibility of any particular currency, is difficult to analyze with any degree of precision, let alone to quantify. But this does not reduce the role of trust in the system, and experience often seems to be a significant factor in supporting trust and credibility. People tend to believe that a currency that is now, and that has been in the past, unquestioningly accepted by others is likely to remain so. They therefore continue to accept it themselves, thereby sustaining its acceptability, and so on.

Governments have traditionally helped create and sustain trust in national currencies. For example, laws have sometimes compelled their issuers to convert them, on demand, into something with a ready market as a commodity, the gold standard being the best-known historical example of such an arrangement. Legal-tender laws, which guarantee the acceptance of a particular money in payment of taxes and require its acceptance in payment of private debts, are also widespread. Such arrangements help enhance individuals' confidence in a currency's acceptability in day-to-day transactions, but they cannot, by themselves, guarantee that the currency's acceptability will continue.

Currency reforms are usually a response to erosion of trust in an existing currency — an erosion that, in turn, results from adverse experience. Inflation has that effect, and it is a testament either to the importance of experience in such matters or perhaps to habit that people have continued to use a currency even when raging inflation has sharply reduced its value. But sometimes inflation undermines confidence in a money so thoroughly that it becomes preferable to replace it with a new one — that is, to undertake a currency reform.

success and acceptance in Europe at large was in no way taken for granted at the time. Reunification required the full support of Germany's neighbors, which was won amid a storm of political and economic turbulence. Germany wanted to be securely embedded in Europe, and Europe wanted Germany safely tucked in. The depth of this desire is revealed in the way that the euro's introduction inverts Germany's (and Europe's) traditional outlook: that economic and political integration would produce a sound framework from which to launch a single currency. Instead, a new currency was to become a glue that would both bond the monetary union together and limit enlarged Germany's potentially overwhelming weight within that union. The single currency itself was expected to help hold the union together while the stresses of further political integration played out.

Thus, political imperatives proved decisive in mapping out the route to monetary union. The euro's introduction, as opposed to monetary union itself, must ultimately be seen as a currency reform undertaken in response to Germany's political weight and the deutschmark's success. As a consequence of that reform, an immensely valuable piece of social capital — namely, the credibility of the deutschmark and of those national currencies that have been pegged to it (for example, the Austrian schilling and the Dutch guilder) — will be abandoned, and the difficult and uncertain task of creating credibility for the euro from scratch will begin. No historical precedent exists for such a bizarre act.[4] And though the final arguments were purely political matters, the fact that they prevailed among the EMU's architects is likely to have economic consequences.

Box 2: *The Maastricht Treaty and European Economic and Monetary Union*

Since 1965, the European Union, in its various guises, has favored fixed exchange rates among its members. The "Werner Report," published by the European Commission in 1970,[a] envisioned a process whose goal, to be achieved by 1980, was irrevocable currency convertibility, free capital movement, and fixed exchange rates, with the latter holding open the door to a single currency.

At the time, fixed exchange rates — and the gold standard — were viewed as the norm, but the collapse of the Bretton Woods agreement and the newly floating US dollar put an end to the locking strategy the EU had assumed to be viable.

Ever hopeful of a stronger union, in 1972 the EU began a short-lived experiment known as "the snake in the tunnel," which specified a range *vis-à-vis* the US dollar within which its few member currencies were to keep. Lack of commitment and a difficult external environment soon killed "the snake," but it was replaced in 1979 by a similar exchange rate mechanism (ERM), embodied within a European Monetary System. This managed exchange rate system had the support of all EU members, although the United Kingdom remained out of the ERM at the time.

The 1980s saw some minor crises within the ERM, but by the end of the decade the project as a whole had been judged a success, particularly since exchange rate volatility had more or less steadily decreased over the period of its operation.

In 1988, the European Council felt the time was ripe to map out a new route to fixed exchange rates, which was laid out in the report of the Commission's president, Jacques Delors, in April 1989.[b] The goals were essentially the same as before, but the report specified that they were to be reached in three stages:

- the development of economic and monetary coordination (implying a distinct degree of political unification);
- the formal unification of monetary policy; and
- the creation of a system of European central banks, which would facilitate the locking of exchange rates and hence the ultimate step, creation of a single currency.

Key to the proposal's viability were rules that would set limits on a national government's fiscal policy, and monetary policy that would be fully independent of political control.

The Maastricht Treaty, approved by the EU members' heads of state or government at Maastricht, Netherlands, in December 1991,[c] converted the route envisaged in the Delors Report into hard policy commitments to which members felt they could adhere. These commitments are the "con-

Currency reforms sometimes fail and sometimes succeed; but they are always risky. Hence they are usually measures of last resort, and usually undertaken when it is thought easier to establish trust in a new currency than to re-establish it in an old one (see Box 1). EMU members hope to persuade the world that this reform is not very risky at all, because their success in achieving the political integration of Europe first requires successful flight of the EMU.

Maastricht

Given that the EMU's success is inextricably entwined with the euro's credibility, it is reassuring that the union's architects have sought institutional features aimed at enhancing that credibility. The institutional mechanism intended to buttress the euro before its formal launch is the set of arrangements negotiated under the Maastricht Treaty (the content of which is outlined in Box 2). Perhaps unsurprisingly, under the treaty's constraints, the resultant euro *looks* remarkably like the deutschmark without actually being the deutschmark.[5] This resemblance has been created by

- using rules on fiscal policy meant to enforce German standards of fiscal probity on all EMU members;

Box 2: *The Maastricht Treaty and European Economic and Monetary Union* – continued

vergence criteria," the basis for judging prospective EMU members. The salient criteria are:

- a rate of inflation close to — that is, within one and a half percentage points of — the average rate of the three EU members with the lowest inflation;
- a long-term interest rate within two percentage points of the rate in those countries;
- at least two years spent within the EMUs 15 percent allowable fluctuation margins;
- a sustainable national government budgetary deficit of no more than 3 percent of gross domestic product;
- a public debt-to-GDP ratio of no more than 60 percent; and
- a national central bank that is formally independent of direct political control.

With respect to the budgetary ratios, some flexibility is contemplated. Deficits can exceed 3 percent of GDP as long as the number remains "close," and the excess must be "exceptional" and "temporary." The debt figure, too, must not be "excessive" if it is above 60 percent, and it must be "approaching the reference value at a satisfactory pace."

The treaty's terms set a schedule for determining membership; that schedule has now run its course. In March 1998, the European Commission recommended that 11 EU members partake in the EMU: Austria, Belgium, Finland, France, Germany, Ireland, Italy, Luxembourg, the Netherlands, Portugal, and Spain.[d] Of the remaining four EU members, Greece was held to have an "excessive deficit" and to have failed to meet the exchange rate criteria. Sweden and the United Kingdom did not meet the exchange rate criteria (since they had not been in the ERM for the requisite two years); but they, like Denmark, had in any case elected to stay out of the EMU for the time being, so the Commission's views on their status was irrelevant.

The European Parliament formally endorsed the Euro-11 on April 30, 1998,[e] and the European Council ratified the choice on May 2, 1998.[f]

[a] Pierre Werner, *Report to the Council and the Commission on the Realization by Stages of Economic and Monetary Union in the Community* [Werner Report], Supplement to Bulletin 11-1970 of the European Communities (Luxembourg: Council / Commission of the European Communities, 1970).

[b] Committee for the Study of Economic Union, *Report on Economic and Monetary Union in the European Community* [Delors Report] (Luxembourg: Office for Official Publications, 1989), pp. 1–43.

[c] Council of the European Communities / Commission of the European Communities, *Treaty on European Union* (Luxembourg: Office for Official Publications, 1992).

[d] Commission of the European Union, "Commission Recommends 11 Member States for EMU," Brussels, March 25, 1998. For the full text of the recommendation, see http: / / europa.eu.int / comm / off / rep / conver / recom_en.htm.

[e] European Parliament endorsement vote, April 30, 1998, procedural reference A4-0130 / 98.

[f] Council of the European Communities, Session 2088, May 2, 1998, reference CNS98812.

- establishing political independence for the ECB and for the national central banks that make up the European System of Central Banks over which it presides; and, in particular,
- prohibiting central banks from financing by any national government's fiscal adventurism.

Criteria for EMU Membership

No Maastricht Treaty provisions have attracted more attention than the monetary and fiscal criteria for achieving EMU membership. To begin with, inflation rates had to converge to a central and low average value before the union came into being, and countries whose inflation rates failed to do so were not to be admitted. Exchange rates also had to become stable and continue to be so in the years preceding the union's formation. These measures, of course, required would-be EMU members to mimic German monetary policy.

Recognizing that fiscal expansionism may have driven many past inflationary episodes, Maastricht also set down apparently strict fiscal criteria for EMU membership. The treaty was widely understood as requiring that national governments of would-be EMU members run fiscal deficits of no more than 3 percent of GDP on a sustainable basis and achieve debt-to-GDP ratios below 60 percent by the time they joined the EMU.

But the treaty's fiscal criteria were never that strict. Violations of the quantitative limits were to be allowed if the European Commission[6] viewed them as not too great and believed that satisfactory progress was being made toward satisfying the criteria.

Furthermore, it should have been obvious from the outset that this waiver would be invoked. If the EMU was ever to be more than a Franco-German arrangement, it would have to include at a minimum the Benelux group. But it was never conceivable that Belgium, with a debt-to-GDP ratio of 129 percent when the treaty was signed (much higher than the more widely discussed Italian figure of 101 percent) could meet a 60 percent target over the time horizon envisaged for the EMU's formation.

Maastricht's standards of fiscal rectitude have been steadily eroded over the past few years, not least because France and Germany have had some trouble meeting the deficit criteria. With the Commission's approval, France[7] and Italy[8] have successfully resorted to what might reasonably be called "creative bookkeeping" in order to improve fiscal appearances, although the Commission recently rebuffed Italy's attempt to use internal transactions in gold holdings to bolster reported budgetary revenue. More disturbing, not long ago Germany's federal government attempted a similarly flagrant evasive maneuver, inviting the Bundesbank to revalue its gold reserves and declare a one-time dividend in favor of the government.

The fact that this last-mentioned attempt failed in the face of Bundesbank opposition, to the government's great public embarrassment, is beside the point. Once the attempt was made, the German leadership could never again insist that any other potential EMU member be strictly held to the Maastricht fiscal criteria. Spain, Italy, and Portugal were thus assured of membership if they wanted it. And of course they did want it, not least because the countries with the most to gain by importing monetary credibility from their associates are precisely those whose monetary stability has been threatened by domestic fiscal problems — a group that notably includes these so-called Club Med nations.

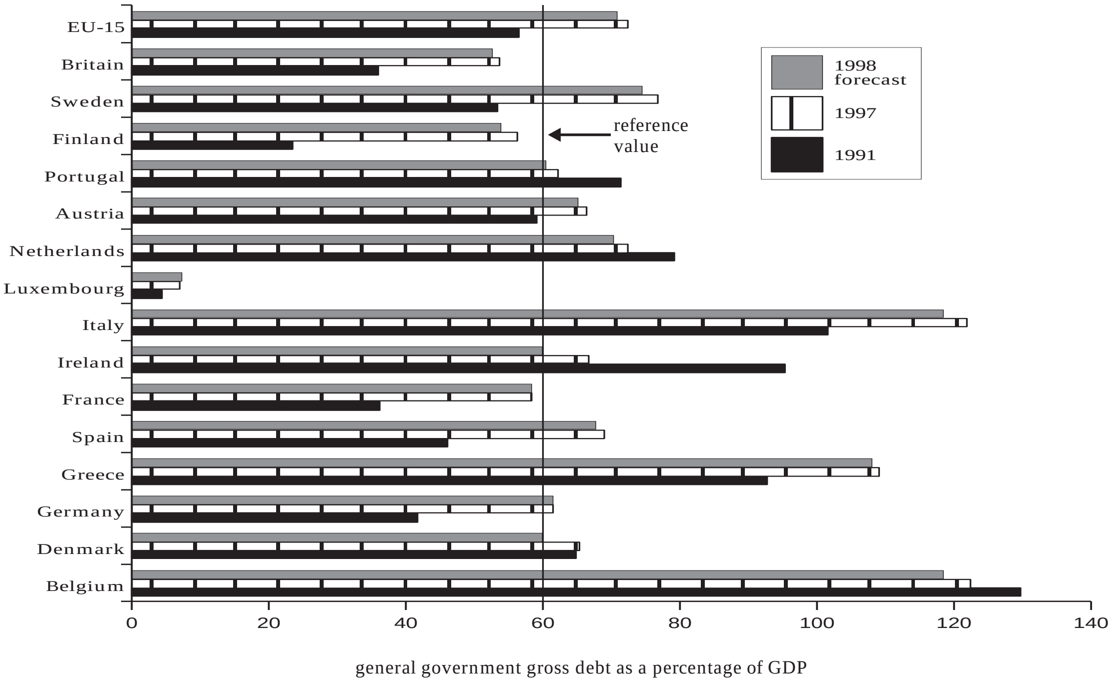
This is not to suggest that the Maastricht criteria have had no beneficial effects on fiscal policy within Europe. It is hard to believe that countries such as Spain and Italy would have made as much fiscal progress as they have in the 1990s without the political cover the criteria have provided. Given the severe unemployment problems affecting Germany and France, it is equally hard to believe that their governments would not have pursued fiscal expansionism had they not been publicly committed to setting an example for the rest of Europe in this regard.[9]

It may also be possible to overplay the importance of meeting the Maastricht criteria in practice, as opposed to demonstrating an earnest zeal to meet them in principle. That is, the goal of Maastricht may merely have been to establish the *bona fides* of potential EMU members, reflecting the belief that a display of financial rectitude before the EMU would be indicative of performance after the union's introduction, implying that fiscal pressure would not in future bear heavily on monetary policy, and that the euro might therefore remain stable.

Even so, as the EMU is about to come into being, its members' fiscal houses are in much worse order than expected when the Maastricht Treaty was signed, particularly on the debt front (see Figure 1, panels A and B). Yet Greece is the only EU country that has been excluded from the EMU as a result of a failure to

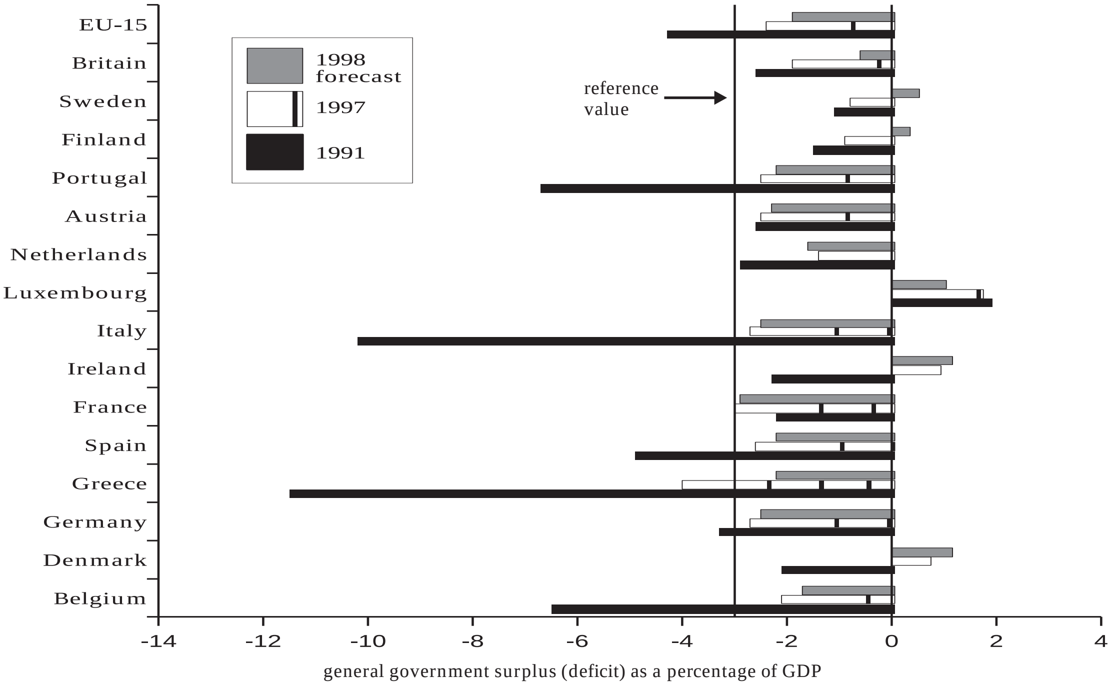
Figure 1: *Selected Fiscal Indicators for EU Member Governments*

a. General Government Gross-Debt-to-GDP Ratios



Source: European Commission.

b. General Government Surplus(Deficit)-to-GDP Ratios



Source: European Commission.

Box 3: *The Growth and Stability Pact*

The process and convergence criteria established by the Maastricht Treaty did not deal with an important question: If fiscal frugality was so important in determining the EMU's initial membership, why would not such restraint remain important once the EMU obtained?

The answer the EU found is the Stability and Growth Pact, approved by EU heads of state or government in Amsterdam in June 1997. The pact threatens financial penalties for member states that persistently fail to keep deficit and debt small relative to GDP; the target levels match those set out under the Maastricht Treaty, although it is envisaged that the deficit target should drop to 1 percent of GDP as soon as such can be negotiated.

The penalty schedule appears in a briefing note of a European Parliament task force,[a] from which the following summary is quoted:

- The Economic and Finance Council (ECOFIN) would have *three months* following the submission of budget figures by a Member State to decide whether an "excessive deficit" existed (Article 104c(6)), and to issue a recommendation (Article 104c(7)). Council would initially base its judgement on the "official public decisions" by the national government concerned. It would reserve the right to reconsider if these decisions were not enacted by the national legislatures within a specified time limit.
- If ECOFIN decided after *another four months* that no effective action had been taken by the [M]ember State in question, it could make the recommendation public.
- Failing action by the offending Member State within *one month*, ECOFIN could then issue a notice for the Member State to take deficit-reduction measures.
- If *within another two months* no satisfactory measures had been taken by the Member State, ECOFIN would, "as a rule, decide to impose sanctions".
- The *total time* between the reporting date for budgetary figures and any decision to impose sanctions would have to be *less than ten months.*

If a deficit is found to be excessive, the penalties follow a specified route, beginning with requiring the offending state to make a non–interest-bearing deposit, to the European Community budget, of

- a fixed sum equal to 0.2% of GDP;
- and a supplement equal to 0.1% of GDP for every percentage point by which the budget deficit exceeded the 3% reference level.

meet the convergence criteria (and its exclusion is as much a matter of its relatively high inflation rate as of its serious fiscal problems).

Constraints on Fiscal Policy after Monetary Union

A curious feature of the Maastricht Treaty is that, although the fiscal criteria for achieving EMU membership in the first place were initially expected to be strict and to be backed by a real sanction (denial of membership), the rules that will govern members' fiscal policies once the union is in force are much less well defined.

This evident weakness received subsequent attention in the form of the Stability and Growth Pact (see Box 3) that was negotiated in 1997 to supplement the treaty. The pact defines quantitative criteria for post-EMU fiscal policy — the same 3 percent ceiling on the deficit-to-GDP ratio as will be required for membership — and attempts to define both the seriousness of the circumstances that would justify their violation (for example, a 2 percent contraction of GDP in a year) and a time limit for such violations (two years). But, as with the entry criteria, the pact contains much hedging about how much leeway violators may be granted without sanctions being invoked.

Box 3: ***The Growth and Stability Pact –*** continued

These provisions would, however, be subject to two qualifications:

- [t]here would be an *upper limit* of 0.5% of GDP; and
- [i]f the excessive deficit were due to non-compliance with the *government debt criterion* (the 60% of GDP reference value), only the fixed sum would be due.

If the deficit persisted two years later,

- the deposit would become a fine, and be paid into the Community Budget;
- a new non-interest-bearing deposit would have to be made;
- some of the other measures outlined in Article 104c(11) might also be imposed.[b]

The Noordwijk ECOFIN of April 5, 1997, decided that a fine of up to 0.5 percent of GDP could be levied for each year during which the excessive deficit persisted. However, after the first year the 0.2 percent fixed sum would no longer apply — that is, a 4 percent deficit would incur a 0.3 percent of GDP penalty in the first year (0.2 percent + 0.1 percent); but only 0.1 percent of GDP in the second.

The Council is free to abstain from imposing these sanctions if it feels that the budgetary deficit is "exceptional and temporary," resulting perhaps "from an unusual event outside the control" of the relevant member. This exemption is to be extended automatically if the offending state's GDP drops at least 2 percent annually. If the drop is less than 2 percent, the member state may still escape being fined, provided that it is experiencing a "severe recession" (the Council offers a drop in GDP of 0.75 percent as representative of such a recession).

[a] Task Force on Economic and Monetary Union, *The Stability and Growth Pact*, Briefing Note 24 (Brussels: European Parliament, January 1997). Emphasis in original at http://www.euro.emu.co.uk/offdocs/brief24.shtml.

[b] Article 104c (11) of the Maaastricht Treaty stipulates only that offending member states may be required to publish additional information, to be specified by the Council, before issuing bonds and securities; that the European Investment Bank might be invited to reconsider its lending policy toward that state; and that additional deposits to the Community budget may be requested or further fines "of an appropriate size" imposed.

The sanctions for violating these criteria will be fines, although it is hard to see much logic in, and therefore much likelihood of, subjecting a country that is already under fiscal pressure to more of the same by imposing such penalties. Putting decisions about these matters in the hands of the European Council, and therefore of other governments that might themselves be in difficulty in future, only makes the matter more problematic.

The Need for Fiscal Controls

Canadian readers might wonder how much all this will matter in practice. After all, Canadian provinces set their own budgets, free of any rules laid down in Ottawa, and although federal and provincial fiscal policies have sometimes been at cross-purposes, the arrangement does not seem to have put any long-term pressure on Canadian monetary policy.[10]

The Canadian system seems to work the way it does for two reasons. First, there is no rule that obliges the federal authorities to bail out any province that is in difficulty, although markets do seem to attach some positive probability to discretionary federal intervention in such an event. Second, and probably more important, provincial governments have no access to lines of credit at the Bank of Canada, nor does the Bank hold or otherwise deal in the marketable debt of any province.

In practice, the reactions of capital markets constrain borrowing by Canadian provinces long before serious pressure is put on monetary policy. At first glance, it is hard to see why markets would not be equally effective in disciplining national governments in Europe. In the absence of a captive printer of money, EMU members' borrowing would no longer meet the traditional definition of sovereign debt and would therefore be subject to a steeper risk premium than might otherwise obtain.[11] If this discipline were indeed binding, the fiscal constraints underpinning the EMU might have been unnecessary in the first place.

But the analogy here between Canada and Europe is not quite perfect. In Europe, not only is there no obligation on a central fiscal authority to bail out a member state's government that gets into in difficulty, but there also exists no body with the fiscal capacity and political authority to do so. Thus, market pressures on national governments in fiscal difficulty will likely be more acute than those on Canadian provinces. Though the ECB is forbidden to offer credit to governments or other public agencies, the marketable debt of member governments apparently will play a role in the day-to-day execution of monetary policy in Europe.[12] It is not difficult to imagine quiet but suffusive pressure on the ECB to accumulate the issues of EMU members in search of a ready market for their debt. Hence fiscal problems in member states might produce pressures on European monetary policy, too. The need to constrain fiscal profligacy in order to avoid such difficulties in the first place is thus a real one.

Central Bank Independence under Maastricht

The conjecture that insulating the central bank from political influence offers some guarantee of monetary stability has been much studied by economists — and, by and large, the empirical evidence seems to support the hypothesis.[13] That is one reason why the ECB, on paper at least, has been created as the most independent such institution in history.

To begin with, the ECB's governing statute is embedded in an international treaty — the Maastricht Treaty — negotiated by the national governments of what is now the EU and ratified according to the rules of the EU's member states. By comparison, the independence of the Bundesbank, which in many respects has been used as a prototype for the ECB, has its legal basis in an act of Germany's federal parliament and could have been revoked at any time over the past 40 years by simply amending that act.

Furthermore, the ECB statute itself goes out of its way to insulate the ECB's decisions from political pressures.[14] Neither the ECB itself nor any national central bank within the system of central banks over which it presides may seek or take instructions either from any other EU institution or from any national government. Neither the ECB nor any national bank is allowed to grant credit facilities to national governments or to any public sector institution. And the ECB's mandate gives pride of place to maintaining price stability. Although the ECB is also expected to support the EU's overall economic policies, as laid down in article 2 of the Maastricht Treaty, such support is to be given without prejudicing the price-stability goal.

The term of office for members of the ECB's executive board, including its president, is eight years, longer than any electoral cycle; appointments cannot be renewed; and the governors of national central banks must be appointed for at least five years. These appointments are of the "good behavior" type; incumbents cannot be removed for any political reason or because their policy stance does not meet with popular approval.

So far so good. The Maastricht Treaty sets up a central bank with a mandate to pursue price stability above all else and insulates that bank from political pressures to enable it to pursue this goal single-mindedly.[15] If the academic studies cited earlier are indeed reliable, all should be well. But academic economics yields another lesson about monetary policy, a lesson that is far better established than any message about the relationship between a central bank's legal status and inflation: Monetary policy can be used to pursue only one goal at a time.

Employment Goals

If monetary policy is to be used to pursue domestic inflation targets, it cannot also be used to pursue an employment target. And when the number of policy targets exceeds the number of available policy instruments, the result is suboptimal performance on all fronts.

What is the implication for employment policy of mandating the ECB to the single-minded pursuit of price stability? To the extent that the ECB's monetary committee perceives a conflict between goals, employment goals must yield to price stability. Thus, while the Maastricht Treaty recognizes promoting employment as a goal of the EMU, price stability alone is the ECB's target.

The Exchange Rate

But the implications for international monetary relations are similar to those for employment. Given the price-stability goal, the exchange rate must be allowed to follow whatever time path is necessary to reconcile that goal with international monetary conditions. The Maastricht Treaty recognizes the potential conflict here, just as it does in the case of employment. Significantly, however, the mechanism laid down for resolving such conflict differs from that to be used in the case of competing employment and price-level goals.[16]

Specifically, the treaty gives ultimate authority in matters of exchange rate policy not to the central bank but to the European Council. And only in the case of *concluding* a formal international agreement about exchange rates is Council unanimity required in order to make policy. Policy toward the exchange rate that stops short of entering into a formal agreement — indeed, any decision to enter into negotiations about one — is to be decided by a qualified majority of that body (that is, a majority in which each vote is weighted by the size of the country whose representative casts it).

The ECB is accorded a role in these processes, of course; the Council cannot act alone. But the Maastricht Treaty lays down different requirements in different cases. On matters of exchange rate policy that do not involve formal international agreements, the Council can act either on "the recommendation of the Commission and after consulting the ECB, or on the recommendation of the ECB," and what it does here should be "without prejudice" to the price-stability goal.

The treaty is silent on whose judgment should prevail in the case of a disagreement between the Council and the ECB about how a given exchange rate policy will probably affect inflation. Since the ECB is guaranteed only a consultative role, power would presumably lie with the Council and the Commission. If these bodies were willing to argue that a particular policy toward the exchange rate between the US dollar and the euro, for example, would not prejudice the pursuit of price stability in Europe, they would have the authority to overrule an ECB that disagreed with them and to have this policy implemented. How such a conflict might play out in practice is hard to say. A strong ECB governor who was sure of his or her position might threaten to resign as the conflict developed; a more flexible personality might cooperate with the politicians before disagreement reached a crisis point.

Where formal exchange rate agreements are concerned, power is placed even more clearly in the Council's hands. There is no requirement to consider the price-stability goal should the Council decide to enter into negotiations about such matters. Should those negotiations lead to a formal agreement, the ECB must be consulted about it, but only "in an endeavor to reach a consensus consistent with the objective of price stability." There is no requirement that such a consensus be reached. Once an agreement is in place, exchange rate policy decisions again require only consultation with the ECB, but not its final consent.

In short, the Maastricht Treaty gives the Commission and a qualified majority of the Council, not the ECB, both the responsibility for deciding which exchange rate policy is "without prejudice" to the price-stability goal and the power to pursue that policy. It also gives the Council the power to enter into more formal arrangements (and then to abandon them) after only *attempting* to reach a consensus with the ECB about this same matter.

None of this would matter much if one could always rely on politicians and on central bankers to give equal weight to price stability and to agree on the policies that will produce it. But if one could rely on such a consensus, central bank autonomy would not be needed in the first place. The way in which conflicts between Brussels and Frankfurt play out will depend on the participants' personalities, not on the text of the Maastricht Treaty, because in these conflicts the treaty does not guarantee autonomy to the ECB.

The Macroeconomic Policy Framework and European Policy Problems

The overall configuration of macroeconomic policymaking institutions within the EMU will be distinctly odd. Monetary policy for all member countries will be conducted by a central bank that, in principle, is well insulated from political influence and in pursuit of a single, overriding price-stability goal.

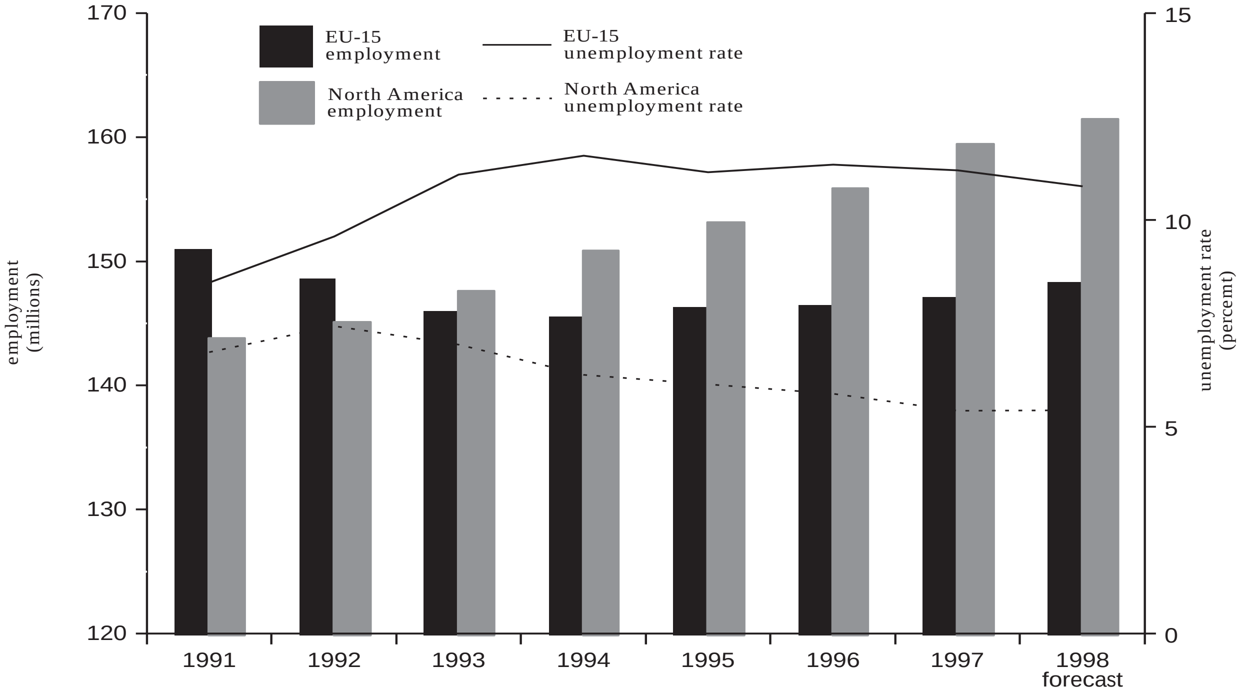
On the other hand, there exists neither an EU-wide framework within which discretionary fiscal stabilization policy can be implemented nor any structure of built-in fiscal stabilizers at that level. Politicians who wish to take macroeconomic action must, therefore, make do with whatever fiscal tools as are available within the borders of individual member countries, subject to whatever constraints the Stability and Growth Pact imposes.[17]

The use of deficit financing in the 1970s and 1980s left an ugly legacy in many European countries, just as it did in Canada. There is much to be said in favor of the current constraints on fiscal policy in Europe. But to assume that those constraints are adequate ignores the political dimension of economic policy. When things go wrong on the macroeconomic front, electorates are inclined to ask their governments for action; and when the latter do not respond, whether by choice or necessity, those electorates are then inclined to seek representatives who will. From the politicians' standpoint, the need to appear to be "doing something" is sometimes more pressing than the need to ensure that the "something" in question will be effective. Respect for liberal democratic principles, not to mention the desirability of maintaining social and political harmony, speaks to the likelihood of their responding to such a need.

Political Considerations and the Exchange Rate

If some perceived serious failure in the performance of the European macroeconomy generates pressures for an activist response of significant scale, European politicians, with domestic monetary policy out of their reach and their powers over fiscal policy limited, are likely to turn to the only remaining macro- economic policy tool under their authority —

Figure 2: ***Employment and the Unemployment Rate in North America and the European Community, 1991–98***



Source: Organisation for Economic Co-operation and Development.

namely, the euro's exchange rate against other major currencies.

But is it realistic to perceive a populist threat to the ECB's independence by this or any other route? Consider the comments of the current governor of the Banque de France, Jean-Claude Trichet, who will become the ECB's president in four years as a result of blatant political pressures applied by the French government during the run-up to the latest stage of the EMU: "Independence does not mean isolation from French democracy....And, in reality, an independent central bank is accountable to the general public, to public opinion itself."[18]

Perhaps this is no more than a simple statement of Trihcet's acceptance of western democratic norms, but perhaps there is also an undertone of tacit acceptance that it is sometimes appropriate to subordinate monetary policy to the political imperatives of the day.

A country such as Canada, which is a small part of the international economy, can unilaterally choose its exchange rate regime and can set exchange rate policy in response to domestic political considerations with few repercussions elsewhere. Because the EMU's member economies will collectively be much bigger, their choices regarding exchange rate policy will have repercussions throughout the international monetary system. The way the EMU's configuration threatens to channel political pressures toward the euro exchange rate therefore changes the policy environment for the rest of the world.

To suggest that macroeconomic difficulties within the EU might generate political tensions is not just a matter of idle speculation about the future. Overall, the EU countries' current macroeconomic performance is mediocre. On the positive side, inflation is low, intra-EMU exchange rates are stable, and fiscal deficits have fallen in the 1990s. But despite this convergence on the Maastricht criteria, there remains a persistent legacy of appalling labor market performance (see Figure 2). Only Denmark, Sweden, the United Kingdom (which all remain outside the EMU for the moment), and the Netherlands might be exceptions to this generalization. Significantly, among the worst labor market problems are those of France and Germany, where unemployment is high (well into double digits) and where job creation, particularly in the private sector, is extremely sluggish.

The Labor Market and Macroeconomic Policy

The link between labor market policy and the credibility of the euro has been well stated by the International Monetary Fund, which has noted that, in the absence of flexible exchange rates among members, the problem of labor market flexibility

> is clearly a critical issue for individual member states, not just because of the social, economic, and budgetary costs of the existing high levels of unemployment but also because of the need for more flexible markets to help their adjustment to shocks and to make their economies more efficient. One should also not underestimate its systemic implications for the euro area. A failure to address labor market problems would prevent Europe from realizing its full growth potential, and could also weaken the credibility of the euro if financial markets perceive that persistent unemployment is eroding support for prudent macroeconomic policies.[19]

The causes of Europe’s poor labor market performance are not hard to discern. Robert Mundell, one of the EMU’s most distinguished proponents, maintains that they stem from “excessively high tax rates, over-regulation of the labor market, and social safety net provisions that have overshot the bounds of allocation efficiency and fiscal solvency.”[20]

But it is one thing to offer diagnoses of problems and quite another to convince electorates of the accuracy of those diagnoses as a prelude to rendering politically acceptable the policy measures required to deal with them. As we have seen in the past two or three years, quite modest attempts at structural reform in France and Germany have met with strong resistance, not just at the ballot box and in legislatures, but also on the streets, where workers have engaged in strikes and demonstrations. In France, all this has led to a major redistribution of political power, not to mention the introduction of new measures that almost certainly will worsen, rather than ameliorate, these problems.[21]

In some historical episodes, unemployment may conceivably have been the consequence of an interaction between deficient aggregate demand and nominal rigidities, particularly those that affect the general wage level. If individual European countries now faced similar problems, the loss of the national exchange rate as a policy weapon and of domestic control over monetary policy — not to mention the imposition of limits on activist fiscal policies — would indeed be causes for immediate concern.

But the conditions that would render such devices effective in improving labor market performance seem not to be present in western Europe. When labor market institutions make it harder, rather than easier, for workers to move between jobs and industries, and when trade unions, the electorate, and politicians focus more attention on preserving the real levels of wages and social benefits than on allowing labor markets to adjust to market conditions, expansionary macroeconomic policies of the conventional Keynesian variety are more likely to engender higher, and perhaps rising, inflation rather than more employment. This, at least, would seem to be the lesson of British experience in the 1970s and of French experience in the early 1980s.

This lesson does not seem to be widely understood among continental European electorates, just as it was not among the British electorate before the end of the 1970s. The desire among would-be EMU members to meet the Maastricht criteria has somewhat restrained their macroeconomic policy. But efforts to prepare public opinion to accept structural reform have been perfunctory, and action toward implementing microeconomic reforms has been all but absent; some initiatives to date can only be described as retrograde. Introducing the single currency has instead been treated as an end in its own right — an unsurprising approach given Maastricht's underlying political agenda — and as an event that will by itself create improved economic performance.

Post-EMU Problems

To the extent that a European politician's commitment to fiscal and monetary restraint stems from a desire to see the Maastricht Treaty implemented, that incentive will weaken once the EMU has been achieved. And to the extent that the electorates' support for such restraint rests on a belief that restraint is only temporarily necessary to get European monetary institutions in place, hostile attention will focus on these same institutions when, after their creation, macroeconomic performance remains poor and those institutions appear to be hindering measures to improve it.

What happens then will depend on the interaction of four factors:

- the likelihood that much-needed labor market reforms will be undertaken after all;
- the degree of insulation from political pressure that the Maastricht Treaty turns out in practice to confer on the ECB;
- the effectiveness of the treaty's provisions, and those of the Stability and Growth Pact, in disciplining post-EMU fiscal policy; and
- the effects of accumulating evidence about these first three questions on the confidence of international markets in the euro.

Fiscal Expansion

Anything can happen, as the saying goes. But with monetary policy removed from immediate domestic political control and well insulated from indirect pressure (not just by the institutional design of the European System of Central Banks but also by strong political incentives to have that institution succeed), pressure will probably focus on fiscal action to be taken by individual national governments. It is fruitless to speculate on the precise form of the governments' response, but it is hard to avoid the conclusion that, the Stability and Growth Pact notwithstanding, fiscal deficits will begin to grow again.

This is a particular risk in France, which has a tradition of corporatist economic policy and where it is widely believed among the electorate that the expansion attempted at the outset of François Mitterrand's presidency failed not because it was inherently flawed, but because France's separate currency could not be defended against depreciation. With this last-mentioned alleged obstacle to demand-led real expansion finally removed by the euro's introduction, governments will be tempted to repeat the fiscal experiment — and, one suspects, not only in France.[22]

At its outset, any program of fiscal expansionism can, and no doubt will, be defended with arguments to the effect that deficits that might violate the Stability and Growth Pact will not emerge because of the likely effects of buoyant and sustained growth on government revenues. As time passes, there will be room for debate about the extent to which current data are accurate or reflect temporary, as opposed to structural, factors, about the reliability of medium-term forecasts of the outcomes of recently implemented policies, and so on. We have already seen this in the run-up to the EMU, and we have also seen how a little creative accounting can be deployed to temporarily distort the evidence when things are not working out quite as expected.

In short, after 1999, some key EMU members will probably relax fiscal policy based on rosy forecasts of the effects of such a relaxation, resulting in upward pressure on European interest rates, particularly in countries where fiscal relaxation is most evident. What else happens will depend on the strength of domestic and international confidence in the ECB and in the euro, and on the practical effectiveness of the arrangements designed to insulate these institutions from political pressure.

A Strong-Euro Scenario

If everything works out as expected by Maastricht's architects and the euro does indeed become a strong currency, one that is proof against fiscal pressures in the longer run, then the euro will appreciate — the natural consequence of fiscal expansionism in the absence of monetary accommodation. This, of course, will exacerbate unemployment problems in EMU countries to the extent that it discourages foreign direct investment and increases incentives for domestic investment to move offshore.

Even if these effects are, in fact, mild, they will not necessarily be presented as such by those who are wedded to current European labor market policies. It will be argued that market forces are taking the euro "too high" to be compatible with other European policy goals. It is hard to believe that the euro's initial strength would not ultimately be undermined by these developments, especially if the underlying macroeconomic fundamentals persistently languish.

A Weak-Euro Scenario

Alternatively, an already difficult employment situation in France, Germany, Italy, or any other EMU country could easily lead to the EMU in general, and the euro in particular, being cast as a scapegoat from the very moment of its introduction. Although the ECB and its members are forbidden to take instructions from politicians, there is nothing to stop the latter from publicly offering advice about monetary policy; and even if the bank does not listen, some members of the electorate will (perhaps enough of them to matter). All this could create doubts in capital markets about the depth of particular countries' commitment to the EMU and therefore about the entire system's future stability or even durability.

The euro might thus begin life not as a strong currency but as a weak one. This would put upward pressure on interest rates as the ECB attempted to stick to its price-stability mandate, over and above that emanating from fiscal policy. Such a state of affairs might well prompt suggestions that speculators, perhaps out of political motivation, were attempting to undermine a currency that threatened the hegemony of the US dollar. As under the strong-currency scenario, political attention would again focus on the exchange rate.

A Benign Scenario

There is, of course, a third scenario, under which none of this would happen. Given a common currency, if fiscal policy is restrained, the only adjustment devices available to national governments would be those designed to reduce labor market rigidity. Achieving the EMU therefore significantly increases the incentive for European policy to address this issue.

This, at least, is how some thoughtful EMU proponents see things. To quote Mundell again:

> Without the supposed weapon of exchange rate policy, governments will in future have to stress reform of the microeconomic provisions that have protected the employed partly at the expense of the unemployed...there will be direct effects...from the increase in transparency of pricing in the labor market, which will foster increased awareness of Europe-wide labor market conditions, increase labor mobility and create pressures for convergence in pensions, unemployment benefits and taxes on labor.[23]

The critical question here, however, is whether the political awareness required to set such changes in motion will come before or after actual economic experience reveals their necessity. Since no European government is now responding with any vigor to the labor market sclerosis that already is so evident, continued inaction on this front looks rather likely in the first few years of the EMU.

International Monetary Arrangements

This *Commentary*'s basic argument has been that:

- the rigid labor markets of key EMU members are even now the source of much economic discomfort;
- the needed reform of those labor markets will be politically difficult, and is therefore likely to be put off until other methods of tackling unemployment have been tried and seen to fail;
- the terms of the Maastricht Treaty will prevent easy access to misguided monetary remedies, but will prove less robust against the deployment of inappropriate fiscal policies by national governments; and
- this will focus pressure on foreign exchange markets, the one place where the Maastricht Treaty leaves ultimate authority in the hands of politicians.

How these matters will play out, and with what consequences, is unknowable in advance. But it is possible to identify certain broad contingencies for which it might be worth planning.

The Politics of Monetary Policy Again

The most obvious risk to international monetary stability from the EMU is that European politicians will blame domestic macro- economic difficulties on “unregulated global markets” whose “untrammeled greed” and politically motivated desire to preserve “US hegemony” meshes with a perceived wish to discredit the “European model of a social market economy.” The European temptation in that case will be to view the exchange rate as an explicit tool of foreign policy.[24]

If events take such a turn, suggestions that the forces creating such problems must be curbed by international cooperation will come from an entity too large to simply be ignored elsewhere, not least in North America. This is not just a matter of the EU’s political influence. Any macroeconomic difficulties in Europe that create instability in euro exchange rates could disrupt the international monetary order. If Europeans wanted to open up discussions aimed at curbing these problems, the potential for new exchange rate volatility would give the United States and Japan strong incentives to accept their invitation to do so.

That EU representatives will be interested in formal international coordination is beyond doubt. In the words of Yves-Thibault de Silguy, the EU's Commissioner for Economic and Financial Affairs, "[t]he creation of the euro... offers Europe and the United States a unique opportunity to contribute jointly to the stabilization of the international monetary system."[25]

And Peter Bekx, head of the internal EU research group known as EMU: The International Dimension, has written:

> [t]he reduced degree of openness of the euro area, its lesser sensitivity to exchange-rate fluctuations and the increased impact of its economic policy at [the] world level have occasionally been cited in support of the suggestion that the euro area could adopt an attitude of "benign neglect" towards the euro's exchange rate. However, such an attitude would be at odds with Europe's experience of co-ordination. Moreover, it will continue to be in Europe's interest to avoid the negative effects of protracted misalignments. There will thus be a case for a continuous monitoring of exchange-rate developments and...for close international co-operation.[26]

Thus, the possibility of a new system of managed, or even fixed, exchange rates among major currencies is bound to be on the agenda of any future discussions. Furthermore, since the impetus is likely to come from a European failure to tackle domestic labor market problems, proposals for exchange rate management could even be linked to an attempt to secure international agreement on social policies in general and on labor market policies in particular. The latter would be presented as a way to create a level playing field and to eliminate "opportunities for social dumping" — in plain language, as a way to share with the rest of the world the cost of labor market rigidity in EMU member countries.

It is hard to believe that the United States, the other main player in all this, would want to be party to such an outcome. A political constituency for European-style social and labor market policies does exist there, in the same protectionist circles that have made further extension of free trade in the Americas so difficult, but the power needed to slow — or even to temporarily halt — the movement of policy in the direction of more openness is a good deal less than would be required to put things into reverse.

Aggressive use of protectionist measures by Europe against North America, however, perhaps combined with attempts to secure competitive advantage by manipulating the euro exchange rate, might well be enough to get negotiations going, even on these issues. How EMU members deal with any problems that arise *vis-à-vis* sterling will give early warning of what we might expect in this context. Box 4 discusses the special position of the United Kingdom, given its economic, political, and geographic proximity and sensitivity to EMU affairs.

The Benign Scenario Again

Even a smooth transition to the EMU will radically change the configuration of the international monetary system. The euro will be the currency of an economy whose annual output amounts to about one-sixth of total world GDP, not far short of the output of the United States.[27] The euro will be held not just as working balances by those involved in day-to-day transactions within Europe, but also, if its introduction goes smoothly and its trustworthiness is rapidly established, as a substantial part of the foreign exchange reserves of national central banks outside the EMU area, and as a liquid store of value by participants in capital markets worldwide.

If the euro begins to play the last-mentioned role on a large scale, it could become what Mundell calls a "Great Currency," and hence a close substitute for the US dollar in

Box 4: *The Position of the United Kingdom*

One feature of the EMU as it is to be configured deserves particular attention — namely, that the United Kingdom, along with Denmark, Sweden, and Greece, will not be a member, at least from the first round. Because of the United Kingdom's importance as an international financial center, the behavior of the euro-sterling exchange rate will be an object of early attention.[a]

Notwithstanding that a stable euro is at least as much in the United Kingdom's interest as it is in the interest of any other EU member, if the euro launch does not go well, it is difficult to imagine that the United Kingdom would engage, for example, in monetary tightening if such behavior were not congruent with domestic interests. The UK authorities' comparative freedom to pursue their own monetary targets would then lead to the accusation that they were taking "unfair" advantage of having a separate currency while claiming all the other privileges of EU membership. Such difficulties are particularly likely to arise between the United Kingdom and Ireland, for the latter will be an EMU member even as its trading relationship with the former remains particularly close.

Depending on how the currently embryonic arrangements among EMU members' governments for discussing and coordinating other aspects of macroeconomic policy develop, all this could threaten to isolate the United Kingdom politically within the EU.[b] EMU members clearly do perceive a need for macroeconomic policy coordination and have begun mapping the range of policy areas over which agreement among them might plausibly be reached. These areas already include harmonizing corporate taxation and may well be extended to personal taxation and to wage and social policy. These discussions may include the United Kingdom, but it is already clear that, where talks touch on exchange rate policy, EU members who are EMU outsiders are to be specifically excluded.

Whether the institutional framework surrounding the EMU would remain unamended as these events played out is hard to say, but difficulties along the way will affect not only the exchange rate between sterling and the euro, but also the exchange rates of the US dollar and the yen *vis-à-vis* the euro. Furthermore, the way EMU members deal with any difficulties over the euro–sterling exchange rate could give an early warning of the way these countries might approach problems within the broader international monetary system.

[a] Even now, the pound's strength is attributed in some quarters to its quality as a safe haven from an uncertain euro, rather than to a reflection of relatively high interest rates in the United Kingdom.

[b] For a discussion of the pros and cons of continued UK membership in the EU, see Brian Hyndley and Martine Howe, *Better Off Out? The Benefits and Costs of EU Membership*, Occasional Paper 99 (London: Institute of Economic Affairs, 1996).

a way that other currencies — the deutschmark or the yen, for example — never quite became. As Mundell points out, this possibility also poses stability problems for the international monetary system, because "the new Euro will create changes in currency preferences of central banks and other portfolio managers. Diversification effects are inevitable."[28]

These effects would put potentially severe downward pressure on the US dollar against the euro, a development that would be unwelcome in both the United States and Europe. As Mundell also notes, "it is unlikely that bilateral handling of the problem would be amicable. It would be safer to recognize that a problem will exist and create an institutional framework for dealing with it."[29]

In short, a successful and smooth transition to the EMU would also bring pressure, albeit of a different kind, for international monetary cooperation involving Europe and the United States. It would give Europe, to quote Mundell one last time, "greater influence in running the international monetary system."[30] That influence would be at the expense of the United States, and this transfer of economic power would move monetary arrangements smartly up the international political agenda.

Canada's Interest

It is inconceivable that Canada will play a major role in any of the above developments. Yet no matter how things play out, vital Canadian interests will obviously be at stake, if for no other reason than that the United States, to which Canada is closely tied through the free trade agreement, will be deeply involved. At the very least, Canada's exchange rate regime will be up for discussion yet again. There has always been a strong constituency in Canada for pegging the Canadian dollar on the US dollar, and that constituency will be heard from.

Macro- and Microharmonization

A high degree of convergence has been achieved between Canadian and US macroeconomic policy in recent years. To be sure, this convergence has grown out of domestic political and economic processes, rather than having been imposed by any international agreement. Even so, it has shifted the starting point for any future discussion of Canadian exchange rate policy. Arguments about the need for exchange rate flexibility in the face of apparently deep-seated divergences in underlying US and Canadian inflation rates and about the associated need for Canada to maintain control of its own domestic monetary policy, which, at the beginning of the 1990s, were in themselves sufficient to make the case for exchange rate flexibility, have now lost their overwhelming force.

On the other hand, any attempt to link discussions of social policy in general and of labor market "standards" in particular to that of the exchange rate regime will introduce a new element into the Canadian debate about such matters. As the preceding discussion probably makes clear, we are deeply uncomfortable about the prospect of any attempts by Europe to export its own problems by this route — not least to Canada, which has enough homegrown difficulties. At the same time, the difficulties in question are the outcome of political choices made in Canada, just as Europe's much greater difficulties are the outcome of choices made there, and just as the more flexible (though, in many eyes, less "humane") social infrastructure of the United States is the outcome of political choices made in that country.

There is no reason to believe that the institutional framework of the United States will remain unchanged over time or will always

C.D. Howe Institute Commentary© is a periodic analysis of, and commentary on, current public policy issues.

David Laidler is Professor of Economics at the University of Western Ontario and an Adjunct Scholar of the C.D. Howe Institute; Finn Poschmann is a Policy Analyst at the Institute. The text was copy edited by Riça Knight and prepared for publication by Wendy Longsworth and Barry A. Norris.

As with all Institute publications, the views expressed here are those of the authors, and do not necessarily reflect the opinions of the Institute's members or Board of Directors.

For publication orders, please contact: Renouf Publishing Co. Ltd, 5369 Canotek Rd., Unit 1, Ottawa K1J 9J3 (tel.: 613-745-2665; fax: 613-745-7660), Renouf's stores at 71½ Sparks St., Ottawa (tel.: 613-238-8985) and 12 Adelaide St. W., Toronto (tel.: 416-363-3171), or the C.D. Howe Institute, 125 Adelaide St. E., Toronto M5C 1L7 (tel.: 416-865-1904; fax: 416-865-1866; e-mail: cdhowe@cdhowe.org).

We also invite you to visit the Institute's Internet web site at: www.cdhowe.org.

Quotation with proper credit is permissible.

$9.00; ISBN 0-88806-439-X

change at the same pace or even in the same direction as that of Canada. Such differential changes would, it is worth recalling, be a species of "real shocks" that might require changes in the real exchange rate. This aspect of the case for Canada's retaining nominal exchange rate flexibility will therefore continue to carry much force in future.

Indeed, it may carry more force than in the past. If the United States begins serious negotiations with Europe about policy coordination, it will naturally pursue its own national interest, not Canada's. The outcome would no doubt impinge on Canada, and a flexible exchange rate would give the Canadian government a little more room to respond to whatever the local side-effects might be.

An Old Debate in a New Context

Our intention in this *Commentary* has been to draw attention to the strong possibility that future debate about Canada's exchange rate regime is likely to take place in a new context. Instead of being concerned mainly with Canada-US bilateral economic relations, the debate's next round will be part of broader discussions about the future of the international monetary system as a whole. That next round is also likely to give a new impetus to a tendency already at work in Canada, but much more advanced elsewhere, when international economic relationships are discussed — namely, to place on the agenda labor market and social policy questions that are usually regarded as purely domestic matters.

The changing context will arise not from domestic political and economic developments in Canada, but as a consequence of the monetary developments currently taking place in Europe. That is why the beginnings of the European Economic and Monetary Union and the launch of the euro should even now be attracting Canadians' serious attention.

Notes

We wish to thank, without implication, the following individuals who provided helpful comments and suggestions: Kenneth Boessenkool, John Crow, Angela Ferrante, John McCallum, William Robson, and Daniel Schwanen, as well as Charles Freedman, John Murray, and James Powell.

1 The EU estimates the potential gain from lower transaction costs to be on the scale of 0.4 percent of gross domestic product (GDP). See Commission of the European Union, *The Path to EMU and the Scenario for the Changeover to the Single Currency* (Brussels: The Commission, 1996).

2 To the extent that currency risk is in any event eliminated through transaction hedges, the reduction in the cost to borrowers is the just the cost of the hedge. But that the potential saving is large seems clear, given published estimates of the benefit of interest rate convergence ranging, perhaps implausibly,as high as 6 percent of GDP. Note that our discussion assumes away the possibility that a national currency risk — associated with the possibility that an EMU member could decide to leave the system and re-establish such a currency — will influence the market once the EMU is established. It is not clear to us that such a possibility should be totally discounted, so this estimate of the gains to be expected from interest rate convergence must be treated as an upper bound.

3 Pedro Schwartz, a thoughtful critic of the EMU, stresses the essentially political element in the EMU's creation and argues that the economic gains of European monetary integration could be realized through currency board arrangements. See Pedro Schwartz, *Back from the Brink: An Appeal to Fellow Europeans over Monetary Union*, IEA Occasional Paper 101 (London: Institute for Economic Affairs, 1997). Note that a currency board regime would involve somewhat higher transactions costs than would outright adoption of the deutschmark, and would also be easier to dismantle.

4 True, nineteenth-century Europe saw a number of currency reforms that were byproducts of political unification, the adoption of a new currency by the German Empire after the Franco-Prussian War being perhaps the most memorable. But these reforms took place against the background of commodity convertibility in a world where this was already the norm — in the case of the German Empire, there was a switch from silver to the gold standard — and thus provide no close precedent for the current European experiment.

5 The credibility issue is rather important to the German people, who have little to gain and much to lose: the Germans would be rather foolish to adopt a currency that would not function as well as the deutschmark. Interestingly, by March 1998, the number of Germans opposed to the EMU and the euro nevertheless had *dropped* to 51 percent ("Survey: 51% of Germans against Euro vs 58% in Jan — Report," Associated Press–Dow Jones News Service, March 13, 1998; http://www.wsj.com).

6 The Commission (officially the "Commission of the European Union") is the EU's permanent bureaucracy, administers the EU's affairs, and has considerable scope for designing and proposing policies. The Council (officially the "Council of the European Union"), which comprises the heads of state or government of member countries, is the main seat of political authority within the EU.

7 About half (0.5 percent of GDP) of France's deficit reduction between 1996 and 1997 resulted from a one-time payment by France Télécom to the central government, and all "one-off" measures contributed a total of 0.6 percent of GDP to the year's reduction in the deficit. European Monetary Institute, *Convergence Report* (Frankfurt-am-Main: EMI, March 1998), p. 64.

8 A variety of temporary revenue and expenditure measures, as well as accounting changes, reduced Italy's budgetary deficit by 1.1 percent of GDP in 1997 versus 1996 (ibid., p. 75).

9 Even so, one must be careful here of the *post hoc ergo propter hoc* fallacy. Over the same period, Canada has made significant progress on the inflation and deficit fronts without the stimulus of the Maastricht Treaty or any similar incentive.

10 The most notable example here in recent history was probably the extremely expansionary fiscal policy implemented in Ontario in the late 1980s by the Peterson government, and carried on for the first year of the Rae government, at a time when the federal government was attempting, however tentatively, to introduce fiscal restraint.

11 Notwithstanding the fact that it is the very lack of access to the printing press which relieves the euro of the currency risk otherwise facing lenders to national governments.

12 Such securities are among the list of assets eligible for purchase and sale by members of the European System of Central Banks. See European Monetary Institute, "Eligible Assets," in *The Single Monetary Policy in Stage Three: General Documentation of ECSB Monetary Policy Instruments and Procedures* (Frankfurt-am-Main: EMI, September 1997), pp. 37–46.

13 The seminal paper on this subject in modern literature is Michael Parkin and Robin Bade, "Central Bank Laws and Monetary Policy" (Department of Economics, University of Western Ontario, London, Ont., 1978), mimeographed. More recent contributions in-

clude Alex Cukierman, *Central Bank Strategy, Credibility, Independence: Theory and Evidence* (Cambridge, Mass.: MIT Press, 1991); and Otmar Issing, *Central Bank Independence and Monetary Stability* (London: Institute for Economic Affairs, 1993).

14 The provisions discussed below are all to be found in the Maastricht Treaty, Title VI, Chapter 3, "Institutional Provisions," pp. 399–400. See Council of the European Communities / Commission of the European Communities, *Treaty on European Union* (Luxembourg: Office for Official Publications, 1992).

15 Or so it seemed until early May 1998, when the European Council took the extraordinary step of appointing the bank's first president for an eight-year term — on the implicit condition that he step down in favor of another, already known, appointee after four years. This does not augur well for the ECB's independence from EU politics in its early years.

16 The way Maastricht divides responsibility for exchange rate policy between political authorities and the ECB has also been noted by Samuel Brittan, "A Cool Look at the Euro," Occasional Paper 53 (Edinburgh: David Hume Institute, 1997), especially pp. 27–28. For political authorities to retain more influence over exchange rate policy than over other monetary measures is not unusual: this is the case in Canada, for example. But the European situation is unusual, because the EU's central political authorities have such sharply limited fiscal policy tools at their disposal that exchange rate policy is not merely the only monetary weapon but also the only macroeconomic weapon in their armory.

17 This, at least, will be the state of affairs at the outset of EMU. But the EU is continuously evolving, and some commentators see the Stability and Growth Pact as a tentative step in the direction of "fiscal federalism" in Europe. See, for example, Nils Thygessen, "Should Budgetary Policies Be Coordinated Further in Economic and Monetary Union — and Is That Feasible?" *Banca Nazionale del Lavoro Review*, Special Issue, "European Monetary Union: The Problems of Transition to a Single Currency" (March 1996), pp. 5–32.

18 "Interview: Jean-Claude Trichet," *Central Banking* 7 (Winter 1997–98): 13.

19 International Monetary Fund, "Crisis in Asia: Regional and Global Implications," *World Economic Outlook — Interim Assessment December 1997* (Washington, DC: IMF, 1997), p. 68.

20 See Robert Mundell, "The case for the euro — I," *Wall Street Journal*, Interactive Edition, March 24, 1998, http: / / www.wsj.com.

21 The obvious example is French legislation shortening the standard work week, having passed second reading not long ago, which goes beyond the requirements of the EU's Working Time Directive (see Council of the European Union, *Directive 93/104/EC on Certain Aspects of the Organisation of Working Time: OJ L 307, 1993*, Bulletin 11-1993 [Brussels, 1993]). Similar legislation in Italy is high on the list of demands of major unions and has the support of the Refounded Communists, a fairly powerful combination of interests in that country.

22 The next German finance minister, should the SPD form the government after the September 1998 elections, will likely be Oskar Lafontaine, who has said that the EMU must be accompanied by agreement on fiscal and economic measures to promote employment, environmentally friendly growth, and social welfare protection. See Peter Norman, "Germany: Court rejects challenge," *Financial Times*, April 3, 1998; http: / / www.ft.com.

23 Mundell, "The case for the euro — I."

24 We do not believe that such a possibility is altogether far-fetched. No less a personage than French president Jacques Chirac has recently been quoted as saying: "In giving considerable monetary force to Europe, [the euro] will allow it to fight better in the world to defend its interests." See Alan R. Katz, "Chirac, Strauss-Kahn both say euro to aid Europe, France," *Wall Street Journal*, Interactive Edition, March 25, 1998; http: / / www.wsj.com.

25 Yves-Thibault de Silguy, Address to the Institute of International Finance, Washington, DC, April 29, 1997.

26 Peter Bekx, Notes for an Address at the Marriott Hotel, Toronto, April 30, 1998, pp. 6–7.

27 The Organisation for Economic Co-operation and Development (OECD) puts total EU GDP at US$8.1 trillion for 1997; for EMU members only, the figure is US$6.3 trillion, as opposed to an estimated US$7.8 trillion for the United States. Note that numerous other European and African countries, outside both the euro area and the EU, will peg currencies to the euro. See *OECD Economic Outlook* 62 (Paris: OECD, December 1997), electronic data.

28 See Robert Mundell, "The case for the euro — II," *Wall Street Journal*, Interactive Edition, March 25, 1998; http: / / www.wsj.com.

29 Ibid.

30 Ibid.

Recent C.D. Howe Institute Publications

Mathewson, G. Frank, and Neil C. Quigley. *Canadian Bank Mergers: Efficiency and Consumer Gain versus Market Power.* C.D. Howe Institute Commentary 108 (June 1998). 32 pp.; $9.00.

Oreopoulos, Philip, and François Vaillancourt. *Taxes, Transfers, and Generations in Canada: Who Gains and Who Loses from the Demographic Transition*. C.D. Howe Institute Commentary 107 (June 1998). 24 pp.; $9.00.

Gunderson, Morley. *Flexible Retirement as an Alternative to 65 and Out*. C.D. Howe Institute Commentary 106 (May 1998). 16 pp.; $9.00.

Robson, William B.P. "Earning Ontario's Fiscal Dividend: Long-Term Programs and Payoffs." *Backgrounder* (April 30, 1998). Free of charge.

Poschmann, Finn. *Where the Money Goes: The Distribution of Taxes and Benefits in Canada.* C.D. Howe Institute Commentary 105 (April 1998). 28 pp.; $9.00.

Simeon, Richard. *Limits to Partnership: Canada-Quebec Relations in a Postsecession Era.* C.D. Howe Institute Commentary 104 (March 1998). 24 pp.; $9.00.

Robson, William B.P. "Making Ponzi a Prudent Man: Establishing the CPP Investment Board." *Backgrounder* (March 30, 1998). Free of charge.

Davies, James B. *Marginal Tax Rates in Canada: High and Getting Higher.* C.D. Howe Institute Commentary 103 (March 1998). 24 pp.; $9.00.

Laidler, David, and William B.P. Robson. *Walking the Tightrope: Canada's Financial System between a "Yes" Vote and Quebec Secession*. C.D. Howe Institute Commentary 102 (March 1998). 24 pp.; $9.00.

Boessenkool, Kenneth J. "The 1998 Budget: Falling Behind on Debt Reduction." *Backgrounder* (February 25, 1998). Free of charge.

Poschmann, Finn. "How Do I Tax Thee? Choices Made on Federal Income Taxes." *Backgrounder* (February 25, 1998). Free of charge.

Robson, William B.P. "Debt, Taxes, and Spending: Three Lessons for the Upcoming Federal Budget." *Backgrounder* (February 16, 1998). Free of charge.

Neave, Edwin H., and Frank Milne. *Revising Canada's Financial Regulation: Analyses and Recommendations*. C.D. Howe Institute Commentary 101 (February 1998). 36 pp.; $6.00.

Robson, William B.P. "How Not to Get Hit by a Falling Dollar: Why the Plunging Canadian Dollar Need Not Usher in a Slump." *Backgrounder* (January 26, 1998). Free of charge.

Richards, John. *Retooling the Welfare State: What's Right, What's Wrong, What's to Be Done*. Policy Study 31 (January 1998). 304 pp.; $18.95.

Robson, William B.P., and William M. Scarth. *Out Front on Federal Debt Reduction: Programs and Payoffs.* C.D. Howe Institute Commentary 100 (November 1997). 24 pp.; $6.00.

Laidler, David E.W. "The Unnatural NAIRU." *Backgrounder* (November 4, 1997). Free of charge.

Schwanen, Daniel. *Confronting the Greenhouse Challenge: Matching Protection with Risk.* C.D. Howe Institute Commentary 99 (October 1997). 36 pp.; $6.00.

Slater, David W. *Prudence and Performance: Managing the Proposed CPP Investment Board.* C.D. Howe Institute Commentary 98 (October 1997). 32 pp.; $6.00.

Robson, William B.P. *The Future of Pension Policy: Individual Responsibility and State Support*, and *A BNAC Policy Statement on Pension Reform*. British-North American Committee 41. 20 pp.; $9.00.

Robson, William B.P. "The Paradox of the Fiscal Dividend: The Bigger It Looks, the Smaller It Gets." *Backgrounder* (October 7, 1997). Free of charge.

Russell, Peter, and Bruce Ryder. *Ratifying a Postreferendum Agreement on Quebec Sovereignty*. C.D. Howe Institute Commentary 97 (October 1997). 28 pp.; $6.00.