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Europe at the crossroads

I shall be telling this with a sigh
Somewhere ages and ages hence:
Two roads diverged in a wood, and I—
I took the one less traveled by,
And that has made all the difference.

—Robert Frost, "The Road Not Taken"

Economic and political integration in Western Europe has been more successful than could have been imagined at the end of World War II. It is perhaps a symptom of our frenetic times that this success could be viewed as in serious trouble after hitting a few bumps in the road during the past year. Prior to World War II, unity in Europe was usually the result of conquest or the creation of alliances in an attempt to fend off conquest. Post-World War II Western European integration, on the other hand, has been based on the voluntary accord of the participants. Yet, in some sense this integration harkens back to yesteryear, because its impetus was largely based on the post-war reaction of the Western allies to that war and to the emergence of the Soviet bloc threat. The receding of the Soviet threat has left the nations of Europe much freer to define and follow their own destinies, but it has also stripped the European integration process of a powerful unifying force.

The most recent milestone in the European Community's (EC) integration process—the Maastricht treaty—has become a major focus of debate within Western Europe. The breadth of this 1991 agreement has magnified issues of national, political, and economic sovereignty and generated widespread concern about the future of a united Europe. This treaty is designed to push the envelope of the integration process, moving the European Community toward increased economic and political integration by setting a schedule for the adoption of common policies on foreign affairs and defense issues and common policies on social issues, such as working conditions in labor markets. It also expands the powers of the elected European Parliament over environmental, educational, and consumer issues. Most controversial among the provisions of the agreement, however, is the ambitious schedule for establishing monetary union—a unified EC central bank and a common Community currency—by 1999.

Vigorous opposition to the Maastricht treaty from many quarters has made the future of European integration uncertain—at least so far as monetary unification and a common currency are concerned. But such arguments tend to oversimplify the complexity of the unification arrangements and interdependencies that have evolved within Europe during the last 40 years and ignore an important, but often missed factor in the European integration process—the Soviet bloc.

As this *Fed Letter* article will argue, the recent concern about EC viability is a mistake of focus and perspective. The current difficulties grow out of a few specific, albeit controversial, provisions of one treaty. Unquestionably, there are difficult choices to be made that will have important long-term consequences for Europe, as well as the rest of the world. But the members of the EC, and the EC as an entity, have experienced an extensive political, social, and economic evolution during the past three decades. When placed in the broad context of this historical development, today's problems, as they relate to Maastricht, are more like wavelets in a pond during a summer storm than rough seas whipped up by a North Atlantic gale.

Western Europe comes together

The devastation from World War II in a Europe barely recovered from the trauma of World War I made it imperative that former opponents come together in a cooperative structure to facilitate the reconstruction process. In part, the need for cooperation among the Western European states reflected the Allies' desire to see Europe reconstituted in such a way that Germany would not dominate the region again. But, in addition, another threat arose almost immediately after the war's end—the dominant influence of the USSR in Central Europe.

As the first step in this process of cooperation, the Organization for European Economic Cooperation was established in 1948, now known as the Organization for Economic Cooperation and Development(OECD), to implement the U.S. inspired Marshall Plan reconstruction. In 1949, the North Atlantic Treaty Organization (NATO) was organized as a mutual defense pact among most of the Western European nations and the United States and Canada. Then in 1951, Belgium, France, West Germany, Italy, Luxembourg, and the Netherlands signed a treaty implementing a plan, inspired by French Foreign Minister Robert Schuman, to pool the resources of the French and German coal and steel industries to form a "common market" in those industries. This was a first tentative step in Europe's experiment with economic integration—the European Coal and Steel Community. In 1957, the six members of the Coal and Steel Community broadened the common market concept in the Treaty of Rome, which created the European Community.

Not only did formation of the EC result in a reduction in restrictions on trade between members, it began the process of setting *common trade restrictions against* *nonmembers.* In other words, participating members gave up their sovereign rights to impose external tariffs—a key step forward in the process of economic and political integration.

During the ensuing years the integration process continued. The adoption of an agricultural policy that was common across borders rather than nationally unique was a significant step toward integration of the member economies. The participation of the EC as a single entity representing its member states in the multinational GATT tariff negotiations was another important step in the integration process. In 1973, members tied their currencies' exchange rates together in a "joint float" against the dollar. And in 1973, Denmark, Ireland, and the United Kingdom joined the EC. In 1981, Greece joined. Then in 1987, Spain and Portugal became members, bringing the current membership to 12. In 1992, Austria, Finland, Norway, and Sweden applied for membership and negotiations toward that end are progressing.

In 1985, the Community laid out a major blueprint for future integration. The EC Commission issued a "white paper" setting forth goals aimed at shaping the EC for the twenty-first century. Members of the EC envision: 1) economic integration of their economies by making the EC a "single market," from a commercial as well as a legal perspective; 2) the integration of financial markets; 3) a common European citizenship; and 4) unified monetary and fiscal policies, including the creation of a common currency.

Most of these goals are scheduled to be met by the year 2000. Impressively, many of the goals associated with the creation of a single EC market and the integration of commercial, financial, and cross-border markets were met with the implementation of the EC's "Europe 1992" plan, which went into effect at the beginning of this year.

Losing a helpful prod

Another economic and political force was also at play at the same time that Western Europe was moving toward economic and political integration. That force—the Soviet bloc—critically influenced the face of Europe during the last four decades. Moreover, the degree of that influence has been accentuated by virtue of its recent demise.

In 1949, under the auspices of the USSR, the Committee on Mutual Economic Cooperation (COMECON—an Eastern/Central European trading bloc) was established. This was followed in 1955 by the formation of the Warsaw Pact—a mutual defense arrangement for the Eastern/Central European Soviet bloc that paralleled the West's NATO. Although COMECON was never a serious economic competitor with Western Europe, the political and military threat of the Warsaw Pact cast a long shadow over Western Europe.

The drive toward integration in Western Europe was fueled, importantly, by fear of the political and military strength of the Soviet bloc. The common threat of the Soviet bloc served to unify the EC during the first 30 years of its existence. By the same token, the recent disintegration of that bloc has diffused the focus of Western Europe in several ways. First, the common external threat now seems much reduced. Second, West Germany has played a major role in the process of European integration, but with the unexpectedly difficult and expensive reunification of West and East Germany, that role has been diluted as its attention has been diverted inward. Third, some Europeans, already apprehensive about German dominance of a unified Europe, are even more apprehensive of a larger and potentially more powerful unified Germany. Finally, the historic issue of national sovereignty in Central and Eastern Europe, suppressed during the USSR's domination of that area, was rekindled with the dissolution of the Soviet bloc. In a parallel development, important for the process of European integration, long dormant issues of national sovereignty were also reopened for many Western Europeans in the absence of the Soviet threat.

The rush to monetary union

While the fragmentation of Central and Eastern Europe has complicated the integration process, most of the concern about the future of European integration centers on older issues, most specifically monetary integration. Arguments alluding to the "falling apart of EC integration" have focused heavily on whether the Maastricht goals that center on monetary integration will be reached on schedule. Arguably this is one of the most difficult components of the integration process, even though Western Europe has been moving toward monetary integration since the introduction in 1973 of the European Monetary System.

During the early years of the EC, international currency markets operated under post-World War II Bretton Woods Agreement. The exchange value of a country's currency was "fixed" in terms of the U.S. dollar. In August 1971, this fixed exchange rate system began to break down and by March 1973 the U.S. dollar link with gold was severed and the exchange rate value of the dollar was set "afloat." At that time the EC made a significant decision. Six of its nine members formed the European Monetary System (EMS)—a joint float against the dollar—holding their currencies in a fixed relationship with each other while allowing their "bundle" to float against the dollar. Here was the kernel of a common monetary policy.

Almost 20 years after the creation of the EMS, a significant component of the Maastricht agreement took monetary integration a giant step farther. This provision contained an explicit time table for the creation of a unified central bank and the adoption of a common EC currency. Initially, attainment of these goals, even ahead of the 1999 scheduled date, seemed a real possibility. But in mid-1992, the Danish electorate rejected the Maastricht agreement in a popular referendum. This resulted in the negotiation of a much watered down version, as it applied to Denmark, which was accepted in May of this year. In September 1992, the French electorate accepted Maastricht, but only by a slim margin.

At this writing, the German government faces a constitutional court challenge to its acceptance of the Maastricht accord (over the specific issue of the abrogation of German *sovereignty* if national functions, e.g., monetary policy, are allowed to be ruled by an outside body, i.e., the EC). The U.K. deferred its final vote on Maastricht until after Denmark's second referendum vote. Although Maastricht appears likely to survive, it no longer possesses the life or the stature of early 1992.

Monetary union identifies for Europeans, more clearly than any other issue to date, the implications of supranational versus national power. It defines where the ultimate political and economic power resides—"foreigners" making decisions that affect home prices, employment, output, and the like. National sovereignty issues have long been a major stumbling bloc that has thwarted European attempts at cooperation, to say nothing of unity. In the absence of the external pressures exerted by the Soviet bloc, the subjugation of national policy to a supranational authority has become an even more poignant issue for the EC.

Even without a formal unified monetary system Europeans are getting a taste of what losing monetary autonomy means under the existing joint float mechanism. Since the East/West unification, Germany, with the dominant currency in the EC, has pursued a tight monetary policy in an attempt to hold in check inflationary pressures associated with the domestic monetary aspects of its unification. In order for other European currencies to remain tied in a fixed exchange rate relationship to the German mark the other governments have been forced to run tight monetary policies. The result? Not only is the German economy in serious recession, virtually all of Europe is in recession. In the attempt to break free from the restrictive German policy, the U.K. temporarily opted out of tying its exchange rate to the mark last fall, as did Italy. Spain and Portugal have had multiple devaluations of their currencies since the fall of 1992, and EC aspirants Finland and Sweden broke the link with the mark. Not only is the German economy paying the price of its unification policies, but so is the rest of Europe—the price of a common monetary policy, explicit or not.

In recent years many Europeans have looked to the Federal Reserve System as a model for a European Central Bank. Interest has centered on the District orientation of the Federal Reserve and an implicit question: Can individual countries (regions) maintain sufficient autonomy to conduct monetary policy within the framework of a unified central bank? (Again, the issue of regional sovereignty.) In fact, regions *can not* follow monetary policies independent of national policy. In a unified monetary system, be it the United States or a united Europe, a tight monetary policy nationally is a tight monetary policy regionally. There may be different economic consequences, depending upon the different structures of the regional economies, but there is only one policy.

Monetary integration implies relinquishing regional sovereignty. A weak housing market in the U.K., for example, might benefit from lower interest rates initiated by a central European monetary authority, but the monetary authority (possibly dominated by continental members) might view rising prices as a more serious threat for the Community overall, and consequently raise interest rates, a negative to the British housing industry. After centuries of building and defending their national identities, to lose this kind of sovereignty is a hard pill to swallow for many Europeans. In this regard, it is instructive to remember that the United States did not have a successful central bank until 1914, nearly 140 years *after* becoming one nation, and that numerous currencies circulated in the U.S. during the late 1700s and throughout most of the 1800s.

A look to the future

To some, the possibility of a unified Europe may seem to be a pipe dream. But over the last three decades the EC has made great strides in integrating the economies of its members. Reduced barriers to trade, the elimination of border controls, relaxed restrictions on capital movements, acceptance of other member's product and testing standards, are developments that, among others, are relatively easy to implement without individual countries having to give up large chunks of autonomy. In short, much of the real sector and financial market integration leading to a united Europe has been accomplished or is well on its way toward being put in place. After centuries of trying, an extensive degree of European integration is a reality.

The recent hesitance to move rapidly onward in the advanced stages of the integration process reflects the reality that the easy parts of the integration process are largely completed and that the external motivation to move forward—the Soviet bloc—has largely dissipated. The next major, and perhaps the most difficult, stage in the process will require the giving up of big chunks of national sovereignty by submitting national economies to an increasingly powerful supranational authority. In an environment now lacking the external prod of the Soviet bloc and facing the structural changes taking place in Eastern and Central Europe and in Germany, the early rush to EC monetary union was faster than could reasonably be sustained. Progress toward that end will surely be more cautious during the next few years. That more cautious approach should not be cause for concern.

—Jack L. Hervey

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Tracking Midwest manufacturing activity

Manufacturing output index (1987=100)

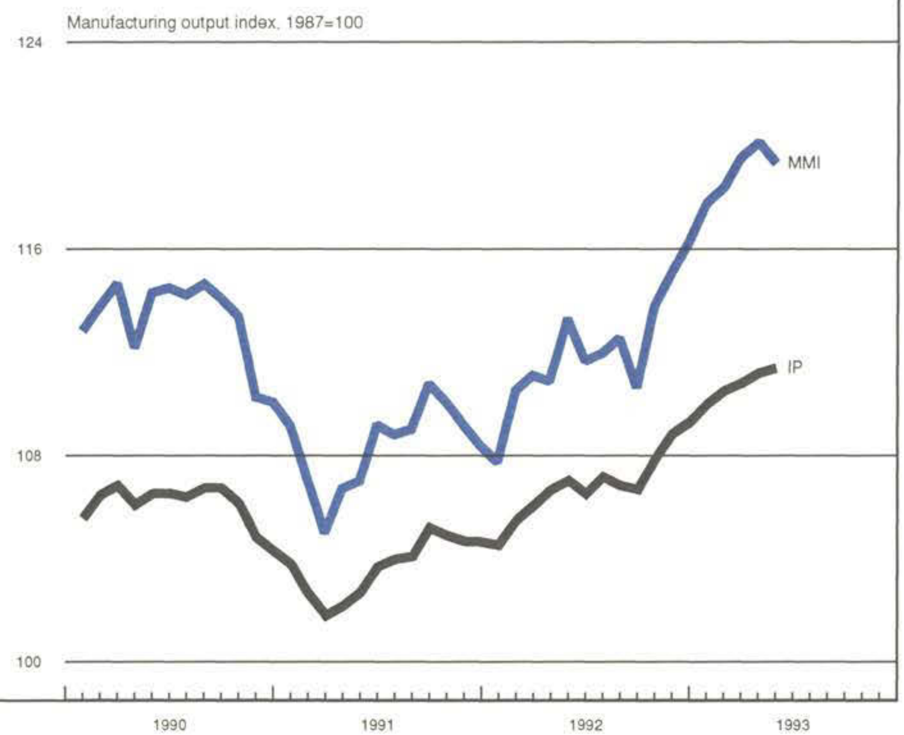
	May	Month ago	Year ago
MMI	119.3	120.2	113.4
IP	111.4	111.2	107.1

Motor vehicle production (millions, saar)

	June	Month ago	Year ago
Cars	5.8	6.0	6.0
Light trucks	4.2	4.1	3.6

Purchasing Managers' Surveys: production index

	June	Month ago	Year ago
MW	59.1	59.7	60.6
U.S.	51.2	55.8	56.4



Manufacturing activity in the Midwest declined 0.7% in May, the first decline since September 1992. Nationally, manufacturing activity continued to expand, although durable goods manufacturing increased by only 0.1% during the month. However, purchasing managers' surveys—both in the District and the nation—continue to indicate expanding activity.

Sources of weakness in the MMI were widely distributed among durable and non-durable goods industries. Transportation equipment, fabricated metals, and food processing industries were the major contributors to the overall decline in May. The weakness in the transportation equipment industry follows a decline in auto assemblies in the second quarter of this year. Recent production plans indicate that this trend should turn around in the third quarter.

SOURCES: The Midwest Manufacturing Index (MMI) is a composite index of 15 industries, based on monthly hours worked and kilowatt hours. IP represents the FRBB industrial production index for the U.S. manufacturing sector. Autos and light trucks are measured in annualized physical units, using seasonal adjustments developed by the Federal Reserve Board. The PMA index for the U.S. is the production components from the NPMA survey and for the Midwest is a weighted average of the production components from the Chicago, Detroit, and Milwaukee PMA survey, with assistance from Bishop Associates and Comerica.

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