

# EU-U.S. RELATIONS AND EUROPEAN ECONOMIC AND MONETARY UNION

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**A**s the European Economic and Monetary Union (EMU) story continues to unfold within a turbulent international economic context, the debate between supporters and detractors of the new European currency, the euro, is focusing less on internal European Union (EU) policies and more on the economic and political effects of EMU on the EU's external relations.

International criticism of the relative silence of European authorities in response to the devastating effects of the Asian and Russian crises was the first hint of this shift. Apart from a few exceptions—for example, Finland was more affected by the troubles in Russia and Asia than other EU countries<sup>1</sup>—the economies of the member states of EMU have not been badly affected by the crisis. Trade flows within Europe and with Europe's main trading partner, the United States, were not disrupted and there were no vociferous claims for action from powerful pressure groups within Europe. Furthermore, the contractual agreements between the EU and the Association of South East Asian Nations (ASEAN) and between the EU and Russia continue to provide a framework for long-lasting cooperation. This apparent stability makes it important to comprehend the real implications of the European Monetary Union for the world economic system.

It is difficult to understand how Europe could appear to be so indifferent to worldwide turmoil. European leaders and the press were in fact more preoccupied with the size, shape and color of the future bank notes than with the alarming news of the daily toll of bankruptcies in the financial sector in Asia. Was Rome fiddling while the world burnt?

Commentary

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1998 will be remembered as a high profile year for the as yet unborn currency. In the course of one year, the currency gained credibility and support both inside and outside Europe. On May 2, the long-awaited results of the amniocentesis were released: 11 countries met the criteria and would adopt the euro. The embryo of the new money was viable. In September it grew steadily in credibility as "mother Euroland" kept out of financial turmoil. Three months before the birth of the euro, no less than the *Financial Times* was moved to praise "the money which will overnight become one of the world's most powerful mediums of exchange."<sup>2</sup>

Away from the turbulence and excitement of the present, the question that should be addressed in this article is: does the new European currency have the potential to become a stabilizing factor for the world economy? Initially, it is worth recalling some of the ideas on the future role of EMU as foreseen by the Forward Studies team in the European Commission<sup>3</sup> a few months ago. Second, the need for a positive EU-U.S. relationship for the success of EMU has to be addressed. Finally, one needs to look at some of the new global responsibilities of the EU with regard to the burden-sharing claim of the U.S. authorities.

#### FROM GEOECONOMICS TO GEOPOLITICS

Let us assume the following scenario: the Monetary Union is successfully established. Most or all EU member states are part of EMU and the European economies remain on track with falling unemployment rates fall, and the euro begins to consolidate its role as an important international trading and reserve currency.

This is the initial assumption that a small group of officials from the external relations and economic and monetary affairs services of the European Commission has made. Under the responsibility of the Forward Studies Unit,<sup>4</sup> this group contributed background papers and participated in a series of brainstorming meetings. Their mandate was to look at the possible medium to long-term impact that EMU would, over time, have on the international balance of economic and political power. The group hoped to create a better understanding of possible changes and to formulate policy recommendations in response to the emergence of the euro.

There was a unanimous feeling in the group that EMU could bring changes to the international balance of economic and political power and that it would intensify developments that are already under way, rather than trigger completely new trends. The three interrelated major trends

the group identified were the increased visibility of the European Union in the international institutional system, the alteration of the balance in the trilateral relationship between the EU, the United States and Japan and possible effects on bilateral relations with other important partners of the EU, such as Russia, South East Asian countries and India.

The analysis behind these assumptions and the possible consequences identified were the following: the most direct global geo-economic impact of EMU will be that in the long run the euro will become a major world currency. Given the stability-oriented policies of the European Central Bank, most analysts predict a gradual but widespread diversification of other central banks' euro-denominated reserves and private financial assets. They also anticipate greater use of the euro in the currency baskets that third countries use as an exchange rate peg. It was assumed that this diversification would also increasingly involve the yen. Thus, the international monetary regime at the beginning of the twenty-first century will be inherently different from the post-Second World War monetary regime, both in a specific and in a general way.

The specific change will be the introduction of a new currency, the euro, into the international monetary regime. Due to the relative size of the U.S. and the EU economies, their shares in global trade, their relative independence from external constraints and the breadth, depth and liquidity of their capital markets, the U.S. dollar and the euro will be the most important currencies in the monetary regime.

A general change which has been underway for some time is that key world currencies in the twenty-first century will not be the same as in the 1950s. Power has diffused in the international system away from political actors toward more private actors in the global financial markets. A more complex set of relations between the political authorities and the markets is developing. Thus, the addition of one new key currency, the euro, will alter the economic and political power gained from holding a key currency. In other words, although we may see the emergence of a bi or multi-currency regime, this will not necessarily result in a simple diffusion of the rights and responsibilities among the countries holding these currencies. Their roles are likely to change in nature because of a shift in their influences within the whole system.

Tangible institutional means, through which the rebalancing of political power and influence will be mediated, are based on several factors. The United States will experience increasing difficulties in financing persistent external deficits. This could constrain U.S. foreign policy and defense capacity and accelerate the gradual erosion of its singular leadership. An increased weight of the EU in the international financial institu-

tions, irrespective of the precise form of its participation, should lead to an enhanced European capacity to influence decisions and to exert leverage. Spillover effects to nonfinancial areas could take place through an enhanced visibility or cohesion of the EU in various United Nations (UN) bodies and in nonmonetary multilateral institutions such as the World Trade Organization (WTO) or the Group of Seven (G-7), the forum for policy cooperation between the world's seven largest economic powers.

The place of the euro in the EU's external policy will be different from the part played in the past by the dollar in U.S. foreign policy. Historically, the dominant position of the U.S. currency has allowed the United States not only to underwrite its economic and strategic supremacy, but has also, on occasion, provided it with a direct policy instrument for promoting specific foreign policy objectives. Already now, and the more so in future, such direct leverage will be even less available to the monetary powers.

The impact of the Monetary Union on the EU's relations with the outside world will also be felt through a number of important indirect and psychological effects, which could play both on the internal strength of the EU and on the nature of its international role. First, EMU will enhance the collective nature of the European Union and its member states and sharpen its image as a distinct economic, as well political, entity on the world scene. This more unified political face, together with enhanced clout in economic terms, can be expected to place the EU higher on the political agenda of third countries who so far perceive the EU only as an economic partner. It could also deepen the political dimension of the dialogue with the United States. Second, the direct and indirect impact of EMU on third countries, particularly on developing countries, could be substantial. The enhanced weight of the EU and the greater availability of funds could, in the medium term, reinforce its capacity to fund activities in areas as diverse as development policy, humanitarian intervention, peacekeeping or environmental protection. Finally, it is felt that the success of EMU venture should also be an important moral booster for the EU and serve to highlight the common interests of the member states, making it easier to develop the political and security dimension of the EU's external policies

#### **PARTNERSHIP OR LEADERSHIP?**

It is necessary to add a note of pessimism to the rather rosy picture of the euro in the midst of the financial crisis, in which European currencies were generally less affected. The example of Norway, where the central

bank was forced to abandon the Norwegian Krone's fixed peg despite heavy intervention by the central bank, is one of the examples used to argue that the single money was insulating the European Union from financial instability outside. The idea here is not to rehearse all the failure scenarios, including violent conflict and war, which have been brought to the public's attention since the euro has become a possible and then a viable option. However, even though the coordination of economic policies leading to the single money has already won a number of battles, i.e. on inflation and fiscal deficits, and seems to be increasingly supported by political will and positive reactions of the markets, the enterprise is still fragile and certainly very sensitive to the global environment.

One of the most obvious difficulties is slower-than-expected economic growth in Europe, which could exacerbate existing tensions and hamper the fight against unemployment that was slowly starting to yield results. Much has been said about the reduced margin of maneuver that individual member states of the EU will now have to solve potentially explosive questions, such as unemployment or the reform of outdated social security systems. Amartya Sen, the 1998 Nobel prize laureate in economics, is only one of the analysts questioning the compatibility of the European Central Bank's primary objective of monetary stability with the reduction of tensions in European society derived from heterogeneous and often rigid labor markets and social traditions.

So far, close cooperation and a large amount of flexibility in negotiations between European governments have helped to overcome the major hurdles in the final months before the single currency comes into effect. In this context, the results of the recent German elections and the government change in Italy seem to have reinforced the degree of cohesion and the political will of European leaders. Such was the impression after the first euro appearance of Gerard Schroeder and Massimo D'Alema at the informal Summit of Pörschach, Austria on October 24 and 25, 1998.<sup>5</sup>

Are these developments a good omen? The answer is yes and no. From a strictly European view, the answer is yes, since the challenges facing the EU will impact on the success of the euro. Unemployment, EU enlargement to Eastern Europe, institutional and fiscal reforms and common defense and security issues could be less difficult to resolve with a younger and more homogeneous political class relying on the large baby-boom generation for its legitimacy.

From a global perspective, the balance that could emerge from a better sharing of responsibilities between leading currencies is far from achieved. Certainly, influential actors in Europe, Asia and the United States

foresee the beneficial effect of having a less lopsided international financial system. As the London *Financial Times* recently put it: "Many central banks in Asia are expected to switch some of their reserves into euros to achieve a more balanced portfolio that is more in tune with their trade flows."<sup>6</sup>

However, the stabilizing effect of the euro will ultimately depend on the U.S. attitude. Confronted with the vast and multifaceted challenge to have to share some of its traditionally unrivaled leadership with another player, the United States could react in a way that would be consistent with the qualities of modern leadership that are taught in its most advanced business schools or universities: "leadership is not control, it is about respecting and taking advantage of the intelligence of others around you and working together to create innovation."<sup>7</sup>

Yet, vested economic interests and historical precedent could influence a less consensual attitude. When, at the end of the 1980s, U.S. businesses started to feel threatened by the formidable growth of the Japanese economy, a policy of depreciation of the dollar helped firms to regain considerable market share and sustain stable growth of the U.S. economy, while a strong Yen aggravated the conditions in Japan and led to the downturn of the Japanese economy. One might wonder whether the United States would encourage monetary depreciation in the same way against the euro in the twenty-first century.

Today, the underlying economic connection between the European Union and the United States is strong and compelling. Transatlantic trade, mainly in services, counts for almost one third of the trade flows of both partners, and despite occasional disputes on certain products or services, the trade balance is fairly established with no permanent strong advantages or disadvantages for either side. Fifty percent of foreign investment in the United States originates in EU countries—this represents three million jobs, and the largest share of non-EU foreign direct investment in the EU comes from the United States, which represents forty percent of U.S. investments abroad. These economic ties create a strong network of common interests.

The New Transatlantic Agenda that was signed in December 1995 has expanded cooperation to wider issues such as a common EU-U.S. commitment to promote peace and democracy, to respond to global challenges like crime and drugs, to expand world trade and to build bridges between European and U.S. citizens. The U.S. government is officially supportive of EMU. Larry Summers, deputy U.S. Treasury secretary, commented: "The more the single currency helps Europe develop a robust and healthy economy open to world markets, the more welcome the project will be on this side of the Atlantic. If EMU works for Europe, it will work for us."<sup>8</sup>

However, the real test will be how EMU impacts U.S. companies both within and outside Europe. Large U.S. corporations may win market shares in Europe, given their lower cost base and their proved ability to work in a single market. However, will this compensate for their losses on the Asian and South American markets? Will the increasingly influential small and medium-size sector be able to cope with the changes?<sup>9</sup> Tensions that could arise between the United States and the EU and that would prompt the use of monetary arms—for example a weak dollar—could certainly create a long-lasting handicap for the regulatory role of the euro. Pressure could be particularly heavy on the U.S. side in the near future as the U.S. economy becomes more deeply affected by the Asian downturn and seems to reach the end of a glorious cycle. Lower prosperity is often countered by an exacerbation of national feelings, which could create pressure in the Congress for an assertion of superiority on the global scene.

### **A RESPONSIBLE INTERNATIONAL AGENDA**

The Economic and Monetary Union is likely to bring some direct but also some less obvious responsibilities to the EU in response to the burden-sharing claim of U.S. authorities. They are likely to require some policy changes, as well as increased cooperation among the most influential players.

**MONETARY STABILITY AND POLITICAL RESPONSIBILITY.** Tighter monetary links between the EU and third countries will impose on the EU the obligation to consider the implications of its economic policy decisions on the rest of the world. EU officials have in the past repeatedly exhorted the United States to show more responsibility toward others. The U.S. government can expect no less after the euro has acquired the status of a key global currency. Tensions could arise from the independent status of the European Central Bank and its commitment to price stability. Hence, there may be no narrow monetary responses to demands on the EU, and responsibilities would have to be fulfilled in other ways.

**THE MANAGEMENT OF ECONOMIC GLOBALIZATION.**<sup>10</sup> The demands on the EU, both by its member states and third countries to take a more ambitious role in international economic organizations will increase. Its capacity to take the lead in promoting a deepening of multilateral cooperation will be enhanced. EMU, which has successfully coordinated the economic policies of its member states, will be in a good position to

facilitate macroeconomic policy coordination among the major international economies. The EU's capacity to respond to financial crises will also be strengthened.

**RESPONSIBILITY TOWARDS DEVELOPING COUNTRIES.** Beyond the benefits that could emerge from increased growth and stability, EMU should allow the EU to play a more effective role in promoting efforts to address global inequalities and sustainable development.

**THE SHARING OF GLOBAL RESPONSIBILITIES.** The more distinct and unified the economic identity of the EU, the greater the expectations that these same attributes will be exhibited in global political and security affairs. The burden-sharing debate, which has surfaced repeatedly, will intensify in the wake of EMU has come into effect. One of the most important foreseeable tasks is to update and widen the concept of global security to include the multiple ways of achieving redistribution of the burden for regional and global security and translate this concept into practical policy terms. This will entail a more effective and coherent policy capacity than exists at present at EU level. This could be prompted by EMU. The agreement reached on October 25, 1998, in Austria by the European heads of state and government offer promising signals.<sup>10</sup>

These are only a few of the most challenging impacts that a successful development of EMU is likely to progressively have on international political and economic relations.

### **MAINTAINING A SPIRIT OF COOPERATION**

There is no easy answer to the question whether the EU-U.S. relationship will be ready for the implications of Economic and Monetary Union. EMU will not have a big bang effect; its impact will build progressively. The extent to which the potential benefits of EMU are realized will depend not only on the answers Europeans will find to meet their internal challenges, but for a large part on how the spirit of fierce economic competition, which has so often poisoned the transatlantic relationship, may make room for a post-Cold War cooperative spirit.

Maintaining a spirit of cooperation will not be easy under the fire of some of the potential tensions that have been sketched out in this article, but EMU, an unthinkable venture just over a decade ago, seems to be coming to life at the right time. Hopefully, it will serve as a benchmark for a more robust, negotiated international monetary system that is able to underpin sustainable growth. ■



## NOTES

<sup>1</sup> Finland sends seven percent of its exports to Russia and 13 percent to Asia, the highest proportion in EMU.

<sup>2</sup> *Financial Times* Guide to Economic and Monetary Union, September 1998, 2.

<sup>3</sup> The Forward Studies Unit was created in 1989 within the European Commission to study long-term trends and potential developments of the European integration process in order to inform the decision-making process at the European level. It reports directly to the president of the Commission.

<sup>4</sup> The paper on the geopolitical implications of EMU, which condensed the work of the group, was written by Agne Pantoulouri.

<sup>5</sup> *Le Monde*, October 27, 1998.

<sup>6</sup> Wolfgang Muenchau, "The Macroeconomics of EMU," *Financial Times* guide to Economic and Monetary Union, September 1998.

<sup>7</sup> James F. Moore "The Internet as a Complex Adaptive System," The Aspen Institute, ed., *The Internet as Paradigm* (Washington, DC: The Aspen Institute, 1997), 123-135.

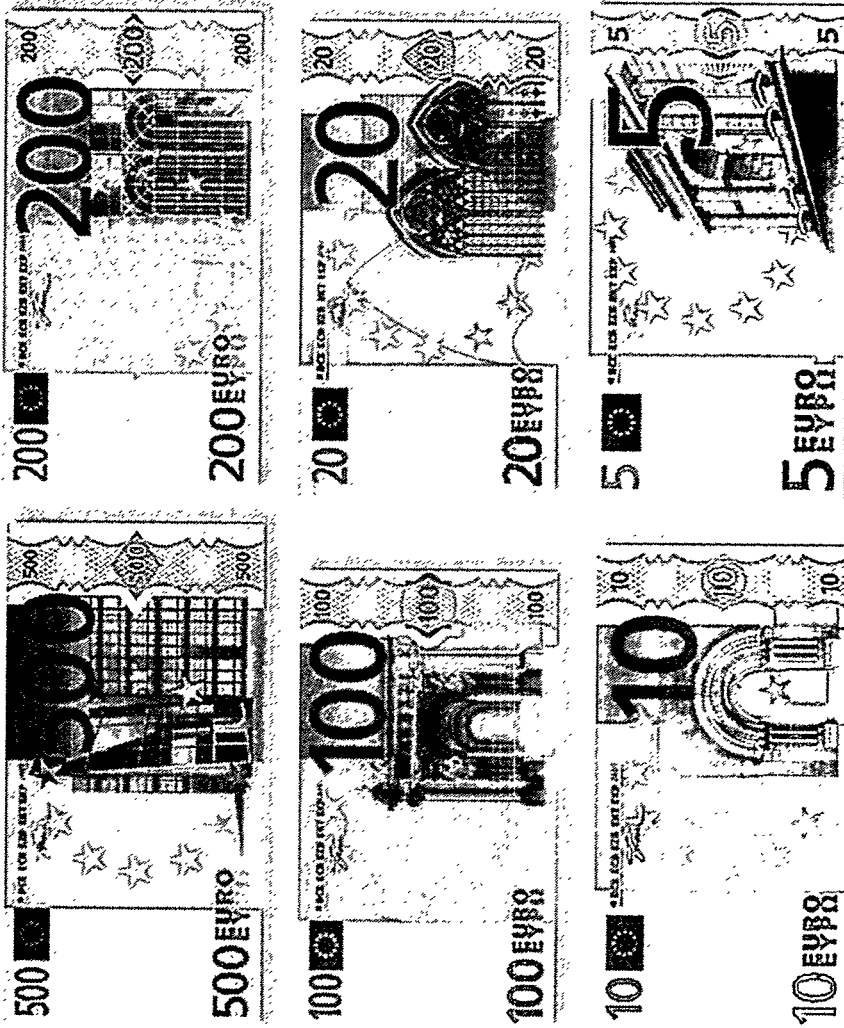
<sup>8</sup> "A personal view from Larry Summers," *Financial Times*, October 22, 1997.

<sup>9</sup> While the new currency will create opportunities for both big and small businesses, the learning curve of the euro is substantial and heavier for small and medium-sized enterprises. Potential sources of errors occurring because of the introduction of the euro can be well hidden. For example, billing in decimals can be a little known trap as some EMU countries use the dot and others the comma. Conference on the euro for Business, World Trade Center, Boston, MA, October 21, 1998.

<sup>10</sup> For an analysis of the ongoing changes in the global economic order, its most important shortcomings and areas of reform, see "Towards a more Global Economic Order", Cahier of the Forward Studies Unit, Office for the Publications of the European Communities, 1997.

<sup>11</sup> The three most meaningful moves made in this respect in Pörtlach were: Tony Blair's initiative for a consensus on a European defense capability, the decision to speak with one voice in international financial institutions and the intensified cooperation on internal security issues which will help to respond more positively to President Clinton's calls for strengthening international cooperation in the fight against drugs and crime.

### DRAFT DESIGNS FOR THE EURO BANKNOTES



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