European Monetary Union and its Implications for Canada

1. Introduction

This paper discusses the European Monetary Union (EMU) and draws out some of its implications. First, the basic framework of EMU and its associated institutions is reviewed, along with the Maastrict criteria for economic convergence. The economic characteristics and implications of a currency union are discussed. Then in the remaining three sections, the implications for Europe, the international financial system, and for Canada are developed.

The underlying motivation for European monetary union (EMU) is largely political[1]; it is characterized as the next step in binding the Europeans (particularly Germany and France) together. The dominance of Germany and the Bundesbank in European finance and the Europeans' propensity for a fixed exchange rate regime system for managing continental European exchange rates have effectively resulted in much of Europe becoming a Deutschemark bloc. The example of German re-unification illustrated how the currency exchange with East Germany, and the ensuing high interest rates, could affect all Europe and highlighted the fact that German economic interests can diverge from those of its partners. While the German central bank has for the most part been a good (if conservative) manager, EMU will provide an institutional framework which gives the other European countries some voice in managing the European monetary system.

EMU is scheduled to proceed as planned on January 1, 1999. However, several factors could negatively affect its prospects: disagreement on monetary and fiscal policies within the EU leading up to the implementation and throughout the transition; another could be the squabbles over technical issues such as participation in the TARGET clearing system, which remains unresolved at the moment. In the longer run, there could be disillusionment on the part of some member states or regions when they find that their lack of monetary autonomy compromises their ability to attain their other economic and social objectives. However, if EMU is implemented, it is likely to be maintained indefinitely. The costs of leaving a currency union are too high for a country to make that decision without very good and compelling reasons.

A highlight of the December 1996 EU Council meeting in Dublin was agreement on the terms of the Stability and Growth Pact, which removes a major obstacle from the

[1]While some (particularly the EU itself) assert that there are major economic benefits, this paper takes the view that these are exaggerated or that the benefits (such as those stemming from increased labour and product market flexibility) will require further desirable but difficult government deregulation.