

Sweden. The periphery in particular would experience increased costs in the form of variability in output and employment under EMU. At the same time, however, the study concludes that some countries in the peripheral regions have a better ability to adapt to shocks than the core and intermediate countries because they display a higher degree of price and wage flexibility than those in the core where markets are more rigid. EMU optimists would point to the emerging trends in European integration which render studies such as this using historical data less relevant for the future. By the time EMU occurs, Europe will probably be more integrated than it is now. While the EU may not be an optimal currency area, it is a feasible one in the sense that EMU is do-able.

The EU would be the only currency area without a central fiscal authority. Most observers seem to accept the need for some form of fiscal co-ordination among members after EMU; the Stability Pact discussed earlier is a step in this direction. Investment banks in London have specialists who are evaluating the creditworthiness of European governments more closely and conveying their opinions to investors. Without currency risk, creditworthiness will be the key distinguishing feature of regional government debt inside EMU (as it is with provinces in Canada).

3. Issues for the Europeans

3.1 Maastricht Criteria: "Fiscal Masochism", or Prudent Convergence?

The Maastricht Criteria for monetary union, described above in section 2.1, set out a means to bring the European economies into synchronization before the introduction of the euro. The two binding constraints for most countries are the deficit and debt criteria. A case can be made that the concerted actions of several large and small European governments working together to reduce expenditures and deficits is at least partly responsible for the current stagnation in Europe, an effect popularly known as "fiscal drag". From a peak of -5.1% of GDP in 1993, EU countries' structural government balances⁵ have tightened to an estimated -3.6% in 1996 and are projected by the OECD to move to -2.5% in 1997.

The preceding discussion is based on short-run aggregate demand effects. However, a growing (even mainstream) opinion in the economics profession now is that fiscal policy is ineffective in the long run. In the Maastricht situation, forward-looking economic agents should foresee the reduced taxes that will result from fiscal contraction, and should increase their spending in response. Reduced interest rates from the lessened borrowing associated with the fiscal contraction also stimulate private expenditure. The fiscal tightening mandated by Maastricht should not in the long run be responsible for stagnation in Europe because private expenditure should be crowded in.

⁵The structural measures are cyclically adjusted and measure the discretionary changes in fiscal policy.