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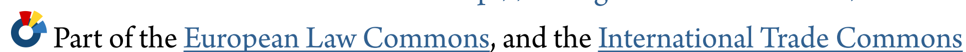
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Second Attempts at European Monetary Union: Post-1999 State Memberships Through the Exchange Rate Mechanism

I. Introduction

The most crucial step for the future of the European Union begins on January 1, 1999. The cultural conflicts that pervade European history will be set aside in favor of collective movement towards enhancing the world's largest free trade zone.[1] The creation of the European Monetary Union (EMU) essentially entails uninhibited capital movement and a single European currency.[2] Several members of the European Union (EU), however, will not satisfy the economic criteria for inclusion in the EMU and thus, will not qualify for 1999 membership.[3]

Theoretically, the nonqualifying countries which intend to become members of the EMU will simply have to wait until they are able to satisfy the economic preconditions established by the Maastricht Treaty of 1992.[4] The EMU plans to assist this initially excluded group through revitalization of a currency stabilization program called the Exchange Rate Mechanism (ERM).[5] Ideally, through stable exchange rates and economic ties to the EMU, the countries outside the EMU will be better equipped for moving quickly towards qualification.[6] Past European attempts at sustained exchange rate stabilization, however, have been subject to widespread breakdowns.[7] The inherent difficulties associated

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[1] *See BOFA Expects Europe to Adopt a Single Currency, But EMU's Success Will Face Obstacles*, Bus. Wire 21:00, June 26, 1996 [hereinafter BOFA].

[2] *See* Matthew J. Eshelman, Comment, *The Maastricht Train: Slowing Down For Sharp Curves*, 11 Dick. J. Int'l L. 605, 607–08 (1993).

[3] *See* Dr. Dieter Kugelmann, *The Maastricht Treaty and the Design of a European Federal State*, 8 Temp. Int'l & Comp. L.J. 335, 341 (1994); *see also* Gerard Lyons, *Counting the Heavy Cost of a Single Currency*, Evening Standard, Feb. 21, 1995, *available in* 1995 WL 11786376.

[4] *See* Christopher A. Whytock, *Eurofed: Toward a European System of Central Banks and a European Central Bank*, 23 Law & Pol'y Int'l Bus. 469, 492 (1992); *see also* BOFA *supra* note 1.

[5] *See* BOFA, *supra* note 1.

[6] *See* Lionel Barber, *Mad Dash for the Line*, Fin. Times, Sept. 20, 1996, *available in* 1996 WL 10614179.

[7] *See* Dominick Salvatore, *The International Monetary System: Past, Present and Future*, 62 Ford-

with currency control threaten to resurface when an elite corps of countries form the planned monetary union and effectively divide Europe into those "inside" and those "outside" the EMU.[8]

Part I of this Note examines the European Union's first use of an exchange rate stabilization system, tracing the development of European cooperation in this area from its beginning in the 1950s to its breakdown in 1973. Part II focuses on Europe's second unsuccessful attempt to control exchange rate fluctuations through the Exchange Rate Mechanism which failed to adjust to the European political and economic realignment resulting from German reunification. Part III evaluates the potential difficulties of a new ERM that will connect the Member States in the EMU with the other EU nations which do not initially qualify. Finally, this Note concludes that the difficulties associated with the past use of the ERM could resurface and disrupt the success, or even the establishment, of the EMU.

II. POLITICAL AND ECONOMIC ISSUES LEADING TO MAASTRICHT: PAST USE OF THE ERM

The European Union and its predecessor organizations have debated the principle of economic and monetary union for nearly forty years.[9] The formation of the European Coal and Steel Community (ECSC) in 1951 constituted Europe's first attempt at economic cooperation.[10] Later attempts at coordination followed quickly in 1957 with the introduction of the European Atomic Energy Community (Euratom) and the European Economic Community (EEC) under the Treaty of Rome.[11] These three Communities were the embryonic stages of the current European Union.[12] Furthermore, these early ideas of co-

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HAM L. REV. 1975, 1997 (1994); Christopher Young, *The Ramifications of the Exchange Rate Collapse in Europe: Implications For Monetary Union*, 13 B.U. INT'L L.J. 263, 264 (1995).

[8] *See How to Shift the Goal Posts: Economic and Monetary Union*, ECONOMIST, Apr. 20, 1996, *available in* 1996 WL 8671807.

[9] *See* RICHARD CORBETT, THE TREATY OF MAASTRICHT 2 (1993).

[10] *See* David O'Keeffe, *Current Issues in European Integration*, 7 PACE INT'L L. REV. 1, 2–3 (1995); TREATY ESTABLISHING THE EUROPEAN COAL AND STEEL COMMUNITY [hereinafter ECSC], Apr. 18, 1951, tit. I, art. 1, *in* ENCYCLOPEDIA OF EUROPEAN COMMUNITY LAW B2003 (1993).

[11] *See* TREATY ESTABLISHING THE EUROPEAN ATOMIC ENERGY COMMUNITY, Apr. 18, 1957, tit. I, art. 1, *in* ENCYCLOPEDIA OF EUROPEAN COMMUNITY LAW, *supra* note 10 [hereinafter EURATOM]; TREATY ESTABLISHING THE EUROPEAN ECONOMIC COMMUNITY, Mar. 25, 1957, pt. I, art. 1, *in* ENCYCLOPEDIA OF EUROPEAN COMMUNITY LAW, *supra* note 10, at B10005 [hereinafter EEC TREATY].

[12] *See* Kugelmann, *supra* note 3, at 337.

operation provided the groundwork for the economic integration envisioned for the European Monetary Union.[13]

Initially, the new Communities were composed of six Member States which were willing to embark on this unprecedented journey of European cooperation.[14] These countries included: Belgium, Federal Republic of Germany, France, Italy, Luxembourg, and The Netherlands.[15] The economic and political success of the European Community has since led to the admission of several other European countries including: the United Kingdom, Ireland, and Denmark in 1972; Greece in 1981; and Spain and Portugal in 1985.[16] The accession of Sweden, Finland, and Austria took place on January 1, 1995.[17]

Economic cooperation was the operating principle behind the formation of the Communities.[18] In contrast, unification regarding intra-European political issues was not yet envisioned in the European Community.[19] Political cooperation, however, still formed a significant underlying premise that later guided many of the European efforts for integration.[20]

Just as formal political unity was not considered an immediate goal, the EEC treaty did not entail many formal legal obligations for Member States regarding economic integration.[21] The Member States were compelled to consult other members on economic policy, but were not obligated under the treaty provisions to adopt particular monetary measures.[22] Article 103 of the Treaty of Rome stated generally that the Member States' conjunctural policies regarding short-term business cycles were matters of common concern.[23] States were obliged to consult each other on matters in this area.[24] The European Council, however, was authorized to enact Community-wide measures to assist cooperation efforts regarding short-term business cycles.[25]

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[13] *See id.*

[14] *See id.*

[15] *See id.*

[16] *See id.*

[17] *See* Kugelmann, *supra* note 3, at 337.

[18] *See* O'Keeffe, *supra* note 10, at 3.

[19] *See id.*

[20] *See id.*

[21] *See* EEC TREATY, pt. III, tit. II, ch. 1, art. 102A.

[22] *See id.* at art. 103.

[23] *See id.*

[24] *See id.*

[25] *See* Daniel T. Murphy, *The European Rate Mechanism: It Continues to Function, But . . .*, 8 FLA. J. INT'L L. 1, 4 (1993).

Article 104 contained a more specific obligation pertaining to the balance of payments.[26] This article, however, used the same general language of Article 103 in explaining the obligations of the Member States.[27] The Members were asked to pursue the economic policy needed to ensure the equilibrium of its overall balance of payments and to maintain confidence in their respective currencies.[28] Obviously, the legal implications of such general language were vague. More importantly, although consultations were required before significant economic policies were undertaken, each Member State retained its economic and political sovereignty.[29] This freedom of action allowed each Member State to acknowledge the Community's concerns while pursuing its own national interests.[30]

Member State obligations regarding exchange rate stabilization were equally vague.[31] Article 107(1), in a manner similar to Article 103, called exchange rate maintenance a matter of "common concern."[32] The scope of obligation was again unclear.[33] Member States were merely authorized under Article 107(2) to enact countermeasures to protect their currencies in the event of independent and nationalist state action.[34] Thus, the initial steps toward economic integration were tentative and based solely on cooperation rather than obligation.[35]

As the ideas of cooperation gained momentum, however, the principle of economic unification became a formal Community objective during the Hague Summit of Community Heads of Government in 1969.[36] At that time, the EU envisioned economic integration as the convergence of economic and monetary policies, without reference to a single currency.[37] The primary method of implementing these economic policy agreements was to restrain exchange rate fluctuations in a fashion similar to the Bretton Woods System of International Monetary Management.[38] The EU acknowledged consistent currency values

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[26] *See* EEC TREATY, at art. 104.

[27] *See id.*

[28] *See id.*

[29] *See* Murphy, *supra* note 25, at 7.

[30] *See id.*

[31] *See* EEC TREATY, at art. 107(1).

[32] *See id.*

[33] *See id.*

[34] *See id.* at art. 107(2).

[35] *See* Murphy, *supra* note 25, at 7.

[36] *See* CORBETT, *supra* note 9, at 2.

[37] *See id.*

[38] *See* Salvatore, *supra* note 7, at 1977. The Bretton Woods System of International Monetary

as an essential element in creating a monetary union among its members.[39]

The goal of monetary union was formally announced in the Werner Report of 1970.[40] The report proposed the establishment of an EMU by 1980.[41] Efforts to maintain stable exchange rates, however, quickly dissipated upon the failure of the Bretton Woods System.[42] The catalyst for this worldwide exchange rate breakdown was the rigidity of the fixed rate policy under Bretton Woods and the currency crisis created by OPEC's oil price increase in 1973.[43]

With full economic sovereignty, the countries of the EU were able to protect themselves individually against economic shocks of this kind by devaluing their currencies.[44] Acting independently, these nations were able to achieve greater manufacturing growth and increased international competitiveness.[45] The currency devaluations, however, did result in a breakdown of exchange rate stability and put the idea of monetary union on hold for several years.[46]

III. EUROPE'S SECOND ATTEMPT AT EXCHANGE RATE STABILITY

A. *The European Monetary System*

In 1978, the Member States returned to the issue of monetary union and established the European Monetary System (EMS).[47] The new program embraced many of the ideas of the previous unification attempt.[48] Exchange rate stabilization was again identified as crucial, resulting in the formal establishment of the ERM.[49] The central ex-

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Management was set up following World War II in response to interwar instability of the exchange markets. The Bretton Woods Agreement established a fixed exchange rate program among the parties to the agreement. This system of exchange rate maintenance collapsed as a result of the international imbalance of payments among leading industrial nations and the disproportionate influx of capital. *See id.* at 1975–77.

[39] *See* David P. Valenti, *Currency Unification in the European Economic Community: The Mechanics, Politics, and Probability for Success*, 28 INT'L LAW. 1039, 1046 (1994).

[40] *See* CORBETT, *supra* note 9, at 2.

[41] *See id.*

[42] *See* Salvatore, *supra* note 7, at 1977.

[43] *See id.*

[44] *See* Eshelman, *supra* note 2, at 612–13.

[45] *See id.* at 613.

[46] *See* CORBETT, *supra* note 9, at 2–3.

[47] *See id.* at 3.

[48] *See* Murphy, *supra* note 25, at 12.

[49] *See* CORBETT, *supra* note 9, at 3.

change rates of the various EU countries were assigned fixed margins between which their currencies could fluctuate, with realignment of those margins subject to common agreement.[50] Furthermore, the ECU was introduced as a composite currency to be used as the denominator of Community transactions.[51]

Voluntary participation in this version of the ERM was limited, but it lasted fourteen years in its original form.[52] The results were considered a success.[53] The realignment of national exchange rates decreased in frequency over the subsequent twelve-year period.[54] Inflation and interest rate differentials also declined.[55] Still, the lack of universal participation in the ERM and the outright opposition of such key players as the United Kingdom, sidelined serious discussion of single currency development within EMS borders.[56]

The growing interdependence of European goods and services markets due to the relative success of the ERM and the pending effects of the 1986 Single European Act (SEA), prompted a study into the need for a single currency.[57] The SEA was an attempt to put the issue of monetary and economic union back on the European discussion table and provided guidelines for a single European internal market.[58] A single market hinged upon the abandonment of all internal controls on intra-European capital flow.[59]

The effects of the removal of trade barriers under the SEA, however, would not be fully realized until 1992.[60] At this point, increased capital movement was expected to make management of exchange rates more difficult while, at the same time, fostering Member State interdependency.[61] These concerns caused the European Parliament to examine the costs of separate currencies on an interdependent Europe.[62] The

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[50] *See id.*

[51] *See* Murphy, *supra* note 25, at 15–16. The ECU is a basket of currencies which consists of stated portions of each Member State's currency. It has no intrinsic value of its own. Its value is derived from the fluctuating relationships of the member currencies to the U.S. dollar. *See id.*

[52] *See* CORBETT, *supra* note 9, at 3.

[53] *See id.*

[54] *See id.*

[55] *See id.*

[56] *See id.*

[57] *See* O'Keeffe, *supra* note 10, at 5–6.

[58] *See id.*

[59] *See id.* at 6.

[60] *See id.*

[61] *See* CORBETT, *supra* note 9, at 3.

[62] *See id.*

results suggested a total cost (including transaction costs, hedging costs against exchange rate changes, maintenance of separate reserves, and reliance on the dollar for pricing in international trade) of 30 billion ECU per year.[63]

B. *The Delors Committee and Monetary Union Under the Maastricht Treaty*

In light of the cost analysis of competing currencies, the European Parliament commissioned the Delors Committee in June 1988, to study the issue and propose a comprehensive plan for EMU.[64] The Committee, consisting of the twelve central bank governors and chaired by Jacques Delors, submitted its report in April 1989.[65] The findings of the Delors Report eventually formed the basis of the Maastricht Treaty.[66] The Delors Report discussed the basic principles behind the proposed EMU and suggested numerous steps for its implementation.[67]

The Delors Report drew an important distinction between the EMU's common goals of economic and monetary union.[68] Monetary union was to entail irreversible convertibility of currencies and would require the creation of new community institutions such as the European Central Bank.[69] In contrast, economic union was to require bi-lateral cooperation between Member States regarding fiscal and monetary policies.[70] Implicit in the creation of centralized institutions was the necessary cessation of significant economic policy decisionmaking power by individual Member States.[71] Since this type of coordination was unprecedented in European relations, the Delors Report recommended a gradual three-step process for economic integration.[72]

The Delors Report's proposal for a three-phase process toward EMU required new agreements among the Member States.[73] The first stage of the development plan proceeded without treaty authorization be-

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[63] *See id.*

[64] *See* PETER B. KENEN, EMU AFTER MAASTRICHT 8 (1992).

[65] *See id.* Jacques Delors, of France, was president of the European Community Commission. *Id.*

[66] *See id.* at 10.

[67] *See id.*

[68] *See* CORBETT, *supra* note 9, at 4.

[69] *See id.*

[70] *See id.*

[71] *See* Valenti, *supra* note 39, at 1047–48.

[72] *See* Whytock, *supra* note 4, at 489.

[73] *See id.* at 485–86.

cause it was only prepatory in nature.[74] The following two stages, however, were inoperable without formal agreements by the Member States because substantive and universal cooperation was required.[75] After several years of Intergovernmental Conferences (IGCs) and other preparations, the European Council finally reached conclusions on all outstanding issues regarding European monetary union.[76] On February 7, 1992, the Foreign and Finance Ministers of all the Member States signed the Treaty on European Union (known as the Maastricht Treaty) in Maastricht, Netherlands.[77]

When the Maastricht Treaty was actually ratified at the end of 1992, it had embraced most of the principles and ideas expressed in the Delors Report.[78] Specifically, the Maastricht Treaty adopted the three-phase guideline, described by the Delors Committee, for instituting EMU.[79] Stage I aimed to remove financial obstacles to economic integration, such as trade barriers, restraints on capital movement, and exchange rate instability.[80] Implicitly, the adoption of this portion of the Maastricht Treaty was expected to signify European political resolve as well as establish an EMU "mindset" among the Member States.[81]

Stage II began on January 1, 1994.[82] It is a transitional phase that prepares for EMU by promoting the general coordination of monetary policies and cooperation between the Member States.[83] Most importantly, the second stage encourages each Member State to strive toward the economic convergence criteria set out by the Maastricht Treaty.[84] The Maastricht Treaty established the criteria in order to ensure that all new members have similarly operating economies at the time of integration.[85]

The convergence criteria requires each Member State to meet specified targets for inflation, interest rates, budget deficits, and currency

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[74] *See* CORBETT, *supra* note 9, at 4.

[75] *See id.*

[76] *See id.* at 5.

[77] *See* TREATY ON EUROPEAN UNION, Feb. 7, 1992, tit. I, art. A, *in* ENCYCLOPEDIA OF EUROPEAN UNION LAW, *supra* note 10 [hereinafter Maastricht Treaty].

[78] *See* KENEN, *supra* note 64, at 14.

[79] *See* Whytock, *supra* note 4, at 489–90.

[80] *See* KENEN, *supra* note 64, at 12–13.

[81] *See* CORBETT, *supra* note 9, at 4.

[82] *See* Kugelmann, *supra* note 3, at 340.

[83] *See* Whytock, *supra* note 4, at 490–91.

[84] *See* Young, *supra* note 7, at 270–71.

[85] *See* Larry Elliott, *Economics: The Single Currency*, GUARDIAN, Jan. 9, 1996, *available in* 1996 WL 4003827.

stability.[86] The European Council will determine, by no later than December 31, 1996, whether a majority of Member States satisfy the requirements.[87] If a majority is found, then a date for Stage III will be set.[88] If no date for the beginning of Stage III has been set by December 1996, Stage III will begin automatically on January 1, 1999.[89]

The third and final stage of the EMU involves the substitution of the single European currency for the national currencies of the qualifying nations.[90] During Stage III, the politically independent European Central Bank (ECB), and its banking network under the European System of Central Banks (ESCB), will be fully operational and charged with implementing the monetary policy of the Union.[91] It will also regulate the official foreign reserves of the Member States, and promote the smooth operation of payment systems.[92]

C. *Exchange Rate Collapse in 1993*

Shortly after ratification of the Maastricht Treaty, the euphoria of European unification was undercut by the collapse of the ERM in August 1993.[93] German reunification efforts since 1989 had caused a substantial breakdown in European exchange rates as Germany attempted to pay for its reunification through governmental borrowing rather than by raising taxes.[94] The resultant deficit spending created a reactionary increase in inflation due to increased German demand for goods and services.[95] The Bundesbank responded by raising short-term

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[86] *See* Whytock, *supra* note 4, at 491. Each Member State vying for participation in the EMU must meet these criteria:

1) price stability—measured by the proximity of inflation rates.

2) soundness of government financial positions—measured by the absence of "excessive" governmental budget deficits.

3) maintainance of exchange rates within the ERM margins for two years without derogation.

4) durability of convergence—measured by the proximity of long term interest rate levels. *See* Michael Abbey & Nicholas Bromfield, *A Practitioner's Guide to the Maastricht Treaty*, 15 MICH. J. INT'L L. 1329, 1341 (1994).

[87] *See* Maastricht Treaty, *supra* note 77, at art. 109j(4).

[88] *See id.*

[89] *See id.*

[90] *Id.* at art. 109l(4). The rate of currency conversion, as it pertains to the individual qualifying countries, will be irrevocably fixed upon the unanimous vote of the participating Member States. *Id.*

[91] *See* Maastricht Treaty, supra note 77, at art. 105(2).

[92] *See id.*

[93] *See* Young, *supra* note 7, at 264.

[94] *See Monetary Crisis: Causes of the Crisis*, EUR. COMMUNITY L. & BUS. REP., Report Sept.–Oct. 1992, at 6 [hereinafter *Monetary Crisis*].

[95] *See* Young, *supra* note 7, at 277.

interest rates to support the deutschmark.[96] Subsequent German refusals to make a significant cut in interest rates demonstrated that German national interests took precedence over the "common concerns" of the Union.[97]

The comparatively high German interest rates allowed the deutschmark to appreciate rapidly against all other European currencies.[98] The rate of appreciation shook the narrow fluctuation bands (2.25%) under ERM to the brink of collapse in September 1992.[99] On September 17, the English pound was unable to maintain its currency position and Prime Minister John Major withdrew the United Kingdom from the ERM.[100] Shortly thereafter, the Italian lira dropped out as well.[101]

After a brief period of stability, the financial disparity between the deutschmark and other currencies was exploited by speculators in the currency markets.[102] On July 30, 1993, market investors started a "run" on the French franc by exchanging francs for the more valuable German currency.[103] The depletion in French exchange reserves forced the EU Finance Ministers to widen the currency bands to allow France and others the opportunity to defend their currencies.[104] The Ministers further decided that from that day forward the EU currencies could fluctuate fifteen percent above or below their assigned levels.[105] Thus, under such a structure, the ERM no longer constituted an effective currency stabilization program.[106]

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[96] *See Monetary Crisis, supra* note 94, at 6.
[97] See Young, *supra* note 7, at 275, 278.
[98] *See Monetary Crisis, supra* note 94, at 7.
[99] *See* Young, *supra* note 7, at 276.
[100] *See* CORBETT, *supra* note 9, at xxi.
[101] *See id.*
[102] *See Monetary Crisis, supra* note 94, at 7.
[103] *See* Young, *supra* note 7, at 277.
[104] *See id.*
[105] *See id.* at 278.
[106] *See id.*

IV. PROJECTED OBSTACLES FOR EUROPEAN MONETARY UNION

A. *The Convergence Criteria and the Temptation for Manipulation*

The second breakdown of the ERM in twenty years does not bode well for the future of the EMU. Although the conversion to a single currency will eliminate exchange rate concerns within the EMU, a new ERM will continue to link the nonqualifying countries to both the EMU and each other.[107] To date, it is uncertain which Member States will meet the convergence criteria.[108] In fact, the current criteria, if strictly adhered to, could leave significant economic players out of the process.[109]

Thus far, the most difficult criterion for the Member States to satisfy has been the requirement that each nation's budget deficit constitute no more than three per cent of its gross domestic product.[110] As of September 1996, only Denmark, Ireland, and Luxembourg met all of the Maastricht criteria for membership.[111] Continental Europe's relative economic progress in 1997, and its anticipated continued growth are welcome concepts, but the gradual nature of such growth is insufficient to make up for Europe's lacklustre economic performance and high levels of unemployment since 1992.[112] Both conditions have contributed to Member States' difficulties in constraining budgetary spending.[113] Even with anticipated economic growth in Europe, the IMF predicted that a "majority of EU countries, including Germany and France, [would] fail the three percent test [if given] in 1997."[114]

Strict adherence to the convergence criteria, however, is questionable.[115] The difficulty of meeting the economic preconditions makes the criteria susceptible to manipulation in an effort to include more members.[116] Article 104(c) of the Maastricht Treaty is an enforcement

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[107] *See* L. Barber, *supra* note 6.

[108] *See* Kugelmann, *supra* note 3, at 341.

[109] *See How to Shift the Goalposts: Economic and Monetary Union,* ECONOMIST, Apr. 20, 1996, *available in* 1996 WL 8671807 [hereinafter *How to Shift the Goalposts*].

[110] *See* L. Barber, *supra* note 6.

[111] *See id.*

[112] *See The Clouds Clear Over Europe,* ECONOMIST, Sept. 27, 1997, at 84; Patrick Donovan, *Money Talk,* GUARDIAN, Apr. 3, 1996, *available in* 1996 WL 4018133;

[113] *See* L. Barber, *supra* note 6.

[114] *How to Shift the Goalposts, supra* note 109.

[115] *See* Joshua M. Wepman, Note, *Article 104(C) of the Maastrict Treaty and European Monetary Union: Does Ireland Hold the Key to Success?,* 19 B.C. INT'L & COMP. L. REV. 247, 253 (1996).

[116] *See id.* at 256; L. Barber, *supra* note 6.

provision for the budget deficit criterion.[117] The article authorizes the European Commission to issue recommendations and possible sanctions to Member States who create excessive governmental debt.[118]

When Ireland's economy deviated from the criteria, however, the Commission chose to ignore the transgression but issued formal reprimands to other nations who also failed.[119] The Commission overlooked Ireland's difficulty in meeting the criteria and instead focused solely on its economic progress.[120] Paragraph 2(b) of Article 104(C) states that the Commission "shall examine compliance with budgetary discipline on the basis of . . . whether the ratio of government debt to gross domestic product exceeds a reference value, unless the ratio is sufficiently diminished and approaching the reference value at a satisfactory pace."[121]

The general language of this treaty provision implicitly authorizes the Commission to use its discretion in issuing sanctions.[122] The Commission's decision regarding Ireland, however, was widely criticized because other EU countries were making progress as well, but only Ireland was excused.[123] Commentators wondered whether "the convergence criteria require an end result smack on target . . . or whether a country will be admitted to stage three if it is simply on a trend moving toward them."[124]

The purpose of the criteria is to ensure that each economy entering the EMU operates in a similar fashion.[125] The European Central Bank must be able to centralize its monetary and economic policy rather than cater to the specific needs of a nation.[126] Manipulation of the criteria will only hurt the prospect of cohesive economic decisions.[127] It is doubtful, however, that the EMU will even come to fruition if serious manipulation of the criteria is allowed.[128]

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117 Maastricht Treaty, *supra* note 77, at art. 104(c).

118 *See id.*

119 *See* Wepman, *supra* note 115, at 255.

120 *See id.*

121 Maastricht Treaty, *supra* note 77, at art. 104(c)(2b).

122 *See* Wepman, *supra* note 115, at 256.

123 *See id.* at 255.

124 *See id.* at 253 (quoting Kevin Muehring, *EC EMU's Bitter Medicine - Tough Rules May Discourage Membership*, INSTITUTIONAL INVESTOR, Apr. 30, 1992, *available in* LEXIS, World Library, Allnws File).

125 *See* Elliott, *supra* note 85.

126 *See* Kugelmann, *supra* note 3, at 343–44.

127 *See id.*

128 *See* Abbey & Bromfield, *supra* note 86, at 1336.

Germany, as the economic leader of Europe, already demonstrated that it places its national economic interests above those of the European Union when it refused to lower interest rates in 1992.[129] It is therefore improbable that Germany will allow fiscally irresponsible countries to join the EMU and thereby risk its solid currency position for the sake of the Community.[130] Since its widely criticized decision regarding Ireland, the EU Commission has vowed to interpret the criteria strictly.[131] Another failure to do so could cause Germany and others to question the benefits of membership.[132]

B. *Historic Problems With the ERM and Their Potential for Resurfacing*

Regardless of how the criteria are interpreted, certain Member States will be excluded from EMU in 1999.[133] Thus, from the beginning "the drive for monetary unity [will] split Europe if some Member States [are] in and others out initially."[134] These "outsiders" will be encouraged to join a new ERM at that time.[135] Due to United Kingdom and Swedish insistence, however, nonqualifying countries will not be compelled to participate in the ERM.[136]

In relation to the EMU, the new ERM will operate much as it did in the past with its attendant problems and benefits.[137] Its role will continue to entail minimizing fluctuation in exchange rates among the nonqualifying countries and the EMU as well as exchange rates between the nonqualifying countries themselves.[138] By joining the ERM each country agrees to an obligation under the Treaty to keep the market value of its currency within the established fifteen percent fluctuation bands.[139] The obligation materializes only upon the need

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[129] *See Monetary Crisis, supra* note 94, at 8.

[130] *See* Young, *supra* note 7, at 274–75.

[131] *See* William Rees-Mogg, *The Case for European Monetary Union,* TIMES (London), Nov. 27, 1995, *available in* 1996 WL 11874971.

[132] *See* Abbey & Bromfield, *supra* note 86, at 1336.

[133] *See* L. Barber, *supra* note 6.

[134] *See* George Melloan, *Eurocrats See the Euro as Their Holy Grail,* WALL ST. J., Sept. 23, 1996, at A21.

[135] *See* L. Barber, *supra* note 6.

[136] *See How to Shift the Goalposts, supra* note 109.

[137] *See id.*

[138] *See* Murphy, *supra* note 25, at 19.

[139] *See Finland Moves to Link Money With the EU,* CALGARY HERALD, Oct. 14, 1996, *available in* 1996 WL 5102522.

for governmental intervention regarding exchange reserves.[140] As proven in the past, the enforceability of this obligation is questionable.[141]

Other substantive and logistical problems from past experience with ERM could also resurface. Although none of the problems of the past have yet destroyed the economic and political framework of the European Union, their disruptive nature may delay crucial memberships of significant economic players into the EMU, undermine European unity, and disrupt currency markets and trade growth.[142]

Europe is currently faced with three, almost simultaneous institutional and economic shocks.[143] The freedom of capital movement and the transition to monetary union and enlargement present cumulative disruptive problems for European economies because of inevitable disparity in distribution costs and benefits across Europe.[144] The oil crisis in the early 1970s and German reunification efforts in the 1990s each undermined Europe's attempts to stabilize exchange rates.[145] Without solid leadership and cooperation within the Union, these obstacles could collapse the exchange rate system again.[146]

Although it is difficult to predict the exact nature of the next economic shock, the European economies are increasingly more vulnerable to such shocks due to the economic strain of meeting the convergence criteria.[147] Germany, France, Spain, and Belgium, which have had difficulty meeting the Maastricht budget deficit target, attempted to tighten their national budgets and often secured deep spending cuts in order to qualify.[148] Spain, if necessary, threatened to freeze public sector wages in 1997 to achieve the three percent budget limit.[149]

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[140] *See How to Shift the Goalposts*, *supra* note 109.

[141] *See* L. Barber, *supra* note 6. EU may lack the political will to enforce a nation's obligation regarding exchange reserves as evidenced by the unchecked dropouts of the United Kingdom and Italy in 1992. However, Mr. Yves-Thibault de Silguy, EU Commissioner for Monetary Affairs, argues that EU nations outside of EMU cannot expect to devalue at will: "If you want the European Bank to defend your currency, then you need to guarantee some discipline." *Id.*

[142] *See* Lyons, *supra* note 3; Melloan, *supra* note 134, at A21; Bill Javetski, *Brussels' Push for Monetary Union Could Shatter the European Union Itself*, BUS. WK., July 10, 1996, *available in* 1996 WL 2230439.

[143] *See* Pier Carlo Padoan, *Single Market, EMU and Enlargement: Can the European Community Cope With Three Institutional Shocks?*, 1 NEW EUR. L. REV. 257, 257 (1993).

[144] *See id.*

[145] *See* Salvatore, *supra* note 7, at 1977; Young, *supra* note 7, at 277.

[146] *See* Padoan, *supra* note 143, at 264.

[147] *See* Donovan, *supra* note 112.

[148] *See* L. Barber, *supra* note 6.

[149] *See id.*

Since even the leading European economies are having difficulty meeting the criteria, the countries, who do not initially qualify for the EMU and then experience economic difficulty, will face the possibility of even further delayed membership.[150] Large-scale spending cuts or other deficit reduction measures could stimulate unemployment, inflation, and slow economic growth.[151] In fact, Italy and the United Kingdom experienced economic expansion only after dropping out of the ERM in 1992.[152] UNCTAD senior economist Yilmuz Alcyuz argues that such independent growth illustrates the need for flexible exchange rates for economic stimulation.[153]

Political backlash follows quickly on the heels of economic strain.[154] European governments, such as Italy, Spain, and Portugal, which are attempting to reduce government spending are faced with public outcry over social spending cuts.[155] Prime Minister Antonio Gutteres of Portugal articulated the pressure felt by those countries struggling to make membership stating, "[w]e want Portugal at the political center of Europe, where decisions are made, not out on the edge where they have to be obeyed."[156] Repeated cutbacks, however, may trigger political unrest in certain Member States which, in turn, may usher in a wave of nationalist isolationism.[157]

A feeling of imposed isolation will undoubtedly result from the division of Europe into those countries participating in the EMU and those whose membership will be delayed.[158] This condition presents concerns regarding the initial effectiveness of centralized monetary policy.[159] As previously discussed, central control of economic policy removes the ability of individual nations to devalue their currencies in order to stimulate growth.[160] The exclusion of fiscally troubled nations such as Italy or Spain could provoke currency devaluations that make

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[150] *See* Lyons, *supra* note 3.

[151] *See* Donovan, *supra* note 112; Tony Barber, *Germany's Fears Blow Monetary Union off Course*, INDEPENDENT, Sept. 23, 1995, *available in* 1995 WL 9811392.

[152] *See* Sarah Ryle, *Europe Divided: Single Currency 'Will Push Up Jobless Total,'* GUARDIAN, Sept. 19, 1996, *available in* 1996 WL 4044635.

[153] *See id.*

[154] *See* Elliott, *supra* note 85.

[155] *See* Thomas Kamm & Cacilie Rohwedder, *Many Europeans Fear Social Costs in Trade Plan*, Dow Jones News Serv., July 30, 1996.

[156] *Id.*

[157] *See* Wepman, *supra* note 115, at 257.

[158] *See* Melloan, *supra* note 134, at A21.

[159] *See* Javetski, *supra* note 142; BOFA, *supra* note 1.

[160] *See* Eshelman, *supra* note 2, at 612–13.

products from those countries less expensive as compared to those of the "insiders."[161] Such trade imbalances could, in turn, cause members of the EMU to impose defensive trade barriers, thus promoting further disunity.[162]

The climate which surrounded the 1997 general election in the United Kingdom illustrated the divergent views regarding membership in the EMU.[163] Both the Conservative and Labour Parties shrank from commitment to the EMU during the campaign period.[164] The political consequences of a decision either way threatened to be disastrous for either party.[165] Under the treaty, Britain is supposed to decide whether it will join the initial single currency group by the end of 1997.[166] The assumption is that it will not.[167] The political pressure building in the United Kingdom already demonstrates the vast potential for isolationism if economic strain were to disrupt European economies.[168]

Finally, the world currency markets lurk menacingly beneath the surface.[169] "If the markets perceive that monetary union will again be botched, traders are likely to bash such currencies as the Spanish peseta, the Portuguese escudo, and the French franc, whose parity with the mark holds the European system of managed exchange rates together."[170] Currency speculation could also disrupt the ERM once the initial EMU members are determined.[171] Since the exchange rates of the participating currencies will not be set against the deutschmark until 1998, market investors will be speculating on the rates of exchange and could thereby threaten the established fluctuation margins as they did in 1993.[172]

V. CONCLUSION

Europe's efforts to control exchange rates among its members have been relatively successful. From its decades of experience, Europe has

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161 *See* Javetski, *supra* note 142.

162 *See id.*

163 *See The Case for Wait and See*, ECONOMIST, Oct. 12, 1996, at 18.

164 *See id.*

165 *See id.*

166 *Euro-go-go*, ECONOMIST, Sept. 20, 1997, at 55.

167 *Id.*

168 *See id.*

169 *See* Javetski, *supra* note 142.

170 *Id.*

171 *See id.* at 6.

172 *See id.*

learned that the rigidity of fixed rates and narrow fluctuation bands cannot cope with economic shocks. The creation of a single currency for a select group of EU Member States will eliminate exchange rate concerns among those members. The exclusion of other European nations from the single currency area, however, and the continued application of the ERM for these excluded countries will promote the historic difficulties associated with managed exchange rates.

There are a number of important consequences which would flow from a post-1999 breakdown of the ERM. First, countries outside of the EMU would have to delay their bid for membership further because a breakdown of ERM signifies inflationary problems, thus undermining a nation's attempt to satisfy the Maastricht criteria. Second, a breakdown would severely undercut the already fragile political will of some Member States and promote disunity of purpose. Lastly, the cooperative links among European nations would be irrevocably disrupted if a breakdown created drastic trade imbalances and currency speculation.

The very existence of a monetary union in Europe depends precariously on the early stages of the EMU and the relationship between those "inside" and those "outside" of it. If several of the economic and political concerns expressed in this Note surface before a monetary union is solidified, the anticipated benefits of the EMU will never be realized.

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