

Liberalized capital markets, state autonomy, and European monetary union¹

ERIK JONES

Johns Hopkins Bologna Center, Italy

Abstract. The conventional wisdom is that capital market integration and now monetary union have limited the options available to macroeconomic policy makers in Europe. The question considered here, therefore, is why many prominent Europeans insist that monetary union is a rational response to capital market integration. Monetary union eliminates exchange rate volatility – but only at a cost in terms of tightening the constraints on macroeconomic policy. Using a combination of macroeconomic theory and (descriptive) statistical analysis of European performance, I find that: capital market integration has *increased* macroeconomic flexibility through a mitigation of the current account constraint; European states have combined macroeconomic policies in a manner that has taken advantage of greater flexibility on the current account; the cost of such flexibility in terms of the impact of financial volatility on the real economy manifests differently in different countries; and monetary union both enhances flexibility on the current account and mitigates financial volatility.

Liberalized capital markets, state autonomy and European monetary union

The traditional justification for constructing Europe's economic and monetary union (EMU) is that the single currency insulates national policy makers from the turbulence of integrated capital markets. As Tommaso Padoa-Schioppa (1987: vi) explained in his report to the European Commission: 'The success obtained by persuading the Community that efficient allocation of resources and price stability come first is what today makes it necessary to verify the overall consistency of the Community's design for years to come.' Padoa-Schioppa's report did not itself call for the creation of EMU. However, it was clear in asserting that if the objective is 'to successfully implement, and benefit from, full economic and financial integration', then 'monetary union is the first-best solution' (Padoa-Schioppa 1987: 106).

Nevertheless, EMU is often seen to exacerbate the constraint implied by integrated capital markets on the macroeconomic policy autonomy of national politicians. Governments can escape the threat of market volatility only by

surrendering control over monetary policy instruments. Under EMU, monetary policy is administered by the European System of Central Banks (ESCB). Moreover, participating Member States have committed themselves to supporting the conduct of a common monetary policy through the joint commitment to maintaining balanced fiscal accounts over the medium term (the Stability and Growth Pact) and through the collective enforcement of rules for fiscal probity (the Excessive Deficits Procedure). Small wonder, then, that many question whether Europe can make a credible commitment to EMU and even suggest that monetary integration may be part of some larger neo-liberal agenda (Richez-Battesti 1996; Luttwak 1997; Moss 2000).

Analysis focusing on the constraints implied by market integration poses a problem for most conventional stories about EMU. First, analysts must explain why industrial states chose to eliminate capital controls. The consensus is that while states might have opted for partial liberalization, they soon found themselves unable to prevent a wholesale integration of capital markets (Goodman & Pauly 1993). Second, analysts must explain why European states chose to prioritize exchange rate targeting over domestic monetary policy autonomy. Here the argument is driven by attempts to make the best of a bad situation: Europe's heads of state and government acknowledged the failure of Keynesian demand management as well as the apparent success of Germany, and so opted to pattern their institutions and behavior along German norms (McNamara 1999). Third, analysts question whether monetary integration necessarily follows from capital market integration and – if so – whether any form of monetary policy coordination is sustainable (Cohen 1993, 1994). The apparent consensus around EMU is historically contingent (to borrow again from McNamara 1999), but the constraints implied by liberalized capital markets and monetary unions are permanent.

The relevant question to ask is why Europe's Member States have opted for a system from which they cannot opt out (at least, not without tremendous and increasing cost). Again borrowing from Padoa-Schioppa (1987), the standard pro-European argument for monetary union is that only a single currency can ensure the benefits of capital market integration. Leaving aside for the moment the general welfare effects arising from the greater efficiency of deeper capital markets, this standard argument places the advocates of EMU in a difficult position. By promoting monetary integration they are also further constraining their room for maneuver in policy making. This is not a necessary paradox, and policy makers may be capable of (altruistically) pursuing the common good even at their own disadvantage. However, it seems a difficult assumption to admit at face value – forcing analysts to posit the existence of 'political influences' powerful enough to encourage politicians to override their material self-interest (see Garrett 2000: 169; here he is not alluding to

strong constructivist influences like those suggested by, *inter alia*, Bieler & Morton 2001). Therefore, without denying that capital market integration does impose some constraint on macroeconomic policy choices, it is useful to look for other implications of liberalized capital movements as well.

The argument in this article centers on a compromise between the two extremes of market efficiency and state autonomy. Using a combination of macroeconomic theory and (descriptive) statistical analysis, it is argued here that the formation of EMU can be interpreted as a means for restructuring the financial architecture of Europe in order to enhance – rather than simply diminish – national autonomy. The effect of capital market integration is not to contrast states and markets, but rather to trade-off one set of policy possibilities for another. The effect of monetary union is to facilitate and reinforce that trade-off. Moreover, the evidence suggests not only that states have taken advantage of the possibilities opened up by capital market integration (albeit perhaps inadvertently), but also that they will continue to do so under EMU.

This argument is developed in two sections. The first section considers the implications of capital market liberalization for current account performance. It begins with the problem of state autonomy and integrated capital markets. It then establishes that European states have relied on greater flexibility in the current account – whether by intent or merely by implication. It concludes by illustrating the relationship between current account flexibility and broader strategies for macro-economic management.

The second section of the article makes the link between capital market liberalization and current account flexibility, on the one hand, and monetary integration, on the other. This section begins with the associated problems of volatility and risk. It then analyzes the role of European monetary integration as a partial solution for these problems. Finally, the second section concludes with a consideration of the problems of flexibility and empowerment within a European monetary union.

Capital market liberalization and state autonomy

The argument that EMU reinforces the trade-off of one set of policy possibilities for another begins with a change in perspective regarding the effects of capital market liberalization. Most analyses of the relationship between market liberalization and state autonomy focus on the constraint of market integration on the possibilities for state action. In its simplest form, the argument is that states which choose to remove capital controls must inevitably choose between exchange rate policy and monetary policy. Either monetary

policy must be directed toward manipulating capital flows in support of exchange rate targets, or exchange rate targets must be allowed to respond to the flows of capital resulting from monetary policy changes (Andrews 1994). In this sense, the impact of market liberalization on state autonomy is both mechanical and direct. The more deeply capital markets are integrated, the more elastic are flows of capital with respect to changes in monetary policy variables and the more influential are international capital movements as determinants of national exchange rates.

The starting point for this analysis is not constraint, but empowerment. The concern here is not so much how international capital mobility has affected monetary interactions between states, but rather how governments have taken advantage of integrated capital markets. While accepting that constraints do exist, the point to note is that international capital mobility increases the range of options available to macroeconomic policy makers. Not only do international capital flows promise to finance current account deficits, but they also provide alternative sources for domestic investment that might otherwise be 'crowded out' by government borrowing (or that might fail to be 'crowded in' by fiscal consolidation). Hence macroeconomic policy makers with access to international capital markets can afford to overlook important constraints – both external and internal – that policy makers with closed domestic capital markets must accept.

The greater macroeconomic flexibility afforded by integrated capital markets was immediately apparent after the 1973 oil price shock. Confronted with a high dependence on energy imports and a correspondingly low price elasticity of demand for energy, policy makers in advanced industrial societies relied on international capital accounts to finance inevitable current account deficits. The extent of this reliance was so great that already during the period from 1974 to 1976 foreign exchange reserves created in international capital markets became the principal source of international liquidity (McCracken et al. 1977: 129). Meanwhile, the public sector share of gross domestic product (GDP) increased in most countries and government borrowing increased as well. As a result, firms also increased their reliance on international capital markets as an alternative source of investment resources as well as opportunities. The volume of international financial transactions – and the macroeconomic flexibility they afforded – grew apace. The implications are evident in Figure 1, which provides aggregate data for current account performance for 23 advanced industrial states.² The data in the figure reveal that while average current account performance deteriorated sharply to a deficit of 2.7 per cent of GDP soon after the 1973 oil price shock, it gradually moved to a surplus of 0.8 per cent of GDP by 1997. If we treat the period from 1974 to 1982 as one of adjustment, the pattern of average current account deficits both before and

after is pretty much the same. Nevertheless, the variation of current account performance across countries has changed characteristically since the early 1970s – almost doubling the mean standard deviation from 1.9 before 1973 to 3.6 thereafter.

The implications of this new flexibility were not all salutary, and neither were they easily reversible. Released from the tight confines of national capital markets, firms and other private actors began to whittle away at those restrictions on capital flows that remained in place. Meanwhile, governments benefiting from a relaxation of the short-run current account constraint confronted the tension between moral hazard and international creditworthiness. Although international capital flows can finance current account deficits, foreign debt must be serviced and ultimately repaid (Corden 1972: 30–34). Therefore, the problem with the liberalized capital markets of the 1970s was not that countries became hugely indebted to foreign lenders, but rather that governments did not use the breathing space offered by international capital flows in order to encourage the structural changes necessary to generate current account surpluses in the future (McCracken et al. 1977: 125–126). For many countries, the challenge was to create an environment suitable for investment or investor confidence. And in some cases – most famously Italy and the

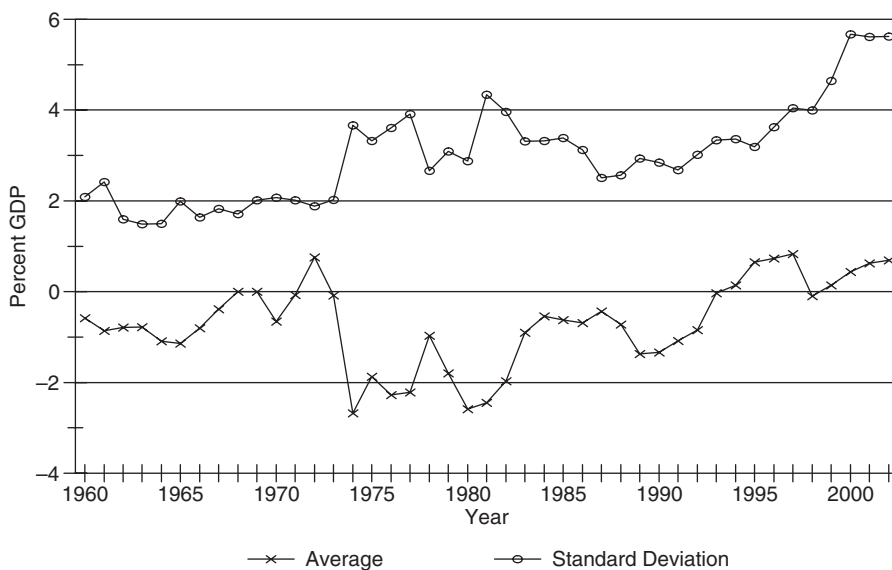


Figure 1. Current account performance in 23 industrial societies.

Note: aggregates are unweighted.

Source: European Commission (2002).

United Kingdom – international lending threatened to dry up, facing the government with an immediate crisis in the balance of payments affecting both the current and capital accounts.

The experience of the 1970s left three important lessons behind. The first two are well-known: governments can liberalize international capital markets more easily than they can control them, and governments can ignore developments in international capital markets only at their own peril. The third lesson has had more obvious acceptance among economists than elsewhere. Simply, even governments with access to international capital markets cannot disregard the current account over the long run. This third lesson is supported by a powerful body of data and analysis (Razin 1995). Nevertheless, despite the strength of economic argument in favor of a long-run current account constraint, governments seem content to accept (and even encourage) long-term imbalances. Within Europe, some countries have taken advantage of international capital mobility to support consistent current account surpluses, such as Germany before unification, the Netherlands since 1982 and Belgium since 1985. Other countries have run consistent deficits, such as Spain and Italy in the late 1980s and early-to-mid 1990s, and Portugal from the late 1980s onward. There are clear advantages on either side. The surplus countries benefit from an export-led pattern of growth. The deficit countries can draw upon foreign capital for domestic investment. Persistent imbalances also entail costs. For the surplus countries, the risk is that capital exports will undercut domestic investment (Bean 1989: 42). For the deficit countries, the risk is that capital imports will do little more than fuel consumption. How these benefits and costs add up is a case-by-case consideration. In general terms, it suffices to demonstrate that current account variability has undergone a step change at the European level just as it has across the industrialized world. This data is presented in Figure 2, which is a replica of the previous figure but excludes those countries outside Europe's recently formed economic and monetary union. Again, the point to note is that while average current account performance returned to its pre-1973 level after 1982, the variation in performance across countries increased from a mean standard deviation of 2.0 before 1973 to a mean standard deviation of 3.2 thereafter.

Structure or policy?

The changing status of the current account reflects a fundamental transformation in the way one understands economic relations between national economies and the outside world. For example, where once it might have been possible to describe a country's competitiveness solely in terms of its ability to sell goods abroad, the liberalization of capital markets and the relaxation

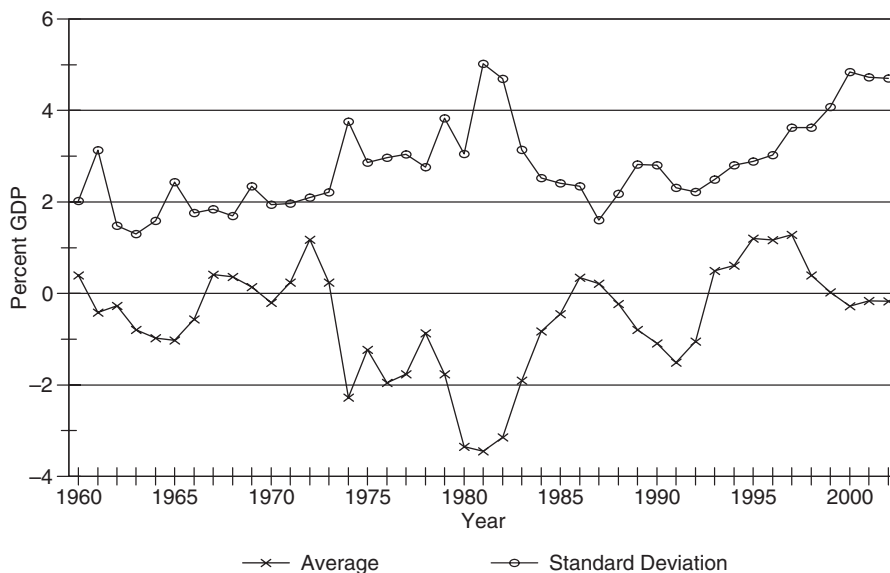


Figure 2. Eurozone current accounts (11 EMU participants).

Note: aggregates are unweighted.

Source: European Commission (2002).

of current account constraints help to undermine any such easy definition. Instead, 'competitiveness' can take on a wide number of contradictory meanings (cf. Krugman 1994). A competitive country can suppress the international value of its currency in the hopes of selling more to the world. By the same token, however, it can also increase the value of its currency as a means of controlling more of what the world produces. A competitive country can have its major firms invest across the globe, or it can attract investment from firms worldwide. It can maximize the use of its labor resources, or it can maximize the productivity of its labor inputs. It can encourage innovation, or it can support long-term relationships.

The objective here is not to rehearse debates about how best to structure economic relations between national economies and the outside world. Rather, it is to demonstrate that there are no simple structural prerequisites for a particular outcome on current accounts. Thus while it may be possible to argue that specific policy formulas entail specific results, the conclusion to draw is that political – and not structural – considerations determine the policy mix.

Table 1 provides evidence for the diverse groups of countries achieving similar outcomes on current accounts. The table is ordered and grouped by

Table 1. Current account performance as a percentage of gross domestic product, 1983–2002

Country	Low	Average	High
Portugal	-10.2	-4.3	2.1
Greece	-4.7	-2.9	-0.5
Spain	-3.6	-1.3	1.6
United Kingdom	-4.6	-1.2	1.1
Austria	-2.9	-1.1	0.6
<i>United Germany (1991–2002)</i>	<i>-1.7</i>	<i>-0.9</i>	<i>-0.1</i>
Ireland	-6.8	-0.3	3.7
France	-2.5	-0.2	2.5
Denmark	-5.4	-0.2	2.8
Italy	-2.5	0.2	3.2
Sweden	-3.6	0.6	4.3
<i>United Germany (whole period)</i>	<i>-1.7</i>	<i>0.8</i>	<i>4.8</i>
Finland	-5.4	1.0	8.1
Belgium	-1.2	2.4	5.2
<i>West Germany (1983–1994)</i>	<i>0.7</i>	<i>2.5</i>	<i>4.8</i>
Netherlands	1.9	4.3	6.4

Note: German entries are italicized to highlight differences in terms of compatibility, both in terms of time periods and of the consistency of the German data set over time.

Source: European Commission.

average current account performance, from low-to-high, but also includes data for country highs and lows. The point to note from this data is that the subgroups tend to be more diverse at the middle than at the extremes. It is easier to anticipate similarities between Portugal and Greece, than between Spain, Britain and Austria or between Ireland, Denmark and France. Likewise, it is easier to associate Belgium and the Netherlands, than it is to connect Finland, Sweden and Italy.

The differences between the extremes are unlikely to be the product of structural features within the national economies. Consider, for example, Greece, Spain and Portugal, on the one hand, and Belgium, Germany and the Netherlands, on the other. The relevant similarities across the two sets of countries are often stronger than they are within groups. The structure of Belgian imports is more like that for Portugal than for any of the other four countries. Germany's exports are most like Spain's. Only Greece is a clear outlier, and yet it is no more different from the North European countries than it is from Spain or Portugal. Evidence for this point can be found in Table 2, which

Table 2. Structural correlations of trade, 1996

Imports/exports	Belgium	Germany	Netherlands	Greece	Portugal	Spain
Belgium		0.93	0.95	0.33	0.66	0.90
Germany	0.88		0.90	0.21	0.74	0.98
Netherlands	0.85	0.95		0.45	0.61	0.90
Greece	0.91	0.92	0.92		0.52	0.34
Portugal	0.95	0.92	0.90	0.95		0.76
Spain	0.91	0.91	0.90	0.93	0.99	

Notes: Import correlations are in the bottom half of the table, export correlations are in the top half; 'Belgium' is Belgium and Luxembourg.

Source: United Nations.

provides structural correlation matrices for goods trade.³ The conclusion to draw from this data is that current account performance is not obviously a function of some countries producing what the world wants while others do not.

A related point concerns cost structures. Perhaps the surplus countries are more productive or efficient than those that run consistent deficits. This claim has some merit in relation to very broad measures of productivity, such as the ratio of GDP per person employed. Greece, Portugal and Spain are clearly weaker in this regard than their counterparts in Northern Europe. However, the translation of such broad productivity measures into relative cost structures is not automatic. Also, the comparison of North and South in terms of either the manufacturing share of employment or the labor share of value-added suggests deep similarities. Aggregate productivity may reflect relative prices more than productivity *per se*. Moreover, real unit labor costs have improved more in the South than in the North over the 1983 to 1997 time period. Thus while aggregate productivity may be lower, costs are likely to be lower as well. This data is collected in Table 3.

Despite the similarities, however, it remains the case that the Northern countries tend to run current account surpluses while the Southern countries tend to run deficits. This is so not only in aggregate terms, but also in bilateral terms. Belgium and Germany run bilateral trade surpluses with Greece, Spain and Portugal. The Netherlands runs surpluses with Spain and Greece and only a modest deficit with Portugal (which disappeared in 1997). These bilateral trade balances are collected in Table 4. The conclusion they suggest is simply that trade and current account performance is likely to be determined by something other than economic structures *per se*. Countries are not predestined to perform well or badly.

Table 3. Relative productivity and costs, 1997

	Belgium	Netherlands	Germany	Greece	Portugal	Spain
GDP per person employed (1,000 ECU)	57.2	55.7	52.1	28.2	19.9	36.4
Manufacturing share of employment (%)	17.5	14.1	22.1	16.0	23.4	18.6
Labour share of value-added at factor cost (%)	71.6	65.1	67.2	67.7	71.9	67.1
% change in real unit labour costs relative to 22 partner countries, 1983–1997	-0.30	-1.38	-1.05	-7.58	-4.90	-7.27

Source: European Commission.

Table 4. Ratio of exports to imports, 1996

Importer/exporter	Belgium	Germany	Netherlands	Greece	Portugal	Spain
Belgium		1.00	0.97	0.19	0.81	0.61
Germany	1.00		1.15	0.59	0.81	0.77
Netherlands	1.03	0.87		0.22	1.04	0.77
Greece	5.28	1.68	4.56		1.41	2.60
Portugal	1.24	1.23	0.96	0.71		2.60
Spain	1.63	1.29	1.29	0.39	0.38	

Note: 'Belgium' is Belgium and Luxembourg.

Source: United Nations.

Strategies and outcomes

The macroeconomic strategies that result in different patterns of current account performance are idiosyncratic to a large extent, but bear certain family resemblance within groups. In illustration, therefore, this section on state autonomy and capital market liberalization concludes with three sets of paired cases – consistent deficits, consistent surpluses and cross-overs between deficit and surplus. The first two sets of cases are identified using the data from

Table 1. Greece and Portugal are clearly the most extreme deficit cases. Belgium and the Netherlands are the most extreme surpluses. The third set is somewhat more arbitrary and compares Germany (which went from surplus to deficit) with Italy (which went from deficit to surplus). These patterns for current account performance are illustrated in the Figure 3, which provides a separate panel for each set of cases.

The policy strategy resulting in consistent deficits can be characterized in terms of tight monetary policy, loose fiscal policy and real exchange rate appreciation. The tight monetary policy (expressed in the form of relatively high interest rates) slows the growth of domestic prices, while at the same time attracting foreign capital and pushing up the exchange rate. Meanwhile, loose fiscal policy fuels domestic demand, which spills over onto imports (and potential exports) even as these traded goods become relatively cheaper than non-traded goods as a result of the exchange rate appreciation. So long as interest rates remain high and domestic demand remains strong, a rapidly deteriorating and self-sustaining current account deficit is the result.

The advantages of the policy mix are domestic. Loose fiscal policy fuels consumption, tight monetary policy reins in inflation and an appreciating

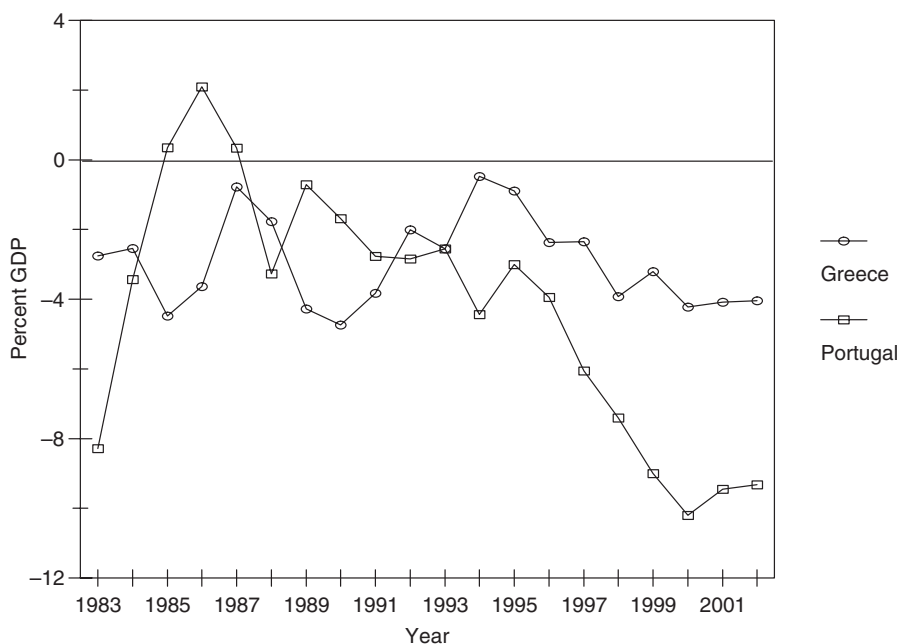


Figure 3a. Patterns of deficit and surplus on current accounts: consistent deficits.

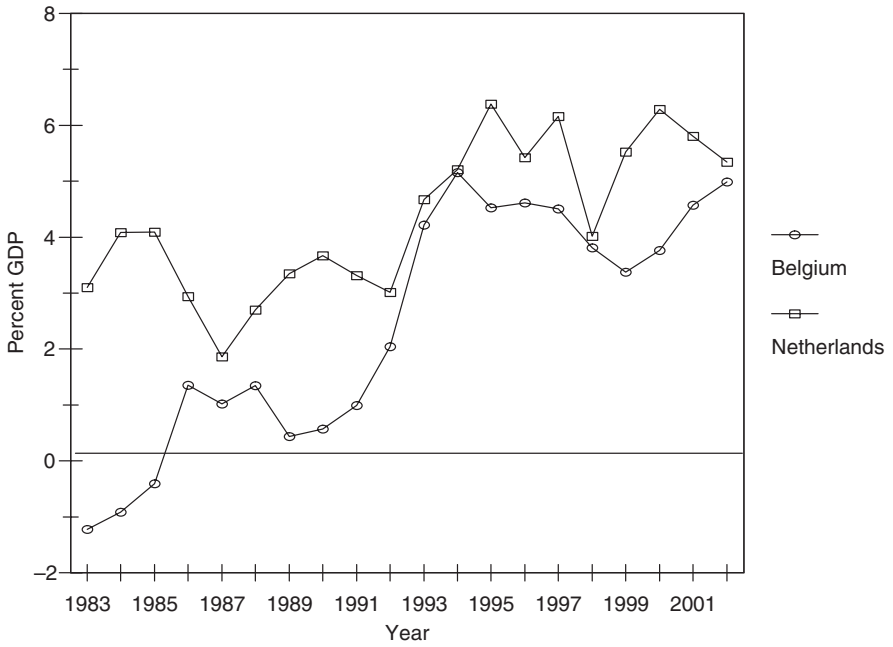


Figure 3b. Patterns of deficit and surplus on current accounts: consistent surpluses.

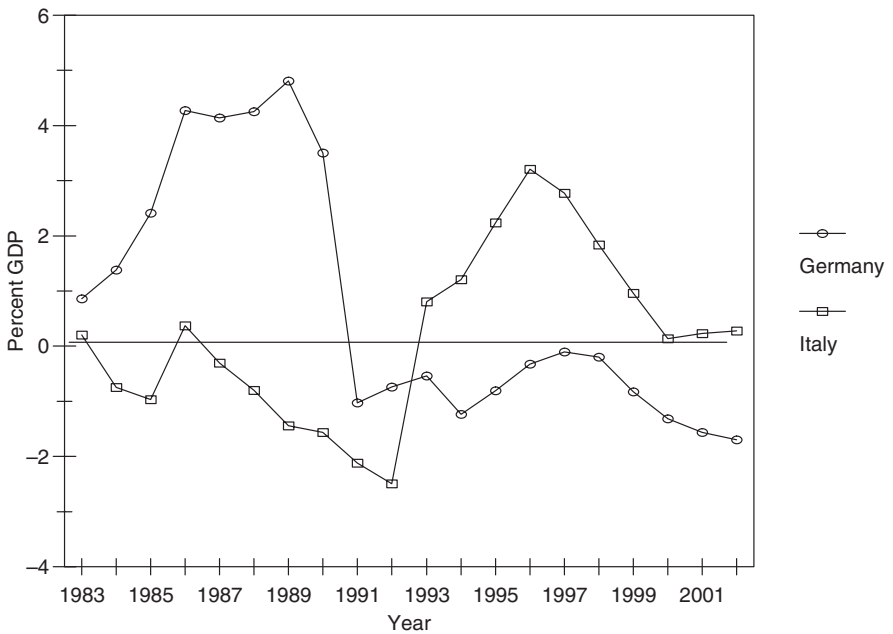


Figure 3c. Patterns of deficit and surplus on current accounts: surplus and deficit.

exchange rate improves the terms of trade (i.e., allows for cheaper and more plentiful imports). In the event that the country also suffers from a shortage of investment capital, an additional advantage is the increase in foreign funds for domestic restructuring. The disadvantages of the policy are both domestic and international. Although the domestic economy experiences a boom in consumption, the lower price of imports ensures that manufacturing faces intense competition from foreign producers. Meanwhile, tight monetary policy results not only in attracting capital from across the globe but also in raising real interest rates. Funds for investment may be more available, but they are also likely to be more expensive.

This pattern can be found – at least roughly – in both Greece and Portugal during the 1980s and 1990s. For much of that period, monetary policy makers in both countries relied on relatively high interest rates as a means to attract foreign capital for use in domestic modernization and – particularly during the run-up to EMU – as a means to control the growth of domestic inflation. At the same time, governments in Portugal and Greece ran relatively high fiscal deficits even as they struggled to implement a series of successive austerity programs. Burgeoning current account deficits were the result (Detragiache & Hermann 1999; Lolos 1998; Vamvoukas 1999).

The fit between theory and case study is not perfect in either instance. Neither country succeeded in attracting the bulk of its foreign investment through market instruments and both instead relied on European Union transfers and foreign remittances (from nationals working abroad) to provide the larger share of their capital inflows. By the same token, governments in both countries declared themselves to be willing to tackle the ‘twin deficits’ on fiscal and current accounts. The problem was that domestic political opposition made fiscal consolidation difficult (Torres 1998; Tsakalotos 1998). The advantage was that capital market liberalization made consolidation of current account performance less pressing (cf. Makrydakis 1999).

By the end of the 1990s, both Portugal and Greece were able to muster sufficient control over fiscal resources to be able to relinquish control over monetary policy altogether by joining EMU. Nevertheless, the desire to attract foreign capital remains important to governments in both countries, and so politicians are eager to find the means to do so even if this means sending the current account even further out of balance.

The pattern of policies resulting in consistent current account surpluses shows a higher level of intentionality than the pattern for consistent deficits. Where countries such as Greece and Portugal might be accused of seeking to attract foreign capital for investment, they cannot be accused of striving for consistent current account deficits *per se*. By contrast, Belgium and the Netherlands have worked explicitly to achieve sustainable current account

surpluses. Since the crisis period of the 1970s, when the current accounts of both countries fell into deficit, Belgian and Dutch politicians have sought means to ensure that exports of goods and services will systematically exceed imports.

The policy mix for supporting consistent surpluses on current accounts necessarily centers on mechanisms to restrain domestic demand and to resist capital inflows. Restraints on domestic demand – whether in the form of fiscal austerity or price-incomes policy – not only have the virtue of holding down the consumption of imports but also help to moderate the relative growth of prices for non-traded goods and services. Meanwhile, efforts to resist capital inflows – including the encouragement of domestic firms to reinvest their export earnings abroad – are necessary to prevent the accumulation of foreign exchange reserves and the consequent expansion of the domestic monetary base. At the juxtaposition of these factors, interest rates and inflation rates will remain relatively low and growth will be export-led, rather than consumption-led.

As in the deficit case, the advantages of pursuing a surplus are domestic. Unlike the deficit case, however, these advantages are also relatively concentrated in the tradable goods sector. Export manufacturers benefit from a relatively favorable real exchange rate, from elevated profits and from enhanced international liquidity. The disadvantages are both domestic and international. Domestically, the non-traded goods sector must labor under unfavorable terms of trade (i.e., fewer and more expensive imports), constrained wages and a relative lack of investment. Internationally, other countries must deal with the asymmetries inherent in the quasi-mercantilist accumulation of foreign assets, including foreign exchange reserves.

The Belgian and Dutch formulae for sustaining current account surpluses hew closely to expectations for the policy mix. Starting in the early 1980s, governments in both countries implemented wage restraints and began to wrestle with fiscal austerity. Meanwhile, firms reacted to the depressed domestic demand and the strong emphasis on export promotion by transferring investments and reinvesting profits abroad (Kurzer 1993). As a result, the current accounts of both countries surged into surplus. Also, while fiscal austerity was no easier in these countries than in Greece or Portugal, the combination of fiscal austerity and wage restraint gradually emerged as a cornerstone for economic policy making.

In Belgium, the consensus lay on the necessity of austerity and wage restraint for participation in EMU. This negative consensus has not always held and Belgian elites have faced considerable problems implementing their adjustment strategies. Nevertheless, the success of the policy mix can be seen in Belgium's entry into EMU despite levels of public debt in excess of 100 per

cent of GDP. In the Netherlands, the consensus had more positive connotations and lay on the virtues of austerity and wage restraint as part of the country's celebrated '*polder*' model for economic adjustment (cf. Delsen & de Jong 1998). The model itself may have been oversold, and yet the implementation problems faced in the Netherlands have been considerably less than in Belgium (Hemerijck et al. 2000; Visser & Hemerijck 1997).

The cases of German and Italy constitute a study in contrasts. During the 1980s – and before German unification – Italy was a consistent deficit country while German ran consistent surpluses. Neither government was particularly apt at fiscal consolidation or reform, yet where the Italians labored under relatively high interest rates and an incipient real appreciation of the Lire, the Germans benefited from wage concertation and low inflation. Movements on the capital account helped to square the circle in both cases – by providing (albeit expensive) financial resources for Italy and investment opportunities for Germany.

After the shock of German unification, the situation reversed itself. Italian politicians discovered a capacity to restrain the growth of domestic demand both through fiscal actions and through negotiations with the social partners (meaning representatives of labor and industry). By contrast, German politicians confronted both a weakening of wage concertation – particularly in the form of rapid wage convergence between the five new *Länder* and the 'West' – and a sudden and colossal demand for domestic investment. The realignment of exchange rates as a result of the crises of 1992–1995 played a role in this reversal, to be sure. However, only the change in the policy mix can explain why this series of realignments has had lasting effects on the current account positions of both countries, while the multiple realignments of the 1980s did not. In both cases, the liberalization of capital markets during the 1980s and 1990s facilitated the changes in the policy mix.

From capital market liberalization to monetary union

Integrated capital markets offer the promise of macroeconomic flexibility, but only at a cost. The cost is expressed in terms of risk and volatility. Countries that rely on international capital markets face the risk that lenders will withdraw their credit or borrowers will default on their obligations. They also run the risk that sudden movements of capital between currencies will cause dramatic swings in exchange rates – altering relative prices in complete disregard for 'the fundamentals' such as movements in relative costs. Indeed, given that goods markets play so little role in determining the value of exchange rates, countries run the risk that no matter how favorable their cost structures may

be relative to their competitors – or how coherent their macroeconomic policy mix – a sudden or long-term movement of exchange rates may obliterate any advantage in relative prices (MacDonald 1999). Finally, countries run the risk that capital market and exchange rate effects will reinforce each other, with a credit crisis leading to an exchange rate crisis or the other way around, and so on. The permutations of such risks are vast, and each contributes to the volatility of exchange rates and interest rates.

In turn, this volatility is both self-reinforcing and costly in its own right. Investors estimating relative returns must bring forward their time horizons and so assume shorter positions that focus on shorter-term gains. Industries hoping to protect the value of their capital and output must either accept the cost of exposure to volatility, redistribute the risk onto weaker groups in the marketplace (suppliers, workers, consumers) or engage in financial hedging. The results of such distributive games are ‘negative-sum’: everyone loses. Weaker groups must share in the cost of international exposure even if the focus of their activity is domestic. At the same time, the financial intermediaries that offer hedging contracts must cover their own exposure. In the end, the hedging instruments themselves become a focus for short-term investments and an additional source of volatility (Garber 1999; Watson 1999). The fact that forward markets consistently under-predict the scale of volatility suggests that inefficiency – and therefore cost – is somehow inherent to the system (Rogoff 1999).

The costs of capital market integration are systemic in origin but not in distribution. Institutional arrangements can influence both the allocation of risks and the nature of volatility. Similarly, institutions can influence the economic mechanisms that make risk and volatility important in the first place, changing perceptions or expectations and so moderating behavior. As a consequence, the negative impact of capital market integration is not everywhere the same. This is most obvious in the fact that different countries represent different ‘risks’ for international investors and so must pay different premiums for access to international capital. There are premiums associated with the choice of macroeconomic strategy (sovereign risk), premiums associated with the possibility of sudden movements in the value of the currency (exchange rate risk) and premiums associated with the ease of getting into and out of the national capital market (liquidity risk). In turn, these premiums result in a higher cost of capital for some countries than for others.

The differences in premiums charged by international investors are obvious in any comparison between the industrialized and developing worlds. Where industrialized countries seem to be able to access international capital markets with relative impunity, developing nations do so only at great cost. Moreover, any attempt by developing countries to exercise the type of macro-

economic flexibility described above is likely to meet with disaster, as international investors raise the cost of borrowing exorbitantly or cut off lending altogether. The impact of different institutional arrangements on the cost of participating in international capital markets is less obvious in comparisons between wealthy middle powers like the countries of Europe. It remains important nonetheless.

Moreover, the imposition of premiums on the cost of borrowing is only one manifestation of the 'costs' of integrated capital markets. Another manifestation works through the impact of volatility on the real economy. One way to illustrate both the impact of volatility and the differences in that impact across countries is through a comparison of France and Germany. The comparison revolves around the influence of volatility on levels of investment, but could as well focus on other real variables such as employment or unemployment (cf. Gros 1998). The general theoretical argument is that investors confronting volatility in either interest rates or exchange rates will choose to defer their investment until markets calm down (Darby et al. 1999). By implication, the expectation is that any relationship between volatility and investment will be negative – more volatility means less investment and the reverse. In more specific terms, the impact of volatility on investment should be influenced by the importance of exchange rates or interest rates to the return on capital and by the ease with which investors can hedge, transform or eliminate either a specific investment or their exposure to volatility. Thus we should expect investment in some countries to show a greater sensitivity to volatility than in others. This expectation is consistent with the claim that welfare state institutions help to mitigate or redistribute exposure to risk (Rodrick 1998).

Consider first the impact of exchange rate volatility (as measured by the annual standard deviation of month-to-month log changes in the nominal exchange rate). In France, volatility in the Franc/Deutschmark (Ffr/DM) exchange rate has a powerfully negative effect on the level of real gross fixed capital formation after a lag of one year. In Germany, the effect is less powerful but more immediate. Volatility in the Ffr/DM exchange rate has a contemporaneous negative effect on real gross fixed capital formation. This contemporaneous effect may be the result of some prior factor influencing both volatility and investment at the same time. However, while that would diminish the importance of such volatility to Germany, it would increase the apparent differences between Germany and France. Evidence for these effects is provided in Table 5.

The table includes OLS (ordinary least squares) regression results for two equations: one displaying the level of real investment as a function of its own past and the other including a measure of exchange rate volatility as an additional explanatory variable. In the case of France, the measure of volatility is

Table 5. Investment and exchange rate volatility, 1973–1996

Dependent variable is real gross fixed capital formation	Constant	First lag of dependent variable	Second lag of dependent variable	Ffr/DM exchange rate volatility*	Adj. R ²	S.E.E.
France	103.2	1.4	-0.5		0.91	47.9
	(1.3)	(7.3)	(-2.5)			
	262.2	1.3	-0.5	-45.0**	0.94	40.0
	(3.3)	(8.2)	(-3.0)	(-3.4)		
Germany	74.8	1.4	-0.5		0.84	23.7
	(1.6)	(6.8)	(-2.5)			
	135.2	1.2	-0.4	-18.2	0.88	20.7
	(2.9)	(6.7)	(-2.5)	(-2.6)		

Notes: *volatility is annual standard deviation of month-to-month log changes; **volatility is lagged by one year; T-statistics in parentheses.

Sources: European Commission and International Monetary Fund.

from the year prior to the level of investment, while in the case of Germany investment and volatility are measured in the same year. The sign of the coefficient on volatility is negative in both cases and so conforms to the theoretical expectation that more volatility means less investment. The statistical significance of the coefficient is indicated by the T-statistic (in parentheses). A T-statistic of 3.4, like that for volatility in France, means that the odds of finding this result by accident are on the order of 3 in 1,000. A T-statistic of 2.5 is somewhat less extreme, and the odds increase to more than 2 in 100. Nevertheless, such odds are still within the conventional 5 per cent threshold regarded as 'significant'. Finally, the impact of volatility on investment can be measured using the change in the S.E.E. (standard error of estimate) from one equation to the next. The difference between the two numbers represents the amount of variation in real investment in the present that cannot be explained with reference to investment in the past. In France, exchange rate volatility explains more than 16 per cent of this variation. In Germany, it explains less than 13 per cent.

A second example concerns the impact of nominal interest rate volatility (measured in the same way as exchange rate volatility). In France, volatility in 3-month interest rates has a contemporaneous negative effect on real gross fixed capital formation. Moreover, volatility in French 3-month interest rates is a positive contemporaneous function of volatility in the bilateral Ffr/DM

exchange rate. Neither of these effects seems to operate in Germany. Investment appears to be unaffected by interest rate volatility, and interest rates appear to be unaffected by volatility in exchange rates. These results are presented in Table 6. Once again the table contains two equations – one with the measure of volatility and one without. In both the French and German cases, the coefficient on volatility takes the expected (negative) sign: more volatility means less investment. However, the coefficient in the German case is not statistically significant – meaning that it may well be zero. The impact of interest rate volatility in France explains slightly more than 13 per cent of the variation in real investment (after accounting for the past). The impact in Germany is non-existent.

Table 6 also contains two equations explaining interest rate volatility as a function of volatility in the exchange rate. The expectation is that more volatile exchange rates will lead to more volatility in interest rates. However, this expectation is borne out only in the French case where the effect is positive and strongly significant. The coefficient in the German case is also positive, but is not statistically significant. More analysis would be required to establish why this is the case. The presumption is that institutions play the determining role. For the moment, all that is necessary is to suggest that volatility is important, and yet the importance of volatility differs across countries both mechanically and in significance.

EMU as empowerment

The benefit of access to international capital markets is greater macroeconomic flexibility. The cost is increased risk and volatility. The challenge, then, is to lower the cost without sacrificing the benefit. The problem is that different countries have different aspirations and confront different costs. At the same time, the existence of such differences constitutes a new problem in its own right. Variation from country to country raises fundamental questions about the equity and even utility of market integration. Finding one solution that fits all cases is difficult, to say the least. Nevertheless, it is necessary if market integration is to be sustainable in the long run, which is what the Europeans have tried to achieve through monetary union.

The founders of Europe's single currency hope to provide much the same flexibility afforded by capital market integration, but at a lower cost. They also intend EMU to serve as a necessary bulwark for the completion of Europe's internal market. Such motivation is political to be sure. However, it is not altruistic. Far from constituting self-sacrifice in the common interest, EMU simply culminates a change in the source of macroeconomic flexibility and nature of macroeconomic constraint.

Table 6. Investment and interest rate volatility, 1978–1996

Dependent variable is	Constant	First lag of dependent variable	Second lag of dependent variable	3-month interest rate volatility*	Adj. R ²	S.E.E.
real gross fixed capital formation	France	138.8 (1.8)	1.5 (8.1)	-0.6 (-3.3)	0.93	41.9
		287.7 (3.2)	1.4 (7.8)	-0.5 (-3.2)	0.95	36.3
	Germany	87.8 (1.7)	1.3 (5.6)	-0.5 (-2.1)	0.82	23.5
		118.9 (1.8)	1.3 (5.3)	-0.5 (-2.1)	0.82	23.8
3-month interest rate volatility			Constant	Ffr/DM exchange rate volatility*	Adj. R ²	S.E.E.
	France		1.7 (1.0)	7.9** (5.1)	0.58	3.4
	Germany		4.4 (3.9)	0.2 (0.2)	-0.1	2.4

Notes: * volatility is annual standard deviation of month-to-month log changes; ** volatility is lagged by one year; T-statistics in parentheses. Sources: European Commission and International Monetary Fund.

The interpretation of EMU as a source of state empowerment is consistent with the history of European monetary integration (the term ‘empowerment’ is an allusion to the argument made by John Gerard Ruggie (1983) about the functioning of the postwar international economic order). Countries within Europe have long recognized that differing domestic institutional structures have a powerful influence on the costs of doing business with the outside world. This is particularly true in the context of exchange rates, where the diverse impacts of volatility across Member States have become part of the legend of monetary integration. The first proposal to create a monetary union in Europe – the Werner Plan of 1970 – emerged from the exchange rate crises of the late 1960s and the monumental difficulties of creating a single system to protect French farmers and German manufacturers alike (McNamara 1993). Each subsequent phase has reiterated the importance of monetary macroeconomic stability both in its own right and in order to create a favorable environment for investment.

The argument that EMU empowers its Member States is also consistent with what Jeffrey Frieden (1996) has identified as ‘the impact of goods and capital market integration on European monetary politics’. Frieden’s argument is that those countries that are most closely integrated have the greatest common interest in stabilizing exchange rates. His reasoning is that closer integration increases the importance of volatility in *specific* bilateral exchange rates such as between France and Germany. By implication, the relative importance of exchange rate volatility in other bilateral rates is lower. Where both France and Germany exhibit a negative relationship between real investment and volatility in the Ffr/DM exchange rate above, neither France nor Germany displays a similar relationship between investment and volatility in the exchange rate between their national currency and the United States dollar. Indeed, the coefficients generated through OLS analysis are not only statistically insignificant, but they also hold the wrong sign (are positive) in both cases. Thus while dollar volatility may be important for Europe as a whole (Belke & Gros 2000), it is less important for Europe’s Member States than volatility between them.

Having made the claim that EMU is a source of state empowerment, however, it is necessary to illustrate two points. First, EMU offers protection from the problems associated with capital market integration. Second, Member States retain the flexibility afforded by a relaxation of the current account constraint. The first point is most easily demonstrated during the immediate run up to monetary union. Europe’s heads of state and government announced the values for their irrevocably fixed exchange rates in May 1998. Soon afterwards, the financial shock waves of the Asian, Latin American and Russian financial crises hit Europe. However, rather than forcing a change in

the parities between European countries, the existence of these crises seemingly added to the rationale behind EMU. Even those countries such as Spain and Portugal that have displayed periodic vulnerability to adverse speculation in capital markets were able to retain their currency pegs. Moreover, they were also able to complete the process of interest rate convergence on European (i.e., German) norms. By December 1998, these countries no longer had to shoulder the burden of risk premiums for their access to international capital (European Central Bank 1999: 43–48).

The protection afforded by EMU is also evident with reference to countries that remain outside of it, most notably the United Kingdom. Between January 1999 and October 2001, the exchange rate between the British pound and the Euro appreciated by 13 per cent while the exchange rate between the pound and the dollar depreciated by 14 per cent. In effect, the European and American currencies traded places in their relative value toward the pound – with the British currency being worth \$1.66 and 1.40 Euros at the start of the single currency, and \$1.44 and 1.60 Euros 34 months later. Despite the apparent symmetry of these movements, however, the disparate impacts of this reversal of fortune did not cancel out. Instead large manufacturers, particularly in the automotive sector, began to clamor for rapid British entry into the single currency. They also began to redistribute some of the risks of currency volatility onto their suppliers (Toyota) and onto their workforce (Vauxhall). These actions resulted in a minor political crisis over British membership in EMU during August 2000.

The flexibility afforded by EMU can be seen by returning to Figure 2. What is evident from the figure is that the variability of current account performance in Europe has increased over the past three years. Whether this constitutes another step-change in how Member States regard the current account remains to be seen. What is clear is that the elimination of national currencies has pushed the current account constraint even farther into the background. Without the threat of currency crises and armed with a supranational central bank, the Member States of EMU should have ready access to international capital markets. For those countries in current account deficit, the challenge will be to attract sufficient funds for domestic investment. However, the significance of this challenge is greatly overwhelmed by the elimination of premiums on the cost of capital. For those countries in surplus, the difficulty remains one of eliminating the inflationary potential of capital inflows. The point to note, however, is that such inflows present an inflationary problem only if Europe as a whole runs a current account surplus. The point is largely theoretical. If the first three years of EMU are any indication, such surpluses are likely to be more than offset by capital flows from Europe to the United States (Bank for International Settlements 2000: 32).

Conclusion: The perils and pluses of flexibility

If there is a dilemma posed by EMU, it arises from the excess of macroeconomic flexibility monetary integration affords participating countries. The danger is not that countries will be unable to manage their economies, but rather that they will take advantage of their relaxed current account constraints and strengthened creditworthiness to run excessive deficits. Just as during the early expansion of international capital markets, such deficits could result in enormous future burdens of adjustment. They could also destabilize European macroeconomic performance in the present. Therefore it is small wonder that Europe's heads of state and government would be so adamant about setting down rules to ensure macroeconomic stability under EMU. It is also small wonder that concern in Europe would focus on how such rules could ever be enforced and whether they will actually be obeyed.

The experience of the Bretton Woods system is instructive on this point. The conventional wisdom is that Bretton Woods collapsed under the weight of excessive dollar liquidity. The United States ran balance of payments deficits both to ensure adequate provision of liquidity for international trade and as a symptom of fiscal imbalances resulting from the Vietnam War. In turn, these deficits ultimately destabilized the whole of the exchange rate system (McCracken 1977: 12). This conventional wisdom may be deficient, however, it touches on a fundamental conflict between 'the conditions for economic growth . . . and the practices of modern governments' (Keohane 1978: 109). Governments do not always exert self-discipline even when it is in their country's long-term self-interest. From the European perspective, the United States is viewed as continuously culpable of falling prey to short-term political pressures. Therefore, any hope for reforming the international financial architecture must start by reforming the United States. A second best solution centers on a reform of the Europeans themselves. This is the course that EMU follows. However, where such reform will lead remains open.

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Notes

1. Some parts of this article develop ideas from my book (Jones 2002).
2. The countries included in the figure are: Australia, Austria, Belgium, Canada, Denmark, Finland, France, Germany, Greece, Ireland, Italy, Japan, Mexico, Netherlands, New Zealand, Norway, Portugal, Spain, Sweden, Switzerland, Turkey, United Kingdom and United States. Note that the figure remains virtually unchanged when the sample set is restricted to the 11 Member States of EMU. Given its extremely small size, Luxembourg is excluded from the analysis.
3. This pattern of correlation is calculated using 1996 data for 1-digit SITC codes for imports and 1- and 2-digit manufacturing codes for exports. However, the patterns of correlation is much the same if we use a lower level of aggregation in the coding of the trade data, and if we use 1986 data instead of 1996 data. These calculations are available upon request from the author.

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Address for correspondence: Erik Jones, Johns Hopkins Bologna Center, via Belmeloro 11, 40126 Bologna, Italy
Tel.: +39 051 291 7833; Fax: +39 051 22 85 05; E-mail: ejones@dnsville.com