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European Monetary Union as a Response to Globalization[†]

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European Monetary Union as a Response to Globalization

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European debate about the architecture of global finance has become inextricably linked to the problem of state autonomy. The reason for this is simple. "Globalization" as a framework of integrated national markets for goods, services, and (most important) capital has replaced the embedded liberalism that supported the "golden age" of the welfare state (Ruggie 1983, Scharpf 1999). In the process, the natural order of things has somehow become inverted. Where embedded liberalism meant that market integration took place only to the extent to which it did not conflict with the underlying values of separate national states, globalization implies that states must operate only to the extent to which they do not hinder the functioning of shared (and integrated) markets (Ruggie 1995, McNamara 1998). The implications for policymakers are clear. Failure to heed this newly established hierarchy invites international financial crisis.

Or does it? Presumably if states could eliminate the threat of exchange rate collapse (and so shore up their attractiveness to foreign investors) then they could enjoy the benefits of liberalized capital markets without sacrificing domestic autonomy. Indeed, following much this sort of reasoning, the links between market liberalization and monetary integration are tight, both analytically and causally. Analytically, liberalized capital markets weaken state control over exchange rates and complicate the task of monetary policy coordination between countries. Causally, recognition of the threat posed by capital market integration to the European monetary system was an important factor in the political drive for monetary union during the late 1980s. As Tommaso Padoa-Schioppa (1987: vi) explained in the introduction to 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" (p. 106).

But is monetary integration really part of the solution or part of the problem? Like globalization, EMU is often seen to subvert the basic principles of the national state. Where the state is inherently political, EMU appears wholly technical. Where the

priorities of the state are national, the priorities of EMU are international (and internationally imposed). Where the focus of the state lies on institutional arrangements, the focus of EMU lies on market behavior. And where the state promises economic stability, EMU necessitates flexible prices, wages, and incomes. Small wonder, then, that many question whether the member states of Europe can reconcile their diverse social objectives with anything like 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)."

The argument in this chapter is that the formation of EMU is about restructuring the financial architecture of Europe in order to enhance—rather than simply diminish—national autonomy. By implication, EMU functions—at least in part—to shore up and insulate Europe's member states during a period of necessary adjustment. The need for adjustment derives from the growing requirement for flexibility in the allocation of economic and political resources (Rhodes and Mény 1998). Such flexibility is necessary for market actors and state agents to meet a range of objectives in the provision of goods and services, private and public. In part, these objectives reflect the requirements of participating in an ever more integrated global economy (Berger 1996). In part, they also reflect the changing values and priorities of diverse European electorates (Inglehart 1997). However, *that* Europe's states require greater flexibility does not necessarily predetermine *how* such flexibility is achieved. EMU represents a common response to the problem of adjustment, but it does not preclude diversity elsewhere. Indeed, given different institutional starting points, it should be expected that Europe's member states will arrive at different formulas for enhancing flexibility at the national and local levels (Pierson 1998, Esping-Anderson 1999, Regini 2000, Scharpf 2000).

This argument is developed in five sections. The first section makes the broad claim that Europe's economic and monetary union effectively reconstitutes the compromise of embedded liberalism at the regional (European) level. The second focuses on the relationship between capital market integration and the development of greater flexibility in the current account. The third places current account flexibility against the background of broader strategies for macro-economic management. The fourth draws attention to the associated problems of volatility and risk when capital markets are integrated but currencies are not. The fifth section concludes by returning to the problem of reforming the welfare state.

I. EMU as Embedded Liberalism

The benefit of access to international capital markets is greater macroeconomic flexibility. Countries with access to international capital markets do not necessarily have to worry about the impact of macroeconomic policies on the current account balance—so long as they can borrow sufficient financial resources from abroad. The cost is increased risk and volatility. Countries that rely on capital inflows to finance deficits on the current account must face the prospect that international lending will dry up and so throw the overall balance of payments (and the exchange rate) into crisis. When countries cannot attract sufficient resources from abroad, they face an immediate need for structural adjustment—and one often accompanied by a collapse in the external value of the currency.

The challenge confronting national policymakers in Europe (as elsewhere) 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. And that is what the Europeans have tried to achieve through monetary union.

The founders of Europe's single currency hope to provide much the 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 and neither is it necessarily federalist. Rather, EMU represents an alternative form of "the compromise of embedded liberalism". Where the architects of the postwar order chose to limit capital markets in order to preserve domestic monetary autonomy while promoting free trade, the architects of Europe have chosen to eliminate national currencies in order to preserve access to international capital markets while laying the basis for a common market. The hierarchy of values is the same in both cases. Domestic diversity predominates over international conformity. All that has changed is the source of flexibility and nature of the constraint.

The interpretation of EMU as a new form of embedded liberalism is consistent with the history of European monetary integration. 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 serious 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 operates as a form of embedded liberalism 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 bilateral exchange rates such as between the member states of Europe. By implication, the relative importance of exchange rate volatility in other bilateral rates is lower. Thus while dollar volatility may be important for Europe as a whole (Belke and Gros 2000), it is less important for Europe’s member states than volatility between them.

Having made the claim that EMU acts as a European compromise of embedded liberalism, however, it is necessary to illustrate two points: first, that EMU offers protection from the problems associated with capital market integration; and second, that 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 thereafter, the financial shockwaves 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 (read German) norms. By December 1998, these countries no longer had to shoulder the burden of risk premiums for their access to international capital (ECB 1999: 43-48).

The protection afforded by EMU is also evident with reference to countries that remain outside, most notably the United Kingdom. Between January 1999 and September 2000, the exchange rate between the British pound and the euro appreciated by

15 percent while the exchange rate between the pound and the dollar depreciated by 13 percent. 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 € 1.41 at the start of the single currency, and \$ 1.45 and € 1.63 twenty-one 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 and may have contributed to the solidification of the Blair government's campaign for membership.²

The flexibility afforded by EMU is more difficult to establish. This is true both because monetary integration implies the transfer of monetary policy authority to the supranational level and because it builds on a foundation of integrated capital markets. The constraint implied by ceding monetary policy authority is tautological and therefore impossible to refute. The constraint implied by capital market integration is well established as well. In its simplest form, the argument is that states which choose to remove capital controls must inevitably select 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 capital market integration 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.

II. Capital Market Integration and State Autonomy

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 and

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. 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 policymaking. This is not a necessary paradox, and policymakers may be capable of (altruistically) pursuing the common good even at their own disadvantage. Alternatively, politicians may be courting favor with the voters precisely by "tying their own hands" (cf. Giavazzi and Pagano, 1988). 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 (Garrett 2000: 169). 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 starting point for this analysis is not constraint but empowerment. My concern 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 policymakers. 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 policymakers with access to

international capital markets can afford to overlook important constraints—both external and internal—that policymakers 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 took over from U.S. balance of payments deficits as the principal source of international liquidity (McCracken et al. 1977: 129). Meanwhile, the public sector share of gross domestic product increased in most countries and government borrowing increased as well. As a result, firms too 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 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 benefitting 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 United Kingdom during the late 1970s—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 note that current account variability has undergone a step change at the European level.

Evidence for the change in European current account performance is assembled in Tables 1 and 2. Both tables contain the average and standard deviation for the balance on current accounts as a ratio to gross domestic product (GDP) for the periods from 1960 to 1973 and from 1983 to 2000 respectively. The period from 1974 to 1982 is omitted because of the powerful influence of the two oil price shocks (1973 and 1979). The countries are ranged from deficit to surplus, and clustered into "large" and "modest" groups. In comparing the 1980s and 1990s with the 1960s and early 1970s, three changes stand out: More countries are running average deficits; the extreme deficits and (particularly) surpluses are greater; and the variability (standard deviation) of national performance has increased in all but three cases—Portugal, Greece, and Spain. What is less apparent from the tables—but can be calculated from the underlying data—is that national performance during the earlier period tends toward balance (zero) while during the later period it tends toward imbalance. The conclusion, then, is straightforward. Under conditions of international capital mobility, the variability of national performance on current accounts has increased.

Insert Table 1 and Table 2 about here.

III. Strategies and Outcomes

Having established that there has been increasing variation in European current account performance, the next step is to explain how this change relates to macroeconomic policy. My argument is that the most extreme cases of current account imbalance are the result (whether intended or not) of the prevailing macroeconomic policy mix. The level of demonstration at this point is only illustrative and not comprehensive. Rather than rehearse a variety of policy scenarios under different regimes and using different models, my strategy is simply to establish the existence of policy combinations that (a) are not available in a world of closed national capital markets and (b) can explain the increasing divergence of current account behavior.³ Because this is a general argument, the examples draw from outside Europe as well as from within.

A. Consistent Current Account Deficits

Examples of countries with consistent current account deficits include the United States in the 1980s and 1990s under a flexible exchange rate regime and Spain and Portugal in the 1990s under the fixed-but-adjustable regime of the European Monetary System (EMS). In all three cases, the policy mix combines loose fiscal policy with tight monetary policy. The effects this mix are easiest to describe under a flexible exchange rate regime. The fiscal expansion increases domestic consumption and so draws down on the current account. Meanwhile, tight monetary policy raises interest rates and so attracts an inflow of foreign capital. Despite the deterioration on the current account, this inflow of foreign capital places upward pressure on the exchange rate and so induces an appreciation of the currency. This currency appreciation blocks off the use of relative prices as a means of correcting the current account and so prolongs and even intensifies the deficit. Nevertheless, so long as the country can continue to attract foreign capital, it can also continue to finance a deficit on current accounts. Therefore, over the short-to-medium term the stability of the policy mix is principally dependent upon the international creditworthiness of the country as well as its relative attractiveness to foreign investors.⁴ Over the long-run, however, accumulated foreign debts will have to be serviced and ultimately repaid. Therefore the long-run stability of the strategy depends upon the governments willingness to use foreign capital to support domestic investment and

restructuring in order to generate current account surpluses in the future.

The advantages of the policy mix are domestic. Loose fiscal policy fuels consumption, tight monetary policy reins in inflation, and an appreciating exchange rate improves the terms of trade (read 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.

The United States experience during the 1980s and 1990s illustrates all of the hallmarks of the loose fiscal / tight monetary policy mix. Under the first Reagan administration, both real interest rates and fiscal deficits increased, leading to a massive inflow of foreign capital, a strong appreciation of the dollar, and a dramatic deterioration on current account. This strategy was both surprising and unwelcome. Not only did it seem to encourage a rapid “de-industrialization of America,” but it also threatened the stability of the international economic system. As the decade progressed, concern that the U.S. economy would experience a “hard landing” rather than a smooth adjustment increased (Marris 1987). Meanwhile, the presumption was that the U.S. ability to sustain such current account deficits is a function of its unique role in the world economy. It is American hegemony in a less powerful and more decadent guise (Calleo 1992).

The argument here is that the policy mix is less a function of American power than of the integration of capital markets. Therefore it is possible to identify a similar strategy used by smaller countries as well. Spain and Portugal follow the characteristic pattern of the tight monetary / loose fiscal policy mix in the early 1990s: domestic expansion leading to a deterioration on current account financed by capital imports induced through relatively high real interest rates. Evidence for the Spanish and Portuguese policy mixes is assembled in Table 3, which provides average data for fiscal balances, current accounts, nominal short-term interest rates, interest rate differentials with Germany, and real interest rates (GDP deflated) for the period from 1988 to 1995. In order to facilitate comparison, Table 3 also includes U.S. data from 1982 to 1998. The data support the broad similarities between the policy mixes and current account performance in the United States on the one hand and Spain and Portugal on the other hand. In all three

cases, persistent current account deficits were only possible as a result of foreign capital inflows and therefore of capital market integration.

Insert Table 3 about here.

Despite the similarities, however, the experience of Spain and Portugal differed from that of the United States in three respects. First, the smaller countries benefitted from capital transfers and so did not rely solely on foreign borrowing as did the United States.⁵ Second, the two countries did not undergo such a strong currency appreciation despite their reliance on capital inflows to finance deficits on current account. Third, both Spain and Portugal were subject to periodic currency crises as international lenders questioned whether and how long the tight monetary / loose fiscal policy mix could be maintained. These three differences reflect the importance of America's hegemonic position in the world economy to its ability to maintain current account deficits over the long run. Because of its economic and military might, and because most countries hold dollars as a reserve currency, the United States has a relatively easy time attracting foreign capital and maintaining international creditworthiness. For Spain and Portugal, running consistent current account deficits is both more difficult and more volatile. Indeed, it may be possible only because where the United States can benefit from hegemony, Spain and Portugal can rely on their institutional and symbolic association with Europe.

Spanish and Portuguese participation in the European Union and specifically in the fixed-but-adjustable exchange rate mechanism (ERM) of the European Monetary System (EMS) can account for much of the difference between U.S. and Iberian experiences. The European Union represents the source of much of the capital transfers to the Iberian peninsula—and with the ostensible purpose of stimulating regional and structural reforms. Moreover, for both Spain and Portugal, the demonstration of a willingness to undertake domestic economic reform lent credibility to their participation in the EMS (Torres 1998, Calvet 1996). In turn, EMS participation enhanced the creditworthiness of both countries by reducing exchange rate risk and so made them more attractive to foreign investors. Finally, once foreign capital inflows began to place upward pressure on the peseta and escudo, the intervention requirements of the ERM displaced responsibility for maintaining the system of fixed-but-adjustable exchange rates onto the weaker European currencies.⁶

The combination of macroeconomic policies, capital transfers, and EMS participation was not wholly stable. Both Spain and Portugal experienced sharp depreciations during the 1992, 1993, and 1995 currency crises within the ERM. Nevertheless, both countries were able to sustain persistent deficits on current accounts using foreign capital to stave off a crisis in their balance of payments. Moreover, reliance on capital inflows meant that the escudo and peseta tended to appreciate between crises even in the face of persistent current account deficits. At the same time, this tendency to appreciate was contained despite the strong inflow of foreign capital. Indeed, both currencies remained in the top of their intervention bands against the median EMS currency even during periods of gradual depreciation such as that between 1996 and 1998 (European Commission 1998: 158-159). Such a performance would not be possible without integrated capital markets.

B. Consistent Current Account Surpluses

Capital flows can offset consistent current account surpluses as well as consistent deficits. From an intuitive standpoint, however, the alternatives are not symmetrical. If a country is able to outperform its competitors either domestically, in the rest of the world, or both, why would investors—domestic and foreign—prefer to place their money elsewhere? Why would a government not encourage its successful manufacturers to repatriate profits and invest them at home? Alternatively, why should governments not allow current account surpluses simply to translate into ever increasing official holdings of foreign exchange reserves—a mercantilist war-chest so to speak? The answer to the first and second questions has to do with relative returns on investment while the answer to the second and third questions concerns the risk of domestic inflation. Capital will flow where the rates of return are relatively higher or the opportunities for investment are greater. By the same token, capital inflows—including repatriated profits and increased foreign exchange reserves—increase domestic liquidity.

If governments confronting a current account surplus do not take action, the likelihood is not only that capital will flow into the country but also that firms and workers will use their increased earnings to bolster investment and consumption. The result will be higher prices coupled with a change in performance on the current account. The logic of this mechanism suggests the paradox that governments hoping to run consistent current account surpluses may have to loosen domestic monetary conditions in order to

hold down demand and stave off inflation. More generally, such governments must not only allow but also encourage international capital mobility.

Loosening monetary conditions to dampen demand and control inflation only represents a paradox when monetary policy instruments are directly and consistently assigned to domestic stabilization. When monetary policy instruments are assigned to influence international capital accounts the paradox is eliminated. All that is necessary is that the impact of monetary policy changes on the balance of payments as a monetary influence is greater than the direct impact of those changes on domestic monetary conditions—a point made implicitly in Mundell's (1960) early analysis of international capital mobility. However, the assignment of monetary instruments either wholly or principally to influence the capital account—like the constraint that monetary instruments must accommodate international capital markets—leaves open how the government will control domestic sources of inflation. Once again what is interesting is not so much the assignment of (or constraint on) monetary policy but rather the structure of the policy mix.

Examples of countries that have run consistent current account surpluses include Japan and the Netherlands throughout the 1980s and 1990s, (West) Germany before unification, and Belgium from 1986 onward. The macroeconomic characteristics of these countries are similar in that they combine tight fiscal policy, high domestic savings relative to investment, stable prices, and declining real wages. All four countries also benefit from non-market mechanisms for ensuring wage stability, ranging from direct intervention in wage negotiations (Belgium and the Netherlands), to concerted wage bargaining (the Netherlands and Germany), to institutionalized wage restraint (Japan). Data in support of this characteristic pattern is assembled in Table 4, and includes the balance on current account, net national savings, the ratio of savings to investment, the average annual price inflation, and the rate of increase in real unit labor costs. Table 4 also provides comparable data from the United States as a benchmark for relative comparison. What the data reveal is that the four countries running consistent current account surpluses save more, invest (relatively) less, have lower inflation and more rapidly declining real unit labor costs than the United States.

Insert Table 4 about here.

What the data in Table 4 do not indicate is the extent to which the four countries running current account surpluses must manage macroeconomic (and specifically monetary) policy instruments with an eye to their impact on the capital account and on exchange rates. The empirical literature on the subject is substantial.⁷ What it reveals is the complexity of the policy mix both at any given phase in time and across different time periods. Within the mix, monetary policy is not always and completely ineffective in the management of domestic demand.⁸ Nevertheless, its use is not entirely transparent either. For example, Henning (1994: 134-170) outlines five phases in the evolution of Japanese monetary and exchange rate policy during the period from 1980 to 1992. The differences between the phases are categorical, and pivot around whether the Yen should be made stronger or weaker, whether capital flows should be regulated or liberalized, whether interest rates should be raised or lowered, and whether the Bank of Japan should intervene in foreign currency markets. In each phase, however, the maintenance of the surplus on current accounts remains a priority and so at least some international mobility of capital remains a necessity.

As with the current account deficit, the advantages of pursuing a surplus are domestic while the disadvantages are both domestic and foreign. The 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. Meanwhile, the non-traded goods sector must labor under an unfavorable terms of trade (read fewer and more expensive imports), constrained wages, and a relative lack of investment. Internationally, trade competitors are likely to view sustained current account surpluses as prima facie evidence of unfair trading practices. Such international concern is not wholly misplaced. Armed with access to international capital markets, states are empowered to sustain current account surpluses despite the constraints this may place on the exercise of monetary policy. Moreover, the evidence suggests that they have done so.

III. Risk, Volatility, and Cost

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 one-another, 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 which 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 macroeconomic 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 investment in the real economy. The general claim 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 assertion that welfare state institutions help to mitigate or redistribute exposure to risk (Rodrik 1998).

The different sensitivities of national economies to the problem of volatility is even more evident with respect to employment and unemployment. Again, in general terms, the argument is that firms confronting volatile interest rates or exchange rates may delay any decision to expand the workforce and may even be forced into redundancies. Thus, the general expectation is that employment growth will slow—and unemployment may even increase—whenever financial markets become volatile (cf. Gros 1998). Here too, however, national institutions will have a profound effect on the sensitivity of the real economy to volatility in financial markets. Because labor market regulations influence the prospects for hiring and firing, the term structure of wage contracts, and the non-payroll cost of the workforce, they will also have an influence on how firms determine the appropriate strategy for responding to volatility.

IV. Conclusion

Discussion of the cost of volatility necessarily returns us to the problem of welfare state reform. Differences in welfare state institutions explain differences in national responses to the problems of integrated capital markets. The greater the problems, the more important these differences become. However, eliminating the differences between countries will not eliminate the problems themselves. All it will achieve is a leveling of the playing field. And, in Europe, that is simply not the objective. Rather the aspiration is to find a common solution to the problem of volatility—one that will preserve the macroeconomic flexibility afforded by capital market integration while at the same time making it possible to ignore substantial institutional differences between the member states. That common solution is EMU.

At this point it is necessary to concede that Europe's member states are all—from richest to poorest—engaged in some process of welfare state reform. However, such reform would be necessary with or without EMU, under segmented capital markets as well as in a globalized world economy. The reasons for reform have been alluded to in the introduction and can be related to changes in values, demographics, technology, and a host of other variables. It is also important to note that the method of reform undertaken in Europe is idiosyncratic—and deliberately so. The buzzwords adopted at the March 2000 Lisbon European Council summit center on “targeting”, “bench-marking”, and “shared-best-practice”. These are terms for individual improvement within a collective process and not for convergence around a common norm.

What is unquestioned in Europe is that reform is necessary. Europe's member states have emerged from the sclerosis of the 1970s and early 1980s only to confront pernicious unemployment in the late 1980s and 1990s. The problem of this unemployment, more than anything else, drives the debate about welfare state reform at both the national and European levels (Jones 1998). Unemployment is also likely to dominate European discussions well into the future. What is clear is that Europe's heads of state and government are insistent that EMU is part of solution (Jones 2000). What is also clear is that the solution for Europe's unemployment problem is different from one member state to the next (Viñals and Jimeno 1998). For EMU to contribute to resolving Europe's unemployment problem it must be consistent with the wide variety of “solutions” that will be implemented at the national level. The analysis presented in this chapter suggests that it is.⁹

Indeed, 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. Rather, it is that they will take advantage of their relaxed current account constraints and strengthened creditworthiness to ignore already excessive imbalances. Indeed, evidence from the first two years of EMU suggest that this is likely to be the case.

For those countries in current account deficit, the challenge of attracting sufficient funds for domestic investment remains. However, the significance of this challenge is greatly overwhelmed by the elimination of premiums on the cost of capital. 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.

For those countries in surplus, the difficulty of eliminating the inflationary potential of capital inflows remains as well. 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 extremes in this case can balance out.

The point is largely theoretical. If the first 21 months of EMU are any indication, aggregate European current account surpluses are likely to be more than offset by capital flows from Europe to the United States (BIS 2000: 32). The preponderance of these flows explains the collapse of the value of the European currency since its launch in January 1999. Moreover, the flood of capital is so great that it has revived concerns about the differential impact of financial volatility across Europe's member states. EMU is only a partial solution to the problems posed by capital market integration: a regional bulwark within the larger architecture of global capital markets.

The greatest danger at the moment is not that EMU will collapse under the weight of internal division but rather that it will prove inadequate in the face of global forces. 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. EMU is in many ways not the first-best solution suggested by Padoa-Schioppa but rather a second-best alternative to a broader systemic reform. For most Europeans, any such transformation in the international financial architecture must begin with a reform of the United States.

Notes

1. As author, I would like to thank the students of the Institut für Politikwissenschaft at the Johannes Gutenberg Universität Mainz for their very lively and thoughtful contributions to this paper. Among my colleagues, I would also like to thank Leslie Armijo, Robert Elgie, Paul Heywood, Donna Lee, Kathleen McNamara, and Jonathon Moses. Any insights are theirs. The faults are mine alone.
2. Coverage of the political crisis around the automotive industry and EMU can be found in any quality paper in August 2000. The stories I relied upon were published in The Guardian on 10 August. The displacement of exchange rate risk onto the Vauxhall workforce received somewhat less coverage. See, Terry Macalister, "Vauxhall Benefits from Sterling's Strength," The Guardian (24 August 2000). The story relates how Vauxhall activated a clause from its 1998 collective bargaining agreement whereby workers would forgo a £100 bonus if the value of the pound "fell below DM 2.70 for two consecutive months." The story also suggests that Vauxhall would continue to include such clauses in its bargaining contracts for the future.
3. Readers interested in deliberating different macroeconomic models are advised to consult Stevenson, Muscatelli, and Gregory (1988) and McKibbin and Sachs (1991).
4. The problem of maintaining creditworthiness (or credibility) is likely to be more easily resolved for rich industrial countries than for poorer developing countries. Hence many of the arguments here may have only limited application outside the privileged membership of the OECD.
5. Capital transfers played a particularly strong role in Portugal, accounting for more than 80 percent of net capital inflows during the 1988-1995 period as opposed to only 20 percent for Spain.
6. Most analyses of the asymmetric intervention requirements of the ERM focus on the privileged position of Germany given the relative strength of the Deutschmark. The point to note is that it is the position of relative strength and not the Deutschmark per se that is privileged by the intervention requirements. For a general analysis, see Gros and Thygesen (1998: 167-178).

7. See for example, Cooper (1968); Wadbrook (1972); Henning (1994); Kaltenthaler (1998); and Jones, Frieden, and Torres (1998).
8. Pooled cross-section time series analysis of the relationship between real short-term and long-term interest rates in the Group of Seven countries indicates that monetary policy changes have a statistically significant impact on long-term real interest rates (and therefore economic activity) through their impact on short-term real interest rates. At the same time, this evidence suggests that accumulated current account surpluses have a significant negative impact on long-run real interest rates—as should be expected given the necessity for capital to flow in the opposite direction of the current account. See Sasaki, Yamaguchi, and Hisada (2000).
9. This is not to say, however, that national solutions for Europe's unemployment problem are going to be successful. Indeed, the danger is that the member states will fail and so undermine the legitimacy of EMU. For an elaboration on this point, see Jones (1998).

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Table 1: European Current Account Performance, 1960-1973 (percent GDP)

Country	Average	Standard Deviation
<i>Large Deficits</i>		
Ireland	-2.3	1.8
Denmark	-1.9	1.0
Greece	-1.9	1.3
Finland	-1.4	1.0
<i>Modest Deficits</i>		
Spain	-0.3	2.2
<i>Modest Surpluses</i>		
Austria	0.0	0.8
Portugal	0.1	3.9
Sweden	0.2	1.0
United Kingdom	0.3	1.0
France	0.6	0.5
Netherlands	0.7	1.5
West Germany	0.8	0.9
<i>Large Surpluses</i>		
Belgium	1.3	1.1
Italy	1.4	1.5

Data Source: European Commission.

Table 2: European Current Account Performance, 1983-2000 (percent GDP)

Country	Average	Standard Deviation
<i>Large Deficits</i>		
Portugal	-3.7	3.1
Greece	-2.5	1.2
United Kingdom	-1.1	1.5
Spain	-1.1	1.7
<i>Modest Deficits</i>		
Austria	-0.9	1.2
Germany	-0.6*	0.4*
Denmark	-0.6	2.3
Ireland	-0.3	2.9
<i>Modest Surpluses</i>		
Finland	0.1	4.0
Sweden	0.1	2.4
Italy	0.2	1.6
France	0.4	1.0
<i>Large Surpluses</i>		
Belgium	2.2	2.2
West Germany	2.5**	1.5**
Netherlands	4.4	1.3

* 1991-2000; ** 1983-1994.

Data Source: European Commission.

Table 3: Consistent Current Account Deficits

Period Averages	1988-1995		1982-1998
	Portugal	Spain	United States
<i>percent gross domestic product</i>			
Government Deficit	4.7	5.0	3.9
Current Account Deficit	2.7	2.2	1.6
<i>percent</i>			
Nominal (Real*) Short Term Interest Rates	14.1	12.2 (5.9)	6.5
	(4.2)		(3.4)
Nominal (Real*) Interest Rate Differentials with Germany	7.2	5.2	0.6
	(0.2)	(1.9)	(0.1)

* Real interest rates are deflated by GDP.

Data source: European Commission.

Table 4: Consistent Current Account Surpluses

Period Averages	1986-98	1982-90	1982-1998		
	Belgium	Germany	Netherlands	Japan	USA*
<i>percent gross domestic product</i>					
Current Account Surplus	2.7	3.2	4.2	2.5	-1.6
Net National Saving	9.0	10.3	9.6	17.2	5.5
<i>ratio</i>					
Gross Saving/Investment	1.08	1.15	1.17	1.10	0.94
Net Saving/Investment	1.30	1.42	1.59	1.20	0.83
<i>annual percentage change</i>					
Price Deflator, Gross Domestic Product	2.6	2.6	1.8	1.1	2.9
Real Unit Labor Costs	-0.6	-1.0	-0.8	-0.5	-0.2

Note: The United States is a "consistent deficit" country presented here as a benchmark for comparison.

Data source: European Commission.