# 2. THE MACROECONOMICS OF EMU

## The overall economic implications

### Predictions of widespread risk and reward: Emu will lead to a significant redistribution of wealth

There are not many historic parallels that measure up in significance to European economic and monetary union (Emu). The most obvious is the German Zollverein in 1834, the customs union of German states that gave rise first to a fixed exchange rate system between the gulden, the southern German currency, and the thaler, the northern German currency, which merged into the mark in 1873. Historians still disagree over whether customs union and monetary union gave rise to political union, but the parallels to current day Europe are evident.

Emu is without doubt the most important economic event in post-war European history, and it may turn out to have been the most important economic event in most of our lifetimes. At the same time, Emu is fraught with immeasurable risks, and could still turn out to be an economic disaster. This is precisely because it carries deep structural implications for Europe's economies, for Europe's companies and employees, and for competition.

Contrary to widespread belief, Emu is not about lower transaction costs in cross-border operations, or about lower hedging costs, and all the other relatively petty reasons that have been invoked in its defence. Its introduction is likely to have a real economic impact, producing changes, some foreseeable, some less easily so. Some companies will go bust as a direct result of Emu. Others could find windfall gains. There will be employees who will lose their jobs as a result of Emu. There will be many winners and many losers, but their national, regional and sector distribution is impossible to forecast. This is where the political risks set in.

The pure macroeconomic effects of Emu, by contrast, are somewhat easier to assess, with the usual caveat that applies to all economic forecasting. The first prediction is that Emu will lead to a significant redistribution of wealth in the EU. This is not necessarily a redistribution from poor to rich or vice versa, but more likely a redistribution across the board. The single currency will hit many sectors of the economy unevenly. Many industrial companies have warned that they will consolidate the number of their EU-based factories. Surveys suggest that many companies will consolidate their banking relations – the result being a likely haemorrhage of small banks.

Big international companies hope to benefit strongly from the euro; mid-sized companies are more lukewarm, while many small companies fear that the euro will bring only cost, but no benefits and perhaps even danger. Some economists even suggest that governments could find Emu acting as a wealth tax on the black economy, which is after all a cash-based economy. Under Emu, black marketeers would at one point have to transfer their ill-gotten D-Marks – the currency of choice in the EU's black economy – into euros, thereby putting themselves at considerable risk. This could be a popular move, but, given the size of the black economy in some parts of Europe, it could instead turn out to be a highly unpopular move.

Much of this enhanced competition and the ensuing redistribution of wealth and income should have come as a direct result of the single European market. But this did not happen because the residual exchange rate risk left much of the single market's economic potential untapped. A single currency will make prices not just comparable across nations but also more transparent. It will mean a far greater degree of price arbitrage across the EU, for example on the part of mail order companies, which can be relied upon to exploit price differentials with ruthless efficiency. The euro economy is likely to react to price signals far more efficiently than nationally based economies.

Independently of Emu, the single market is likely to grow in importance in any case, because several key sectors of the economy, such as telecommunications and energy, are currently in the process of privatisation and deregulation across the EU.

This brings us to our second prediction: with margins, profits and prices coming under pressure, Emu will be highly anti-inflationary, possibly even deflationary. Another more familiar reason is the way one can reasonably expect the future European Central Bank (ECB) to conduct economic policy. As one of the most independent central banks in the world, the ECB may seek to establish credibility early on. Since successful monetary policy is not a precise science, but a mixture of economic analysis, judgment and good luck, the ECB will probably choose to err on the side of caution. This in turn implies that real interest rates will be high initially and may fall only in the long-run. This assessment makes one crucial assumption, which may well turn out to be wrong: that the new central bank will act in the way in which the Bundesbank, its constitutional and institutional role model, acted in the past. Yet it is conceivable that the ECB may look for inspiration elsewhere, for example the Federal Reserve, probably the world's most successful central bank in the 1990s.

In an interview early in 1997, Mr Alexandre Lamfalussy, then the outgoing president of the European Monetary Institute (Emi), recalled that hardline monetarism was relatively young, having emerged only from what he referred to as a "cultural revolution" in the 1970s. Few revolutions succeed, and even fewer last. But given the prevailing mindset among EU

central bankers, one suspects this revolution is not finished yet.

This brings us to our third prediction: Emu will probably have a positive effect on economic growth in the long run, but could have a negative effect on some economies in the short term. This outcome is probably the least certain of all. There will be increased competition, both from Emu directly and from the single market. The need for tight fiscal policy may accelerate reform of public finances – and already has done in several EU countries – and, if this were to coincide with reforms of social security systems, it could in time take some pressure off the labour markets. The result could be a series of mutually reinforcing virtuous mechanisms.

The negative growth implications in the short term would stem directly from an over-tight monetary policy. This would be reinforced by a tight fiscal policy on the basis of the stability pacts, signed by EU leaders. If the combination of a tight fiscal and monetary stance was to lead to an overvalued exchange rate and a slump in exports, Emu could easily trigger an economic downturn. If the downturn became a recession early on, Emu itself would be at great political risk.

This leads us to the fourth and perhaps most depressing prediction: unemployment will remain significantly above levels considered necessary for price stability for some time to come. High EU unemployment is not only the result of malfunctioning labour markets but of malfunctioning social security systems, which are financed not through general taxation but through levies on the labour market directly.

Most EU countries have yet to take fundamental steps in reforming these systems, which constitute a significant tax on jobs. In Germany, indirect wage costs account for well over 40 per cent of total wage costs, the reason for Germany's top position in the international league tables of wage costs. Most experts agree that it makes no economic sense to place the entire welfare burden on the labour market at a time of record unemployment. But most European governments have failed to push through more than cosmetic reforms.

The final prediction about the macroeconomic effects of Emu is that the euro will become a large reserve currency to rival the dollar. The development is entirely benign, because it would make the international financial system – and the international financial institutions, such as the International Monetary Fund and the World Bank – less lopsided. Many central banks, especially in Asia, are expected to switch over some of their reserves into euros to achieve a more balanced portfolio that is more in tune with their trade flows. Reserve currency status for the euro will have some consequences for monetary policy, and could lead to greater exchange-rate volatilities than would otherwise be the case – a potential problem for exporters.

Taken together, the economic consequences of the euro are likely to be more immense than any policy decision taken for decades. Yet the introduction of the euro was decided primarily on political grounds – to provide a further impetus for European integration, which supplanted the economic argument that a single market requires a single currency to be fully effective. This contradiction has plagued the preparation period significantly, and is posing a great dilemma for countries, such as the UK, Denmark and Sweden, which are sceptical about further political integration, and yet they fear that they may suffer economic disadvantage by staying outside the euro zone. But a currency is not just a medium of exchange, a store of value, and a unit of account as the textbooks suggests. It also forms part of a country's constitutional and political fabric.

Looking at the economy as a whole, the long term consequences of Emu could turn out to be benign as long as the promised efficiency gains come about and as long as the sharp tools of monetary policy are used with restraint. But this depends to a great extent on the wisdom of the governing council of the independent ECB. If it lacks political sensitivity, the result could be very different.

WOLFGANG MÜNCHAU / FIRST APPEARED 28 MAY 97

**UNEMPLOYMENT WILL REMAIN SIGNIFICANTLY ABOVE LEVELS CONSIDERED NECESSARY FOR PRICE STABILITY**

# A market on the scale of the US

**The euro will help to create an integrated European economy, operating – like the US – on a continental scale**

Most of the discussion about the single currency has been conducted in national terms. Which countries will qualify? Which economies will gain or lose from a one-size-fits-all monetary policy? Which nations' politicians will have most influence on the board of the new European Central Bank? But to think of the single currency project in those terms is to miss the point. The essence of the project is to erase the national boundaries that govern most people's thinking.

In many countries, the debate over the euro has focused on its suitability as a replacement national currency. A slightly more sophisticated level of discussion has seen the single currency as merely another variant of fixed exchange rates.

To the business people who must cope with its consequences, however, monetary union is something far more significant. It removes a crucial – arguably the most crucial – barrier to the creation of a fully integrated European economy, operating on a continental scale like the US. What are the reasons for the sweeping nature of this change? And what are the consequences for business?

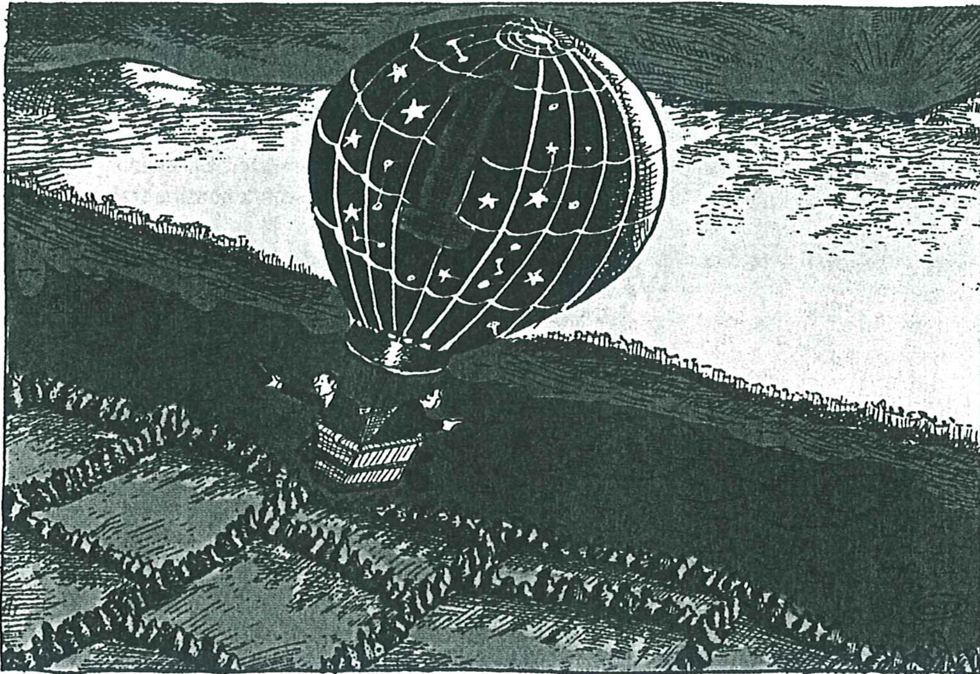
The answers to the first question are not, at first, obvious. After all, there have been currency unions before – between Britain and Ireland, or Belgium and Luxembourg, or the Latin monetary union of the mid-19th century. Few of these justify such portentous language. And though the Bretton Woods system, which governed international monetary relations for the quarter-century after the second world war, was not a currency union, it did impose fixed exchange rates on the whole of the developed world. So why should European business be transformed now by a reversion to such rates?

The reasons for seeing the euro as a watershed are three. First, the creation of the single currency will mark the climax of a sustained effort to create a genuinely single market in Europe, dating back at least to the Treaty of Rome in 1957. A great deal of progress has been made, but the single market still awaits the final, symbolic step: the setting of all prices in a single currency. Overnight – in 2002 when euro notes and coins replace national denominations rather than in 1999 – prices in one country will be instantly comparable with those in its neighbour. Goods and services that have increasingly become homogeneous in packaging and content will now be subject to a common set of pricing disciplines.

Second, monetary policy in the euro region will be set with reference to economic conditions in the whole of the area. Though "core Europe" – today's D-Mark bloc plus France – will strongly influence the decisions of the new central bank, monetary policy will still be less attuned to any country's domestic economic conditions than is currently the case. The nation will be even less relevant as a unit of economic activity. This, of course, is what opponents of the single currency, both economists and politicians, object to.

Third, the new currency is being introduced when technology and globalisation of markets are freeing companies from historic national roots. Individual European governments have much less ability to force companies into line. Again, a national frame of reference becomes less relevant.

So what will the consequences be for business? Some will be practical, others more sweeping and distant. In the short-term, companies will need to cope with the consequences of greater cross-border price transparency. They will almost certainly need to move towards a common European price list, with some regional variation. This will be a big shift from the →



opportunities in order to assemble hasty, ambitious business empires. As is usually the case in eras of financial innovation, many of these "first flush" empires will not survive in their initial form. But from their ashes a smaller number of well-run pan-European businesses will arise – companies that would not have come into being without the excesses of their founders. A third theme of the euro era has already been foreshadowed. Governments will lose influence, and the national frame of reference will become less useful. Companies will think increasingly of non-national target markets: regions, linguistic groups, demographic cohorts, cross-border pools of people with similar aspirations and tastes. As they do so, and as they become larger, pan-European entities, they will come to realise that individual national governments influence them in only a

current pattern of separate national prices, influenced heavily by custom and much more lightly by the desire for Euro-consistency.

Similar nagging practical matters – already widely recognised – will arise over handling the new notes and coins, switching to euros for accounting, issuing new share certificates in euros and so on.

Though these issues will consume millions of hours of work, they are not the central ones. As the merger wave indicates, companies are already trying to scale themselves up to cope with a number of bigger, longer-term trends. The most obvious of these is that physically transportable products, especially ones where there is little difference in national tastes, will become commodities traded in Europe-wide markets by a relatively small number of companies operating on a continental scale.

Money is the most easily transportable product of all, transmissible at the touch of a switch. So it is not surprising that many cross-border mergers are taking place in financial services. When all banks and insurance companies are providing services in a single currency, the biggest remaining national barriers in this industry will have fallen.

There will still be barriers of information, of course. Consumers will be ignorant about non-local suppliers of financial services. Banks will be ignorant about unfamiliar credit risks; insurers about local patterns of health and behaviour. And, despite the EU's single passport for financial firms, there will be local regulatory barriers to foreign firms. But it will be only a matter of time before all these obstacles fall away. In financial services, as in other highly transportable businesses, the winners will be those competitors that most rapidly – and most cost-effectively – develop trusted Europe-wide brands. These may not, of course, be European-owned.

A second big theme affecting companies is the impact of changes in the capital markets. In most European countries, interest rates will fall to historically low levels. They may also – though this is a more controversial point – be more stable, as they shift from following the vagaries of national economic cycles to tracking the larger and more diffuse European one. Certainly, a huge, liquid pan-European bond market will emerge, providing a cheaper, more plentiful source of long-term borrowing.

This will change the competitive picture in capital-intensive businesses, and in those industries where mid-sized competitors have previously had limited access to long-term money. Similar changes may also make equity finance more widely available, as investors react to the absence of currency risk by diversifying their portfolios across national borders.

Across Europe, entrepreneurs will rush to use these new financial

handful of ways – and each of these can be avoided. National governments set tax rates; they establish labour regulations; and they influence the framework for corporate governance.

Increasingly, however, companies have discretion in the extent to which they are subject to these influences. They can shift production abroad; they can move their tax burden round the world; and they can transfer their corporate entities to other stock exchanges and other legal jurisdictions. An integrated European economy will make it ever easier for companies to circumvent national European jurisdictions, undermining the power of governments further. Paradoxically, companies' ability to escape will make governments keener to exact tribute from those that do not, or cannot, threaten to make use of their greater mobility. As the levers of monetary control slip out of governments' hands, and as the fiscal autonomy of euro member states becomes limited both by the "stability pact" governing members' fiscal policy and by the limits of public tolerance for taxation, the battleground shifts. The 35-hour week promises in France and Italy are a reflection of this trend. In the long-run, companies can escape them by moving operations abroad; in the short-run, they reflect a lingering desire on the part of governments and voters to re-establish the national frameworks that are crumbling everywhere.

Such developments indicate the severe political tests that the single currency will have to undergo in the early years of the next century. It may not survive. But if it does, European business people will have to adjust to a completely different environment.

The question of whether monetary union is a good thing for Germany or a bad thing for Britain will come to seem obsolete. Some companies in every country will prosper from its consequences; others will suffer. The members of each group will have more in common with fellow beneficiaries – or sufferers – across Europe's vanishing borders than they will with compatriots in the other camp.

National identity will remain relevant in some areas – culture, law, education, infrastructure. In other areas of life, especially those that influence purchasing decisions, other identities will prevail: local, linguistic, group, or Europe-wide. For 21st century European business, this second category will be the crucial one.

The introduction of Europe's single currency is only one of the forces that are bringing about this shift. But in years to come, we shall see it as the moment at which the balance tipped.

PETER MARTIN / FIRST APPEARED 16 OCT 97

# Reality Check

**The need for realism about Emu: Radical labour market reforms are necessary if monetary union is to survive**

Germany is beginning to wake up to the problems that will have to be tackled after the launch of the single currency. There has been a flurry of warnings that Emu will be born in a difficult environment and require radical economic adjustment among its member states.

Hans Tietmeyer, the Bundesbank president, reminded readers of Die Woche, a German newspaper, last autumn that the Maastricht treaty was taking Europe into uncharted territory and that his own country would have to change. "In Europe, in contrast to other monetary unions, we will have neither a common tax system nor a common social security system," he said. "Unlike most federal states, there will be no system of fiscal transfers. Europe will simply have a single monetary policy." Germany, he said, "must reform itself in such a way that business becomes more dynamic, invests more and employs more, and the public budgets and social security systems are once again placed on sustainable financial foundations."

He pointed out that flexibility in the business sector and the labour market were essential for Emu to survive. Otherwise, the monetary union could produce conflicts, generate demands for fiscal transfers and prove "very problematical". A similar warning came from the International Monetary Fund, which lamented the lack of economic reform in Germany, France and Italy. It suggested greater labour market flexibility was almost as important for the future of Emu as a sound fiscal policy in the member states. Without labour market reform, unemployment would rise and undermine public support for the single currency.

The need for action in much of Europe can be seen in the illustration (below) showing recent forecasts of structural unemployment in 1998 by the Paris-based Organisation for Economic Co-operation and Development (OECD). The OECD expects structural unemployment, which requires changed policies to be corrected, to be 10 per cent of the European Union labour force next year – more than 12 times the 0.8 per cent cyclical jobless rate that might be expected to disappear with an economic upturn.

Concern about European structural problems and their implications for Emu was also apparent among academic economists and monetary officials at the European Summer Institute conference in Berlin in September on the German economy and the EU. The need for reform of its tax systems was highlighted by two Italian economists, Francesco Daveri and Guido Tabellini, who demonstrated a strong link between high labour taxes and high unemployment in Europe. Manfred Neumann, professor of economic policy at Bonn University and chairman of the economics ministry's council of expert advisers, said that "close to nothing" had been done to reform Germany's labour market regulations, the public pension system or the tax system, although it was widely recognised existing structures were "seriously deficient and required major changes".

Prof Neumann said fundamental reform of the labour market was "still taboo" in spite of unemployment at that time, of more than, 4.4m. A mini-reform of Germany's pay-as-you-go pension system, designed by the government, might help for 10 to 15 years.

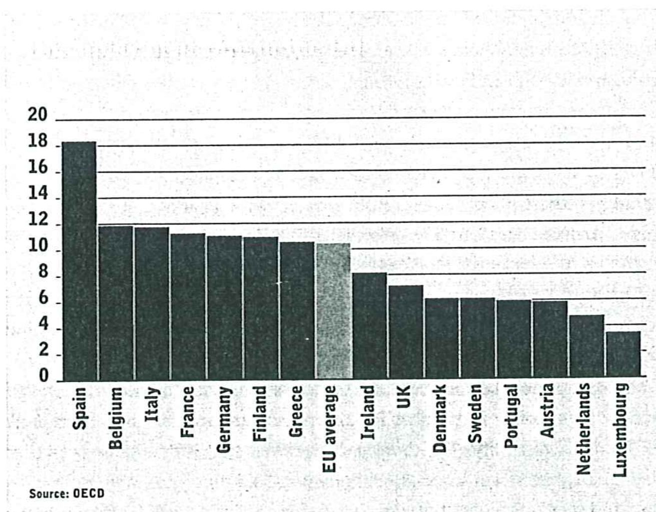
But official forecasts indicated that the number of people aged 63 and above was likely to jump from about 35 per cent of the population of working age in 2012 to 57 per cent by 2035. The implications of this large increase in Germany's elderly population after 2010 were "essentially ignored". Prof Neumann's address questioned whether Germany and other potential launch members of Emu were fit for the euro. The demographic shift starting after 2010 is foreseeable today. In the absence of a policy response, it seems certain to have a profoundly negative effect on German business costs and the country's capacity to meet the Emu debt and deficit criteria in the long-term.

German politics, Prof Neumann complained, was "hypnotised by the objective to qualify for Emu". Some of the closest political allies of Helmut Kohl, the German chancellor, subsequently showed that they also saw an agenda of structural reform in Emu.

A policy statement produced under the auspices of Wolfgang Schauble, the leader of Mr Kohl's Christian Democratic Union and its Bavarian sister party in the Bundestag, said monetary union was aimed at "a radical rehabilitation and modernisation of Europe's economies". The joint paper cast Emu in the role of a disciplinary agent on national governments rather than a vague guarantor of peace and freedom. The Maastricht treaty, it said, was designed to break the vicious circle of rising unemployment and the growing strain on public finances. Monetary union offered a way forward to combat deficiencies such as excessively regulated labour markets, high and complex taxation, outdated education and training system, imbalances in the old age pension system and the continuing rise in health care costs.

Mr Schauble's paper recognised that Emu could be a problem for the government because the painful effects of economic adjustment would be felt long before the benefits accrued. Its publication at the start of 12 months of campaigning up to the German general election in September this year was therefore a bold political step. But it will only mark a new realism about Emu if it is followed by action.

PETER NORMAN / FIRST APPEARED 22 SEP 97



Source: OECD

# Monetary policy under Emu: a six-part series

## A: MONETARY VERSUS INFLATION TARGETING

**European central bankers face a dilemma in deciding monetary policy**

One of the few unresolved questions about the European Central Bank is the choice of monetary policy instrument. Two alternatives are on offer: monetary targeting, used by the Bundesbank and several other European central banks, and direct inflation targeting, used by the Bank of England and the Swedish Riksbank.

There are two broad schools of thought among European central bankers. One says it does not matter. In practice, monetary policy tends to be far more judgemental than most observers, especially financial market economists and journalists, believe. Targets may serve as a useful input, but policymakers tend to "look at everything" when they set interest rates. →

CASE STUDY: ICI

## Uk chemicals company is making sure everyone is involved in preparations

"The sight of January 1 1999 in the desk diary really concentrates the mind," says Peter Everett, spokesman for a multi-disciplinary Emu team at ICI, the UK chemicals company, preparing the group for European monetary union.

ICI itself has been getting ready for monetary union for nearly 18 months – a lot less time than some European companies, which began five years ago – but well ahead of most of British industry.

ICI decided from the outset against limiting Emu preparations to the information technology and financial departments for which it presents the most obvious challenges. Instead, the group has chosen to view Emu as a very broad issue affecting the whole range of its business activities. Pricing, branding, cross-border management, customer and supplier relations all come into the picture, says Mr Everett.

ICI's preparations started in the autumn of 1996, with a paper to the board from Richard Freeman, its then chief economist. Alan Small, the chief financial officer, took overall responsibility and created a steering committee under Richard Sykes, the group's head of information technology, with Mr Everett as his principal assistant.

The committee spent the first few months researching Emu-related material from the European Commission, the UK government and other sources. Later it held a conference of about 40 key executives to review progress and make detailed plans. The meeting was addressed by consultants from KPMG, the accountancy firm, who highlighted the potential effects of Emu on pricing and branding.

The executives left the conference with plans to make detailed commercial preparations at the divisional level ahead of an internal audit and a second conference.

At the heart of ICI's plans is a conviction that the commercial impact of Emu will be relatively small in wholesale markets, where products are already traded on a global or Europe-wide basis, and relatively great in consumer markets.

For example, the company expects Emu to make little difference in bulk chemicals, which have long been traded across western Europe in D-Mark prices on transparent terms. A single market priced in a single currency is already well established.

However, in consumer markets, in which product prices vary between countries, ICI thinks Emu could cause a significant decline in prices, with consumer pressure forcing price cuts in higher-priced national markets. "There is likely to be price erosion. Retailers won't accept those cuts themselves and will try to pass them on to manufacturers," says Mr Everett. The problem is exacerbated by the issue of price points – that is, the prices which retailers find most psychologically tempting to consumers, such as £9.99 or FFr99. With Emu, companies will be obliged to change their prices in Emu-member countries into euros. But a French franc price of, say, FFr99 will not translate directly into a psychologically attractive euro price. Retailers will be under pressure to reduce prices to the nearest attractive price point.

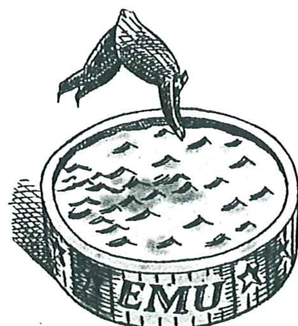
And suppliers selling the same product in more than one country will be under pressure to adjust prices in two or more currencies into one euro price – at an attractive price point.

Mr Everett says that some companies will be able to justify different prices in different countries by providing a greater choice or better after-sales service. Distance from the manufacturing site could also lead to price differentials.

Moreover, companies could try to maintain prices by marketing different brands in different countries. National characteristics will remain important after monetary union, he says.

However, Mr Everett expects that in border areas, where consumers can shop freely in more than one country, the pressure for price uniformity will be intense. "The issue for business will be to harmonise prices or justify differences."

BY STEFAN WAGSTYL / FIRST APPEARED 10 MAR 1998




This is known by economists as the "discretionary" approach. The other school firmly believes in targets – whether inflation targets or monetary targets. The main argument for targeting is consistency. Target followers still look at everything. But they may look first at M3, a broad measure of money supply, and then at various forward-looking indicators of inflation and other economic variables.

The German model is still seen as likely to prevail in the medium-to-long term, but senior officials now acknowledge the need for some flexibility in the ECB's early years.

At a Financial Times conference, Herve Hannoun, deputy governor of the Bank of France, admitted to having doubts. He still came out in favour of monetary targeting, but he did so "with a caveat". As it turned out, the caveat was more revealing than other well-rehearsed reasons in favour of monetary targeting.

Listing all the known arguments for monetary targeting – transparency, consistency – he warns that the strategy hinges on the stability of money demand, by which he means the relationship between the amount of money in an economy and the price level.

"Preliminary research has shown that EU-wide money equations often perform better than comparable national equations. Nonetheless this may provide no safe guidance for the starting period of Emu in so far as the move constitutes a change of regime which might lead to breakdowns in empirical relationships," he said.

Otmar Issing, one of the most influential members of the Bundesbank's decision-making council, has given the most explicit acknowledgement of the need for mixed targeting so far. "Because of the great uncertainties at the beginning of economic and monetary union, a monetary target should be complemented by – as I would call it – an inflation forecast." Here, leading central bankers warn that the monetary policy that Europe's central banks have been using for more than 20 years may no longer work.

The Bundesbank has operated monetary targeting since 1975, but has met its self-imposed monetary targets only 12 times in the last 22 years. Under inflation targeting, the central bank targets an inflation indicator, using a mix of economic and monetary data. The UK, Sweden and Finland use this method.

The European Monetary Institute, the forerunner of the ECB, has left the choice open. Monetary targeting was seen as the hot favourite until recently, but central bankers have become more open-minded. When presenting the Bundesbank's monetary targets for 1998 in November, Hans Tietmeyer, Bundesbank president, merely insisted that monetary targeting should play "an important role" under Emu.

Mr Issing's concession is partly an acknowledgement of the Lucas critique, named after Robert Lucas, the 1995 Nobel Prize winner in economics, who is famous for the observation that a change in policy systematically alters the structure of econometric models.

Applied to Emu, the Lucas critique says statistical relationships that appear reliable on a national level before Emu may no longer be reliable on a European level after Emu.

Mr Issing remains, however, a strong defender of monetary targeting. In an article late last year*, he writes that "the Lucas critique does not imply that economic relationships will be unstable" if the authorities behave consistently.

Ivo Arnold, a monetary economist at Nijenrode University in the Netherlands, observes** that it was the success of the Bundesbank that gave credibility to monetary targeting, and not the other way round. His own research has indicated that the demand for money could be far more unstable under Emu than was widely thought.

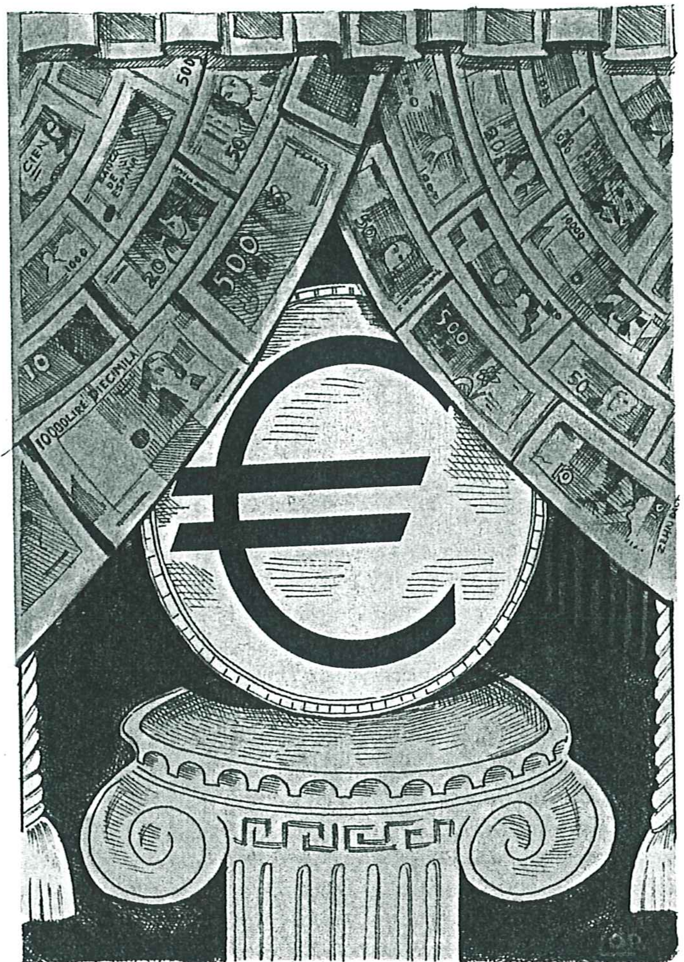
Like many monetary economists, he has argued that inflation targeting is a more appropriate instrument for a new central bank that has yet to build up its own credibility. "The bottom line is that the Bundesbank can afford to regularly miss its monetary targets, the ECB not (yet)," he writes. The growing scepticism about monetary targeting is influenced by forecasts that

Emu might lead to upheavals in the financial sector. Experts are forecasting an increase in bank mergers, and greater use of electronic money. Some economists argue that the choice of instrument does not matter, since central banks tend be pragmatic under any system. The opposite view holds that the choice of target still affects expectations in financial markets, and this could reverberate on the decision-making process itself.

**Otmar Issing, monetary targeting in Germany: The stability of monetary policy and of the monetary system, Journal of Monetary Economics, 39 (1997).*

***Ivo Arnold, Monetary Targeting in the Emu: Lessons from the United States, Kredit und Kapital, Duncker & Humblot, Berlin, 1997, Heft 3.*

WOLFGANG MÜNCHAU / ADAPTED FROM TWO ARTICLES THAT FIRST APPEARED 25 NOV 97 AND 23 DEC 97



## B: THE POLICY MIX

### The ECB must decide how to mix fiscal and monetary policy in the new Europe

The success or failure of European monetary union will depend to a large extent on how politicians and central bankers manage the so-called "fiscal-monetary mix", a term describing the interaction between fiscal and monetary policy.

The mix, which incorporates the combined policy stance of an economic area and is generally counter-cyclical, is the subject of intense interest among economists and central bankers gearing up for Emu. It is a complex and speculative area, with an almost endless number of scenarios.

What makes Emu potentially complicated is the degree to which EU-wide fiscal policy remains decentralised. To set an appropriate fiscal-monetary mix, the European Central Bank will have to co-ordinate with 11 member-governments and the European Commission, which administers the EU's own budget.

This degree of decentralisation could give rise to a "free-rider" problem. Any single country's unilateral fiscal action would have little impact on the Emu-wide average. As a result, governments – especially in small countries – have an incentive to run the highest permissible budget deficits.

Of course, if everyone acted this way, Emu-wide fiscal policy could err permanently on the side of high deficits, and this could quickly become intolerable. Besides, individual government action is limited by a ceiling set by the stability and growth pact, agreed at the EU summit in Amsterdam last June. The ceiling stands at 3 per cent of gross domestic product. The ECB might decide to counter excessive fiscal deficits with a relatively tight monetary policy. If it compensated fully, interest rates would be permanently higher than they would be under perfectly symmetric conditions. The euro, the future single currency, might then rise against other currencies, the terms of trade for the entire Emu area would worsen, and economic growth would settle at sub-optimal levels.

**THE ECB'S MONETARY POLICY MIGHT BE ABLE TO COMPENSATE ONLY PARTLY FOR FISCAL LAXITY**

However, for political reasons, the ECB's monetary policy might be able to compensate only partly for fiscal laxity. In that case, inflation would be higher than under a perfectly co-ordinated policy. Either outcome would be seen as economically inefficient, socially undesirable and politically instable.

In a recent discussion paper ("Options for the future exchange rate policy of the EMU", CEPR Occasional Paper No. 17), the London-based Centre for Economic Policy Research notes that the rigid ceiling imposed by the stability and growth pact could perversely end up damaging the ECB's credibility. It considers a case in which all except one or two Emu countries are in recession. Faced with such a situation, the ECB would run a loose monetary policy. But this stance would be inappropriate in the one or two countries not in recession. "A better policy would call for a smaller monetary expansion, accompanied by a fiscal stimulus in those countries where the recession is deeper," according to the paper.

The 3 per cent deficit ceiling "will put the ECB under pressure to opt for a tight fiscal-easy money policy mix", adding: "It will therefore impede rather than assist the ECB. Nor could the ECB argue for a lax application of the stability and growth pact, for fear of losing its own credibility."

This is one of many scenarios under which Emu could face strains. The authors make the point that the pact is not sufficiently flexible. Fiscal policy flexibility would, however, be extremely important in dealing with asymmetric shocks or asynchronous business cycles.

As long as business cycles are convergent and fiscal policy well co-ordinated, monetary policy may face few obstacles. But it is impossible to know whether some sudden crisis may blow up in the future, forcing a change in arrangements.

This is why the current institutional and constitutional framework of Emu may not be carved in stone. The CEPR researchers conclude that the stability and growth pact is untenable in its present inflexible form, and will need to be replaced by more supple rules.

"Such a reform, however, should be accompanied by procedures designed to foster the co-ordination of fiscal policies among national governments, and of monetary and fiscal policies between Ecofin (EU economics and finance ministers) and the ECB."

This would imply what "Emu-minimalists" have been keen to avoid: the overall stance of fiscal policy will not just become a subject of common concern, as is already the case, but subject to common rule. This means an unprecedented degree of economic government.

BY WOLFGANG MÜNCHAU / FIRST APPEARED 13 JAN 98

## C: ONE SIZE FITS ALL?

### Will one monetary policy fit all? EU members differ and so do the effects of a rate change

Central bankers and economists are becoming increasingly troubled by the consequences of a "one-size-fits-all" monetary policy. At issue are the so-called transmission mechanisms – the channels through which monetary policy feeds through to the real world of economic growth and jobs.

Central bankers know that a rise in short-term interest rates or other forms of monetary tightening will ultimately affect the rate of economic growth. In most countries, they have a rough idea about the time-lag between the two events. But they do not always understand the precise route through which a rise in interest rates feeds through the system.

According to an IMF working paper*, EU countries can be divided into two groups, according to the speed and extent with which they react to interest rate changes. A slow-response group is made up of Germany, the UK, Netherlands, Austria, Belgium and Finland; while a fast-response group is made up of Denmark, France, Italy, Portugal, Spain and Sweden. The result is surprising because, as the authors point out, the two groups do not correspond to the conventional distinction between "core" and "non-core" EU countries. France and Germany are on different sides of the divide, with France falling in a group with several countries generally perceived as non-core. The UK and Finland, by contrast, fall into the core category.

Output in the countries in the first group bottoms out 11 to 12 quarters after a sudden monetary tightening, while in the second group it takes only five to six quarters. However, the economic effects are almost twice as strong in the first group compared with the second.

According to the IMF, a monetary shock would reduce economic growth in the first group by 0.7 to 0.9 percentage points, against 0.4 to 0.6 percentage points for the second. A tightening of monetary policy under Emu would take time to make its full extent felt in Germany, but would be strongly felt in the economy. It would affect France much faster, but with less impact. Monetary policy affects the real economy in several ways. Generally, a rise in interest rates increases the cost of capital and damps demand. In a small open economy, however, exchange rates might be more important: higher interest rates can trigger an appreciation in the nominal and real exchange rate and a subsequent fall in exports. Other potential transmission mechanisms are asset prices, which might fall after a rise in interest rates, and credit, since higher rates can lead to a decline in bank lending. The European Commission has also acknowledged that the different transmission mechanisms in EU countries might pose risks for Emu. In a wide-ranging report on the economic consequences of Emu**, the Commission argues that structural differences in the financial systems are partly responsible for variations between countries' transmission mechanisms. Such economic differences include the degree of competition between banks, the share of bank credit in total financing, ownership structures, the degree of internationalisation of the banking system, and foreign currency holdings.

**DIFFERENT TRANSMISSION MECHANISMS IN EU COUNTRIES MIGHT POSE RISKS FOR EMU**

The Commission's paper adds two mitigating factors. Members of the exchange-rate mechanism may have already made significant adjustments in recent years. In addition, the transition to Emu itself could trigger further harmonisation. "Emu will represent a fundamental regime change which will inevitably modify the structural parameters of national economic systems and, hence, the differences across countries. However, while some of the differences are bound to disappear as soon as a single currency becomes a reality, others will only vanish in the long run, while others will be permanent." In view of the uncertainties about transmission mechanisms, experts are hesitant to recommend concrete policy action.

The IMF paper concedes that the structural differences might narrow after the launch of Emu. But it ends on a cautionary note. "The task of conducting monetary policy at the EU-wide level is likely to be a challenging one in the initial years of the monetary union."

**Ramaswamy R, Sloek T, 'The Real Effects of Monetary Policy in the European Union: What Are the Differences?', International Monetary Fund, Working Paper 97/160, December 1997*

***European Commission, Directorate General 2, 'Economic policy in Emu, Part B', Economic Papers, No. 125*

BY WOLFGANG MÜNCHAU / FIRST APPEARED 30 DEC 97

## D: EXCHANGE RATE POLICY UNDER EMU

### Currency interplay may be very different from that of the past

Another uncertain aspect of Emu is the exchange rate policy that will govern the future single currency. Europe's exchange rate relations with the rest of the world are sure to undergo change as the euro's introduction reshapes the region's economy. Yet exchange rate policy after January 1 1999 remains a largely unresolved issue. That appears rather surprising in light of the fact that the conversion rates for currencies participating in Emu are due to be announced in May.

While the European Union's Maastricht treaty stipulates that the European Central Bank (ECB) should be concerned primarily with internal stability, there remains significant room for interpretation about the need to secure external stability, especially concerning the euro/dollar exchange rate. The question of future exchange rate policy is the subject of a detailed discussion paper* by the Centre for Economic Policy Research in London. The paper makes the point that Emu will transform a group of small open economies into a large closed economy, similar in some respects to that of the US.

This will change the importance of the exchange rate for domestic policy. Under Emu, the export share of gross domestic product will be about 10 per cent, similar to prevailing levels in the US, but significantly lower than current levels in all the EU economies. The reason is that trade between two EU members is now accounted for as foreign trade, while it will become "domestic" trade under Emu. "In a closed economy, monetary policy operates through interest rates and asset prices, including housing. In an open economy, the exchange rate assumes paramount importance," the paper notes. A relatively closed economy, such as the US, has more monetary independence than a small open economy such as the UK, where monetary policy is severely constrained by the exchange rate.

The paper argues that this difference becomes important once the central bank faces a policy dilemma. The Federal Reserve, for example, would invariably focus on the internal objectives, if faced with a conflict between internal and external stability.

"For these reasons, it is natural to expect the ECB will devote less attention to the exchange rate than has been the case with European central banks so far." With an exchange rate policy of "benign neglect", the exchange rate will become a policy issue only under extreme economic circumstances or under extreme exchange rate volatility.

Is extreme exchange rate volatility more or less likely under Emu?

The paper gives no conclusive evidence, but points out that Emu will remove one stabilising factor. At present, when the dollar weakens against the D-Mark, other European currencies also weaken against the D-Mark. As a result, the dollar's overall rate against a basket of European and other international currencies weakens by less than the dollar/D-Mark rate would suggest. Under Emu, that buffer would no longer be there.

Other factors could add to volatility. "Each major currency has its fringe of hangers-on and the euro will be no exception," the authors note. This is a reference to the post-1999 exchange rate mechanism, a voluntary

exchange rate system to link the currencies of non-participating EU countries, such as Denmark, to the euro. Some eastern European countries might also maintain links, such as the currency board operated by Estonia, which at present ties the kroon to the D-Mark. But where no formal exchange rate links exist, the result could be increased volatility in intra-European exchange rates, for example between the euro and the pound.

"Extreme caution will be required to avoid trade friction from boiling over into political tensions on suspicions of beggar-thy-neighbour policies," the authors note.

Under a policy of benign neglect towards the exchange rate, in both the US and the EU, close policy co-operation in international organisations such as the International Monetary Fund and the Group of Eight industrialised countries could in times of need become critical.

But the report argues that formal exchange rate systems, such as the Bretton Woods system in the 1950s and 1960s or the ERM, are unrealistic, because they work only if one currency acts as an anchor. Given the relatively equal economic weight of the US and the Emu zone, the conditions for this are unlikely to apply. Policy co-operation would therefore have to be voluntary and geared to "informal and ad hoc exchange rate arrangements", on lines similar to the exchange rate accords of the 1980s.

So far, relatively little attention has been paid by EU officials and central bankers to how such policy co-operation would work in practice.

*Begg, D., Giavazzi, F., Wyplosz C.: 'Options for the Future exchange rate policy of the Emu'; Centre for Economic Policy Research, Occasional Paper No. 17*

WOLFGANG MÜNCHAU / FIRST APPEARED 6 JAN 98

## E: THE EURO – A STRONG OR A WEAK CURRENCY?

### The new European currency could surprise sceptics with its strength

Nowhere is the herd instinct in financial markets as pronounced as in the belief that the euro is doomed to permanent weakness.

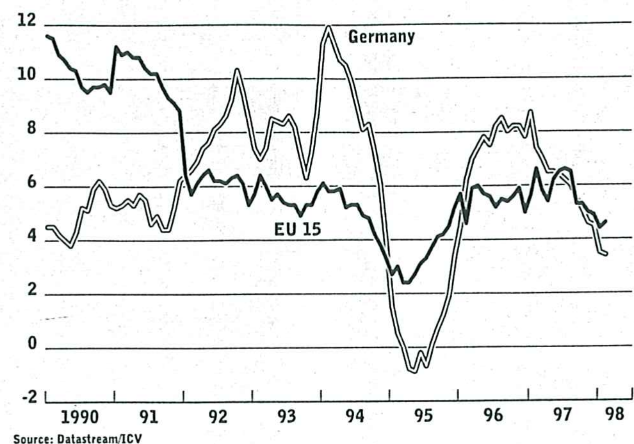
The stress is on "permanent". Currency analysts and several politicians have adopted the notion of a weak euro as one of the great certainties of our time. US fund managers are so dismissive of the future European currency that they rank it somewhere between the Albanian lek and the Thai baht. The D-Mark's weakness against the dollar is the clearest symptom of the euro's questionable reputation.

The myth of a weak euro rests on three assumptions. The first and least questionable is that European economic and monetary union will start on time in 1999 with a large membership base, including Italy, Spain and Portugal. Second, it assumes that these three countries – and maybe others – would return to inflationary fiscal policies the minute they are admitted to Emu. Third, European Union unemployment would remain high because of "inflexible" labour markets – a catch-all argument to explain Europe's recent economic failures.

Whatever the merits of these assumptions, this forecast misjudges two important recent trends. European economic growth is at last picking up, and the Bundesbank, the German central bank, appears determined to counteract EU-wide inflationary expectations.

In some respects it may even be easier to formulate a pan-EU monetary policy than a purely national one. The chart (right) shows that M3, the broad measure of money and the Bundesbank's policy barometer, has behaved much better for the EU as a whole than for Germany alone during most of the 1990s. So what does all this mean for the euro? First of all, the Bundesbank's determination to counteract inflationary expectations is bound to be matched by the European Central Bank.

As a central bank, the ECB will be more independent than the Bundesbank, since its independence is rooted in the European treaties, and not merely in ordinary law as in the case of the German central bank. The Bundesbank has




to support the economic policies of the German government, while the ECB operates under no such constraint.

As a new central bank, the ECB will be keen to establish credibility early on. Given the continued anti-inflationary hawkishness among the EU's central banking establishment, combined with wage moderation and competitive markets, there is little risk of a sustained inflationary surge.

EU central bankers are aware that inflation would pose the biggest political risk for the new currency. Since it is the ECB's primary objective to ensure price stability, its board of governors can be relied on to choose a monetary policy that errs on the side of caution. If the ECB failed in achieving its primary objective, it would not only put its own independence at risk, it may also jeopardise the entire Emu project.

Yet, if the ECB succeeds in its primary objective – as one might expect – the euro would strengthen, unless of course the Emu zone were to languish in permanent recession. Judging by the latest economic statistics, the prospects of permanent recession seem remote.

The long-awaited economic upturn may even have started during the second quarter of 1997, with an EU-wide annualised growth rate of 5.2 per cent, according to a J.P. Morgan estimate.

Admittedly, the economic upturn is export-driven, helped by the recent devaluation of EU currencies. But this is the early stage of a cycle. It is not inconceivable that the EU economy might be growing at a sustained annualised rate of more than 3 per cent in 1999, the year Emu is due to be launched.

If the euro is associated with a booming economy, it might become popular among the general public, contrary to what opinion polls currently suggest. By contrast, most Europeans would remember the 1990s as a decade of austerity and low growth. The euro's popularity might only be a temporary phenomenon but it might help sustain the currency politically in its early years.

If the Emu environment is characterised by low inflation, accelerating growth, and a hefty current account surplus, it is difficult to see how the euro could be permanently weak.

It is, of course, possible that the currency may be temporarily weak. Currency markets fluctuate, and they may fluctuate even more in the future, as some forecasters suggest. The euro might, for example, trade at a temporary discount against the dollar until the ECB has established credibility with the markets.

But such fluctuations are largely irrelevant in the long run. At issue here is permanent – structural – weakness. There is little sign of that happening. If anything, there is a greater risk of a more familiar problem. Far from being too weak, the euro may end up being too strong.

WOLFGANG MÜNCHAU / FIRST APPEARED 1 SEP 97

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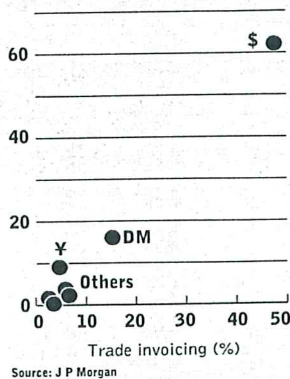


**The big hitters: EU-15's place in the world**

| | Population m / 1995 | Share of OECD GDP % / 1996 | Share of world trade % / 1996 | Export GDP ratio % / 1996 | Foreign exchange reserves $bn/ 1996 |
|---|---|---|---|---|---|
| US | 263 | 32.5 | 19.6 | 8.2 | 49.1 |
| Japan | 125 | 20.5 | 10.5 | 9.0 | 172.4 |
| EU | 370 | 38.3 | 20.9 | 10.2* | 349.8 |

* excluding intra-EU trade

## F: THE EURO VERSUS THE DOLLAR

### The domination of the dollar could be ended by the euro

Emu could end the role of the dollar as the world's dominant currency, according to a growing number of international economists. They also predict that the change from a unipolar world financial system based on the dollar to a bipolar system, based on the dollar and the euro together, could lead to huge swings in the markets. Moreover, the change could affect the way in which the world's large trading blocs co-ordinate their economic policies.

Avinash Persaud, head of currency research at J.P. Morgan, estimates that the euro will take a market share in international invoicing of between 35 and 40 per cent. "The reason why central bankers have certain currencies in reserves is because these are the currencies they intervene with," he said. "Trade and finance are invoiced in dollars because the US is the largest exporter and importer. After 1999, the Emu bloc will be the largest exporter and importer."

At this point, no one can be absolutely certain about the precise way in which the international financial system would undergo such a fundamental transformation. There is even more uncertainty about the timing. International financial markets are complex and could yet show a surprising degree of inertia. But there are various indications suggesting that something may be about to happen.

At present, there is an imbalance between the share of the dollar in international finance and the US share of world trade. The dollar's weight in international finance vastly exceeds that of the D-Mark, the only European Union currency that plays any significant role in international finance. A reasonable estimate would give the dollar a share of around three to five times that of the D-Mark.

At the same time, the US has a smaller economic weight than the 15 EU members combined. In 1996, the EU accounted for some 38.3 per cent of total gross domestic product among the leading industrialised countries, while the US accounted for only 32.5 per cent. The EU also has a slightly larger share of world trade and a larger ratio of exports to GDP.

Fred Bergsten, director of the Institute for International Economics, the Washington-based think-tank, predicts that the euro and the dollar could eventually end up with a 40 per cent share each of international financial transactions. This would point towards a bipolar system with Japan as a "junior partner", he said. This shift would come about because of portfolio diversification. Fund managers will rebalance their investment portfolios and central banks will switch dollar reserves into euro reserves to match their countries' underlying trade flows.

An example is the Bank of Japan, which currently holds no reserves in any of the European currencies because none of Japan's EU trading partners has sufficient critical mass. Once the euro is introduced, that situation is bound to change. For the euro to match the dollar in market share, the portfolio shift would have to add up to a staggering $500bn to $1,000bn.

Mr Bergsten has argued* that 'many analysts agree that the euro will rival the dollar as the world's leading currency. Most believe, however, that such a shift will take considerable time, since any redistribution of international portfolio occurs incrementally.

"But there is evidence from the history of major currencies that major shocks can produce rapid changes in portfolio composition. The devaluation of the pound sterling in 1931 permanently reduced the international role of that currency and propelled the dollar into the dominant position." His analysis is shared by some foreign exchange specialists. Mr Persaud points out that the shift away from the dollar is already taking place. Several central and eastern European countries have been pegging their currencies to the D-Mark. Asian countries may still have their currencies pegged to the dollar, but it is conceivable that the pegs will become more diverse, depending on whether the country in question has greater trade links with the US or with the future Emu zone.

There is also surprising agreement among foreign exchange experts that the euro/dollar exchange rate will become significantly more volatile than the D-Mark/dollar exchange rate. In other words, the stability which the euro will create inside the EU may be bought at the expense of instability in the exchange rates between the EU and its trading partners. All in all, it could be a zero-sum game.

This could have important policy implications. It could greatly add to pressure on the Emu zone and the US to co-ordinate economic policy, a prospect that officials at the EU's Commission regard as a likely external consequence of monetary union.

Conceivably, it could also mean that pressure will increase for the formation of a formal or informal exchange-rate regime to limit the fluctuations between the euro and the dollar. This could open up internal conflict between France and Germany, given Germany's preference for free-floating exchange rates and France's preference for exchange rate management.

Yves-Thibault de Silguy, the EU monetary affairs commissioner, agrees that the euro will end the predominance of the dollar and produce a more symmetrical multipolar system. "The potential gains to be derived from co-operation will not only be greater, but will also be more uniformly shared among participants," he said. If this analysis is correct, European economic and monetary union will affect not only financial markets but also a great variety of international institutions, such as the Group of Seven, the World Trade Organisation and the International Monetary Fund.

That would mean that the euro will not be just another currency. Nor will be it an entirely European affair.

**Fred Bergsten, the dollar and the euro, Foreign Affairs, Vol 76, No. 4, pages 83-95*

WOLFGANG MÜNCHAU / FIRST APPEARED 9 SEP 97