

## THE EURO: PROSPECTS AND IMPACTS

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In December 1991, the European Union (EU) leaders agreed at Maastricht to create a single EU currency, called the "euro," on January 1, 1999 and replace each EU country's currency with it by July 2002. The current European Monetary System (EMS) of fixed EU exchange rates will be replaced with the Economic and Monetary Union (EMU) of the euro. Euro-joiners will be chosen in 1998 on the basis of 1997 economic figures on price levels, interest rates, exchange rates and fiscal deficits. Certain convergence criteria will need to be satisfied for any EU country to be a member of EMU.

A few questions seem appropriate. Why are the EU countries trying to use a single currency? Why are they setting convergence criteria for selecting members of EMU? And will these criteria be applied strictly? Or will the EMU start with countries that can only satisfy some of the criteria approximately? And finally, what will be the impact of euro if it is born as scheduled?

To answer these questions, a good starting point would be to see how Europeans have reached the idea of a single EU currency because the historical approach can reveal the practical reasons they have been so eager to create the EMU in Europe.

### *The Need for a Single EU Currency*

European countries agreed in 1944 on a fixed exchange rate system called Bretton Woods System, which was based on the U.S. dollar. The goal was to build a stable international monetary system, which was necessary for their post-War recovery with the help of

U.S. dollar. The United States was also enthusiastic to create a new international monetary system where dollar would play a central role. The Bretton Woods System was built on a fixed dollar price per ounce of gold. This fixed exchange rate system helped Europe recover from the damage of World War II.

This system, however, began to be shaken in mid-1960s when the U.S. government increased its expenditure for the Vietnamese War and other areas of the public sector. The fiscal expansion and the ensuing increase in the money supply resulted in a high inflation rate, which eventually brought about the devaluation of the dollar against other currencies. Since this brought about a recession in Europe, in the late 1960s the EC countries began to discuss the need for more stable exchange rates at least among them. This discussion of constructing a fixed exchange rate system within Europe, however, could not continue because the existing fixed exchange rate system collapsed in the early 1970s.

The depreciation of dollar in the late 1960s made the EC countries adopt a floating exchange rate system in 1973. When the first oil shock came in October of 1973, many countries chose an expansionary policy and succeeded in escaping from the recession under the floating exchange rate system. The floating exchange rate system was regarded as an excellent system that helped most countries overcome the recession. But unemployment rates in the U.S. and European countries still remained high although production had increased.

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in the late 1970s. The depreciation of the dollar made Germany worry about a recession, and Germany wanted to disperse the negative effects of the depreciating dollar through the EC countries to relieve its burden. Therefore, in 1979 the EC countries established the European Monetary System (EMS) and adopted the Exchange Rate Mechanism (ERM), where fixed exchange rates were applied among the EMS member currencies while their exchange rates against dollar were kept floating.

However, the experience of the 1980s drove EMS members to seek a single EU currency instead of a local fixed exchange rate system. The expansionary economic policy of the U.S. was the cause of the recession in the early 1980s, the biggest since the Great Depression in the 1930s. The Reagan administration increased military expenditures to overcome the recession. The EC countries experienced another recession at the end of the 1980s because of the depreciation of dollar against the German mark. The EC countries needed to make the exchange rates among their currencies more stable to develop their economies. The best way of eliminating uncertainty in the exchange rates is to use a common currency among countries. In 1989, the EC adopted the Delors Report which suggested that EC countries introduce a common currency according to a 3-stage plan.

In December 1991 at Maastricht in the Netherlands, the EC Summit agreed on establishing the EMU and introducing a common currency on January 1, 1999. The Maastricht Treaty suggested three steps like the Delors Report to move to a single currency union. During the first period through 1994 the European Union (EU) countries, formerly the members of EC, would keep their exchange rates with other EU currencies within a narrow band as suggested in the Maastricht Treaty. In the second stage between January 1995 and December 1998 any

EU country wanting to join the EMU would have to satisfy the economic convergence criteria which require each member to keep its price level, interest rates, exchange rates with other EU currencies, and fiscal deficit in particular ranges. Stage Three will start on January 1, 1999, with the establishment of the EMU and creation of a single EU currency, the euro. The existing individual currencies in EMU will be replaced with the euro by July 2002.

From the history of the idea of a single EU currency we can see that the fluctuations of dollar caused by the U.S. business cycles played an important role in the birth of euro. The EU countries, especially Germany, have strong motivation to overcome the negative effects of a fluctuating dollar by creating a single EU currency which can compete with the dollar.

#### *Monetary Policy and Fiscal Convergence Criteria*

The EMS faced serious crises when Britain and Italy left it in 1992 because of their recessions and when the French franc experienced a sharp depreciation against the German mark in 1993. It threatened the plan for the EMU because it became hard for the EMS countries to satisfy the convergence criteria. In December 1996 at Madrid, however, the EMS leaders agreed to apply the criteria strictly, especially on fiscal deficit and government debt, to the EMS countries wanting to be a member of the EMU. More recently, in July 1997 France announced that its fiscal deficit for the first half this year was higher than 3.0% of its GDP, which is the fiscal convergence criterion imposed by the Maastricht Treaty. Even Germany seems to be having a hard time getting to the target value for fiscal deficit. The German mark has been continuously depreciating

against the U.S. dollar, partly because speculators in foreign exchange markets expect that the violation of the fiscal convergence criteria will make the euro a weak currency. Some are raising doubts about the realization of the EMU at the beginning of 1999. However, Germany does not seem willing to relax the criteria. Why? Are the fiscal conditions so crucial that they could not start the single money system without satisfying them? What is the relationship between the monetary policy of the EMU and the fiscal conditions that are required before and after the birth of the EMU?

To answer these questions we first look at the organization and functions of the European System of Central Banks (ESCB), which will be the core of the EMU. The ESCB will consist of the National Central Banks (NCB) of EU countries and the European Central Bank (ECB). The ECB and NCBs will be independent of the governments of the EMU. ECB will take the rights of monetary policy from the EMU members. It will resemble the Bundesbank, the German central bank, because the first priority of the EMU's monetary policy will be the stability of prices in the EMU countries. After introducing the euro on January 1, 1999, ECB will take over around 50 billion euros of the official reserves from each EMU country and control it to achieve its target in the foreign exchange markets. Each NCB will use the rest of its reserves for payments and lending to foreign countries.

The NCBs in Europe have usually chosen interest rates as the target variables for their monetary policy. However, since the priority will be on the anti-inflationary policy, the ECB will choose an aggregate monetary target rather than an interest rate target. In any case the EMU members will lose the independency of their monetary policy. If economic shocks to all members of the EMU are symmetric, then the centralized monetary policy of ECB will do.

But if the shocks are different to each country, the monetary policy of the ECB may fail to absorb their impacts because the ECB can use only one method, the single currency, which will affect all its member countries simultaneously. The inability of monetary policy to respond effectively to idiosyncratic or asymmetric shocks can be a serious flaw to the EMU because it can cause political tensions among the member countries. To overcome the limits of the ECB the EMU countries will be allowed to use alternative measures to deal with asymmetric shocks—however, only within a limited range.

The convergence criteria on fiscal deficit requires each candidate of the EMU to keep its annual fiscal deficit within 3% of its GDP and the cumulative government debt within 60% of GDP. Many candidates for the EMU have reached the convergence criteria on inflation rates, interest rates, and exchange rates. But the convergence condition on fiscal deficit has not been satisfied by most candidates including France, one of the most important candidates for the EMU. The EU will choose the members of the EMU in 1998 based on 1997 figures. However, France's fiscal deficit in the first half of 1997 amounted 3.3% of its GDP, Germany's fiscal deficit also approached 3%, marking 2.9% for the same period. Although during the general election campaign the socialist government of France promised not to stick to the strict value of 3.0%, the socialist government is now trying to reach the 3.0% target even by reducing its expenditure for the middle class. Why?

#### *Economic Reasoning of the 3.0% Limit*

The rationale of the convergence criteria can be found in two ways. One is the theory of optimum currency area. The other is the credibility theory.

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An optimum currency area can be defined as the area where a fixed exchange rate gives a larger benefit than the loss of adopting it. The benefit of a fixed exchange rate system is the reduction of transaction costs and uncertainty in trading currencies. On the other hand, the cost is the loss of independent monetary policy because the countries have to support the fixed exchange rates between them even when high rates of unemployment cause them to need a more flexible monetary policy for their domestic economies. The difference between the benefit and the losses depends upon price flexibility, mobility of production factors such as capital and labor, and the mobility of final goods, all of which affect the size and nature of the shocks. The theory of optimal currency area says that the benefit of a fixed exchange rate system will be larger than the losses in an area with a high degree of integration of production factors and final goods because shocks to the countries with high mobility of production factors will be small and symmetric.

If the shocks are small and symmetric, then restrictions on the fiscal policy will do little harm. If the shocks are large and asymmetric because EU is not an appropriate optimum currency area, any strict limits on fiscal autonomy will cause unequal development among the members of the EMU, raising political tensions. Much empirical research has been undertaken to evaluate the appropriateness of the EU as an optimal area, but the results are conflicting. Furthermore, another study shows that even if the EU is an optimal currency area, the integration can lead to more specialization rather than diversification. This implies that idiosyncratic shocks in a country can become more asymmetric due to the economic integration. In this case more fiscal autonomy is required to adjust to the shocks. In general, to restrict fiscal policy may not be a good idea according to the theory of optimal currency area.

Credibility theory provides another economic reasoning for the limited fiscal policy of an individual country. The credibility of a currency arises from the anti-inflationary policy of the central bank relevant to the currency. The German mark is a good example. EU countries with high inflation rates can get higher credibility for their currencies by fixing their exchange rates against the German mark. In a single EU currency system members are asked to restrain their fiscal deficit to keep the value of the euro as high as the mark. If the value of euro turns out to be lower than that of the mark, Germans will lose their wealth when the weak euro takes the place of the strong mark. This is why Germany is insisting that every member abide by the strict restrictions on fiscal deficit, which can be a safeguard to prevent inflation. Although the credibility theory is dominant in Europe, empirical evidence for it is still insufficient.

The 60% reference value for debt is consistent to the 3.0% reference value for the deficit because a 5% growth rate of annual GDP combined with a 3.0% deficit eventually leads to a debt of 60% of GDP. However, why the criterion for the fiscal deficit is 3.0% of GDP in the Maastricht Treaty is not clear, although the point is the strictness of the restrictions on fiscal policy, not the reference value itself. In summary, the theories reviewed in this section imply that the convergence criteria of Maastricht Treaty on fiscal policy may not have a strong economic basis.

### *Prospects and Impacts*

**C**an the EMU be established on January 1999 as scheduled? The answer is yes. The fiscal restrictions are not so crucial for the birth of the euro as the theories and empirical studies show. Furthermore, the fundamental reason for

creating the EMU comes from the existing international monetary system where the U.S. dollar dominates.

Minor changes to the Treaty can be made such as a delay in the establishment of the EMU or the relaxation of the convergence criteria.

Germany wants to remain as the strongest country in the EU economically as well as politically. Although the German mark is regarded as the source of the strong German economy, Germany would weaken the value of the mark temporarily to accept weak currencies as members in the EMU because the fundamental factors that can boost its economy will be the productivity of its economy rather than the value of its currency. Mr Kohl recently promised that he would stick to the fiscal criteria. This is, however, not based on economic considerations but political ones because his political rival blamed him for weakening mark. The election for a new chancellor is scheduled in autumn of 1998.

France also wants to be a member of the EMU although the socialist government is in dilemma. The government has to increase its expenditures to implement its election promises, while such a policy may make it hard to satisfy the 3.0% restriction on fiscal deficit. France has been trying to create a unified Europe to escape from high inflation and unemployment rates. It attributes the recessions in Europe to the subordination of European currencies to dollar. Although the birth of the euro can make the French economy more dependent on the German economy, France feels that the loss will be smaller than that from the dependence on the dollar.

The U.K. has two alternatives. One is to remain a partner of the U.S. and lose the gains that it may obtain in Europe through its well-developed financial industry. The decline of its economy is urging it to choose this strategy. On the other hand, to be an outsider in the grow-

ing Europe can cause economic as well as political losses that can be hardly recovered because of the initiatives of Germany and France in the EMU. The choice of England is relatively less important, though, because the idea of the EMU developed in Germany and France, not in the U.K.

These minor changes, however, will not affect the direction that the EU countries have chosen. Since the basic motive of creating the EMU is to build a strong Europe that can compete with the U.S. politically and economically, the EMU will be established eventually within a few years.

Then, what will be the effect of the birth of the euro on the international financial market and monetary system?

The euro will most likely turn out to be a currency strong enough to compete with the dollar in international financial markets because of the EU's shares of production and trade in the world economy, which amount to 30% and 20% respectively. However, the euro will suffer from the same problems as the dollar has suffered for the last half-century. First of all, the business cycles caused by internal factors in Europe may cause changes in the value of the euro against other currencies such as the dollar and the yen. Such fluctuations will have stronger effects on the economies of the EMU countries, which will be under the control of a centerline monetary policy. The business cycles orienting from the EU and the U.S. can be two large sources that will make the exchange rates between the euro and the dollar fluctuate. In other words, the euro can make the international financial market more unstable than before its birth. To avoid this instability, the EU and the U.S. will have to reform the existing international monetary system, giving more power to the EU currency. VIP

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