

## **Guest Editorial**

### **EMU and the World Economy\***

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#### **I Opportunities, Risks of EMU and Unsettled Issues**

The EMU is something new and unique: a single European currency without a political union. The euro will be a depoliticized money for consumers and businesses, free from political meddling. There is no doubt that the European central bank needs a medium-term learning period for interpreting the euro-wide aggregates, managing the monetary instruments, experiencing the possibly asymmetric effects for member countries<sup>1</sup> and handling the problems of different economic cycles. Ireland, Finland, Spain and Portugal have pulled out of recession faster than France and Germany. Nevertheless, the European countries have learnt from long and often painful experience of policy coordination, and may profit from well-established personal contacts in the European monetary institutions.

There are other initial conditions facilitating the start of the euro. Europe is coming out of a recession which had been prolonged by the Maastricht conditions. The overall outlook for the countries in Europe reveals a number of optimistic signs for a sustained and balanced recovery in the coming years. The actual policy mix – continued efforts to eliminate public deficits, maintain low inflation rates and moderate wage increases – facilitates a stability-oriented growth and employment performance. Forecasts of the European Commission and the OECD indicate annual growth rates of 2–3 per cent for the next few years. The European Union also profits from a current account surplus, thus avoiding external pressures in the exchange rate markets. There are therefore many signs of a smooth and perhaps even strong growth period exploiting a virtuous circle in Euroland. However, there are also

\* Revised version of a paper presented at the Graduate School of International Studies, Sogang University, Seoul in May 1998.

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<sup>1</sup> Rudi Dornbusch, Carlo Favero and Francesco Giavazzi, 'Immediate Changes for the ECB' 26 *Economic Policy* (April 1998).

worrying and less promising factors around which imply the need for strong and coordinated economic policy efforts beyond 1998.

A number of eurosceptics and the IMF in Washington have voiced serious warnings about one aspect of the European economies: their weak capacity to respond to the new pressures of adjustment. Establishing the euro means losing the exchange rate instrument to absorb (asymmetrical) external shocks. At the same time fiscal policy is constrained by the Stability and Growth Pact. Both factors increase the need for more flexibility in product and labour markets as long as labour mobility in Europe remains weak. One compensatory role will be played by capital movements favouring regions with higher productivity. In fact, the size and impact of foreign direct investment in the EU is not very large. The adjustment needs of EMU, as well as the persistence of high unemployment in most European countries, require fundamental reforms of labour markets and social benefit systems. Equalizing wage levels in the European Union will have adverse effects in the form of growing regional disparities in output and employment (as proved again by the wrong wage policy of the unified Germany). Productivity differentials have to be reflected in diverging wage trends.

Another hotly debated issue is the argument that euro members in financial difficulties will create political pressures for EU-wide large-scale transfer payments. The EU budget in fact amounts to only 1.3 per cent of the total GDP, devoted mostly to the Common Agricultural Policy and the Structural Funds. As long as the European countries control domestic tax and fiscal policies the risk of the emergence of a European transfer union will be small. In addition, the adopted excessive deficit procedure (based on an annual examination) may act as a barrier to unwise public financing and over-borrowing and remove the pressure for the central bank to intervene. But many Anglo-Saxon economists see no direct need for, and sometimes even harm in, tough budgetary constraints. Here EMU is used and perhaps overburdened as a political pretext for realizing other economic policy objectives.

Finally, there is the question of whether a monetary union can survive without becoming a political union. History is not always a reliable guide to providing an answer for the future of Europe. Up to now, many Europeans have not wanted a concentration of fiscal (distributive and tax) functions in Brussels. In the (very?) long term monetary union may well lead to political union. However, political union is no precondition for a successful monetary union. It may happen that the problems of defending the single market and maintaining stable monetary relations will accelerate political integration for some essential functions such as defence and protection against criminality.

## II Euro, US Dollar and Yen: Prospects and Problems

The effects of EMU on the world economy depend on the internal strength and stability of the new currency in Europe and the use of the Euro in international transactions. Both are closely linked together. The arrival of the euro in 1999 will have important repercussions for the international finance system, but large uncertainties remain. For Fred Bergsten, the Director of the Institute for International Economics in Washington

the creation of a single European currency will be the most important development in the international monetary system since the adoption of flexible exchange rates in the early 1970s . . . The Euro's rise will convert an international monetary system that has been dominated by the dollar since World War II into a bipolar regime.

For Bergsten five key factors determine whether a currency will play a global role: the size of its underlying economy and global trade; the economy's independence from external constraints; avoidance of exchange controls; the breadth, depth and liquidity of the economy's capital markets; and its strength, stability and external position.<sup>2</sup>

Some international data may roughly describe the potential weight and openness of the European Union in relation to the USA and Japan.<sup>3</sup> On the first two criteria, output and trade, Europe is superior to the United States. In terms of openness both are broadly similar. Both regions are interested in open capital markets.

The euro will qualify for price stability and low interest rates and will be strong from its inception. The value of the dollar seems much more vulnerable because the USA has run current account deficits for fifteen years. There are even fears that the European Central Bank will steer a more restrictive monetary course (than necessary), especially in the first years in order to establish rapidly its reputation (and there is the supplementary argument that the traditional inflation accounting includes an upward bias).

Finally, EMU will profit from an important potential advantage: to become the world's largest market for euro and euro-denominated assets, especially if the City of London shifts to the euro. The euro

<sup>2</sup> Fred Bergsten, 'The dollar and the euro' 76 (4) *Foreign Affairs* (1997).

<sup>3</sup> Shares of world output: EU(15) 30.8%, USA 26.7%, Japan 21%. Shares of trade in goods and services (excluding intra-EU trade): EU(15) 20.4%, USA 18.3%, Japan 10.3%. Official reserves in 1996 (without gold): EU(15) 20.7% (deutschmarks, sterling, French francs and ECUs), USA 62.6%, Japan 7%. Current account as percentage of GDP in 1997: EU (15) 1.2%, USA -1.9%, Japan 2.2%. Openness in percentages of GDP (exports + imports)/2, goods and services excluding intra-EU exports, 1988-96 averages: EU (15) 10%, USA 11.1%, Japan 9.1%.

offers the opportunity to attract firms, banks and countries outside the EU to use it as transaction, portfolio and reserve and intervention currency.

The global role of the euro will easily exceed that of the deutschmark (which accounts for about 15 per cent of global financial assets in both private and official markets) and may reach 25–40 per cent of its currency share in the world. The international role of the euro will certainly be strengthened by the Central and Eastern European countries having close links with the European Union. The same is expected for Africa, where the French franc will be replaced as reference currency in the Communauté Financière Africaine and in the Mediterranean basin. The euro will serve here and elsewhere as invoice currency. It is therefore likely to challenge the dollar as the world's key currency in the medium and longer term. In fact, the US dollar accounts for 50 per cent of local commercial transactions and 80 per cent of operations on financial markets.

Bergsten estimated the total of private and official shifts from dollar to euros at \$500 billion to \$1 trillion. However, portfolio diversification will take considerable time. History tells us that the change from the pound sterling to the US dollar was implemented over many decades. Only major shocks like high inflation rates or explosive external debt relations could accelerate the redistribution of international portfolios.

It may be that the portfolio diversification out of the dollar will imply a gradual appreciation of the euro during a transition period. The appreciation trends could be counteracted by the extension of international reserves of the ECB, that is US dollar, yen or British pounds, to compensate for the disappearance of the deutschmark as international reserve currency. However, a recent study (by J.P. Morgan) has revealed that the transition to the euro will leave the eleven participating countries with about \$190 billion in foreign reserves of dollar and gold. Analysing the average level of currency and gold reserves in the United States and Japan over the past five years the study calculates that the European central banks will need reserves of only about \$150 billion, thus creating a surplus and price pressure on dollar and gold. My personal bet is that we will see a modest appreciation of the euro against the US dollar in the coming years. This will help to establish the credibility of the euro and will increase its standing as an international currency. However, there are countervailing arguments or policies making a forecast very difficult.<sup>4</sup>

<sup>4</sup> See *Economic Policy*, April 1998.

The advent of the euro as a stable international currency will reduce the role of the tripolar monetary system. The yen will remain a junior partner but play a smaller role and will perhaps not achieve the status of a truly international currency. Japan's failure to deregulate and modernize its fragile finance market may well hamper the development of the yen as an international currency.

The relationship between the dollar, the yen and the euro will be based on floating rates. There are uncertainties in the short term arising from the impossibility of predicting the strength of the euro and the fundamental equilibrium rate of the leading currencies. The uncertainties about the policy reactions and credibility of the ECB may result in a period of unstable and volatile exchange rate relations – but only if Europe regards the external role of the euro with benign neglect, an attitude long adopted by the US authorities in the past. I still remember that a US finance minister, John Connolly, explained to his European counterparts in the late 1960s, 'The dollar is our currency but your problem.'

Europe and the ECB have an interest in avoiding the adverse effects of durable misalignments. In the medium and long term a stable and credible euro will contribute to a healthy and sound international monetary system. International coordination of monetary policies may become easier with two main partners. In the last twenty years, the GATT and WTO have proved that a bipolar responsibility for international trade issues between the US and the European Community in reducing barriers can be extremely beneficial for both partners and the world at large.

Officially, the United States supports the arrival of the European economic and monetary union. 'An integrated Europe is America's natural best partner for the 21st century' (Clinton 1998) . . . 'If Emu is good for Europe it will be good for us' (Summers 1998). But there are mild concerns and hidden doubts. The main dangers for the USA and the rest of the world are that EMU may fail and will lead to a weak euro undermining the competitiveness of export firms outside Europe. It is also understandable that the United States will not be pleased with the economic and political prospects of a strong euro role in the world economy. Up to now the USA has been able to finance its huge external deficits (currently \$160 billion) without any problems in its own currency, thus protected against currency volatility. The United States has profited from seigniorage worth perhaps more than 0.5 per cent of GDP from the use of dollar bills in other countries. The advent of a new international currency will make it more difficult for the USA to run unlimited current account deficits and to practise its monetary policy without regard for other industrial countries. However, the gradual

decline of the US hegemonic role in the world is a long-term trend which started years ago.

Martin Feldstein, a respected US economist, has voiced an argument which looks strange to most Europeans: 'If Emu does come into existence, it will change the political character of Europe in ways that could lead to conflicts in Europe and confrontations with the United States.'<sup>5</sup> Feldstein fears that the 'ever closer union' of European countries (mentioned in the preamble to the Maastricht Treaty) conceived of as a way of reducing the risk of wars among the European nation states may have the opposite effect. For him EMU will lead to a political union with a common military and foreign policy for Europe which may pursue objectives that are contrary to the interests of the United States. Feldstein's arguments are not convincing in a global world with large networks of multinational firms and strong international institutions such as the WTO, the IMF and World Bank. Perhaps all countries, except the United States, have learnt painfully that national policies have more and more lost the capacity to steer domestic developments and that national economies are often exposed to large external shocks and constraints.

### III Main Policy Conclusions

EMU is a grand vision that may change radically the economic and political landscape in Europe. It is also an experiment in running a unified monetary policy, without a common fiscal authority, among a group of sovereign countries with differing traditions and interests. In addition, it will act as catalyst for deep structural change. The adjustments of labour market and social systems are painful but inevitable even without the advent of EMU. The introduction of the euro therefore only accelerates some existing trends and increases some risks. At the same time, the opportunities and benefits have probably been underestimated.

So far, then, the eurosceptics have been proved wrong. The Maastricht conditions have worked. There is evidence that price stability is now well established and that structural change is happening already. Most Mediterranean countries have shown considerable courage in reforming their countries, in deregulating their labour markets and privatizing their state-owned industries. The UK will join the EMU in a few years because the negative effects for the City of London will show up and the risks of being sidelined in some European reforms will become too large for British policy makers.

<sup>5</sup> Martin Feldstein, 'EMU and International Conflict' 76 (6) *Foreign Affairs* (1997).

Over time the euro will become a widely used international currency, used as a trading currency, an investment currency and a reserve currency. The reason for this are the large size of the European economy, its deep and liquid capital markets and its strong and stable performance. It is therefore plausible that the euro will become an important currency in the world. However, can the euro seriously challenge the US dollar or will the euro remain restricted to a regional role in Europe? In any case the emergence of a new international currency will take time. However, the timing and speed of the diversification trends out of the US dollar are difficult to forecast.

Most countries will profit from the stronger competition of two leading currencies. Countries are free to choose the most stable international currency for their businesses and as a vehicle for their internal monetary policy. It will be easier for firms, banks and consumers to be informed about only two large international currencies. Information and transaction costs will be lower for European and other non-US firms and financial institutions which can now profit from savings on transaction costs as their US competitors could formerly.<sup>6</sup> In international terms the winner may be an open and efficient trade and capital system, while the loser may be Japan, losing the opportunity to become the third partner in the international monetary system. A more balanced, bipolar international monetary system will hinder the emergence of inward looking trends. Both partners will have an interest in avoiding the negative effects of exchange rate volatility or protracted misalignment. Therefore, there are increasing incentives for closer monitoring and stronger international surveillance and cooperation.

The euro will not be an automatic success and the new world will not arrive overnight. A successful euro will need strong and sustained efforts of all participating countries. The credibility of the euro and the functioning of the EMU will be decided in the first years. The advent of the euro is a fascinating research object for economists. As one remarked recently, 'The real effects of EMU will emerge with time, and are likely to surprise (and inform) economists.' The central problem for Europe is the persistence of high structural unemployment. The euro will not necessarily and immediately support the creation of new jobs. However, a number of actions to improve the conditions for the success of the euro and the flexibility of the European economics are reinforcing one another. In any way, 'achieving a successful outcome will be a major policy challenge in the years ahead'.<sup>7</sup>

<sup>6</sup> Richard Portes and Hélène Rey 'Euro vs dollar' *Economic Policy* (1998) April.

<sup>7</sup> Bergsten., *op. cit.*