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## European economic and monetary union: Recent progress and possible implications for Latin America and the Caribbean

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European Economic and Monetary Union:  
Recent Progress and Possible Implications  
for Latin America and the Caribbean

This background report was prepared jointly by the Institute for European-Latin American Relations (IRELA), Madrid; the Special European Office of the Inter-American Development Bank (IDB); and the Integration, Trade and Hemispheric Issues Division of the Bank's Integration and Regional Programs Department. The report is based on contributions from three consultants: Rainer Schweickert, Roberto Zahler and Anneke Jessen. The views expressed do not necessarily reflect those of IRELA or the IDB and its member countries.

## LIST OF ABBREVIATIONS

<b>BIS</b>	Bank for International Settlements
<b>ECB</b>	European Central Bank
<b>ECOFIN</b>	European Council of Ministers of the Economy and Finance
<b>ECU</b>	European Currency Unit
<b>EMI</b>	European Monetary Institute
<b>EMS</b>	European Monetary System
<b>EMU</b>	Economic and Monetary Union
<b>ERM</b>	Exchange Rate Mechanism
<b>ERM2</b>	Exchange Rate Mechanism 2
<b>ESCB</b>	European System of Central Banks
<b>EU</b>	European Union
<b>FDI</b>	Foreign Direct Investment
<b>FOMC</b>	Federal Open Market Committee (United States)
<b>GDP</b>	Gross Domestic Product
<b>IDB</b>	Inter-American Development Bank
<b>IRELA</b>	Institute for European-Latin American Relations
<b>NCBs</b>	National Central Banks
<b>OECD</b>	Organization for Economic Cooperation and Development
<b>“the Fed”</b>	The United States Federal Reserve System

## CONTENTS

INTRODUCTION.....	1
I. THE PATH TO MONETARY UNION.....	2
II. PREPARING FOR EMU: MACROECONOMIC AND INSTITUTIONAL ISSUES.....	5
III. PERCEIVED BENEFITS AND COSTS OF EMU AND THE ISSUE OF FUTURE MEMBERSHIP.....	13
IV. INTERNATIONAL ASPECTS OF EMU.....	18
V. IMPLICATIONS FOR LATIN AMERICA AND THE CARIBBEAN .....	23
SUMMARY AND CONCLUSIONS.....	31

## INTRODUCTION

The theory and practice of economic integration have traditionally focussed on aspects of resource allocation. Except for the debate on optimal currency areas in the 1960s, which did not significantly influence regional integration efforts at the time, there has been relatively little analytical or empirical study of the monetary effects of integration.

Recent developments in European integration have nevertheless placed such issues at the forefront of European policy debate. Particularly important in this respect is the European Union's aim to establish a single European currency, the *Euro*, by 1999 - one of the final and most decisive steps in its path towards economic and monetary union (EMU). Given its scope and influence on the region's internal environment, this project clearly represents a major historical and political leap in European integration.

The principal aim of this report is to describe the process towards economic and monetary union in Europe, and by doing so, to offer Latin American and Caribbean policy-makers a broad overview of EMU's main characteristics: its design, its key actors, its timetable and specific operating conditions.

While the domestic repercussions of monetary union are now being heavily debated throughout Europe, few analysts have ventured into an examination of EMU's international implications, let alone its possible impact for specific regions of the world, including Latin America and the Caribbean. This report will also explore such "extra-regional" aspects of EMU, offering some initial and very tentative observations on the subject. Any firm conclusions would of course be difficult to present at this stage, given that the process towards monetary union is far from completed, and that international transmission mechanisms are very complex.

Chapter 1 offers some brief background notes on EMU and discusses how the strategy to define a low-risk scenario for monetary union resulted in the definition of specific *convergence criteria* and the design of an independent *European Central Bank (ECB)*. Chapter 2 examines these issues in more detail, while also discussing a more recent aspect of EMU, the *Stability and Growth Pact*.

Chapter 3 explores different views regarding the economic benefits and costs of monetary union for participating countries. Many of the benefits will derive from a reduction in commercial and financial transaction costs. This should spur intra-European competition and improve the functioning of the single European market. Perceived costs, meanwhile, are related to the concept of policy-making in a monetary union. Given the fact that intra-union exchange rates will be fixed, governments are left with only two broad policy instruments for real adjustment: fiscal and labor market policy. The perception of benefits and costs differs among EU member states, and has naturally influenced the strategies adopted by their governments in the run-up to EMU. Based on such strategies, as well as recent progress observed in the field of economic convergence, the chapter discusses the possible future membership of the union, as well as technical problems associated with the transition process.

The study then moves on to examine the potential extra-regional impact of EMU. Chapter 4 discusses the possible international effects of EMU, analyzing its implications for international coordination and cooperation, and indicating the factors that will determine the external value of the future *Euro*. Chapter 5 offers some tentative views regarding EMU's potential impact on the Latin American and Caribbean economies. It also discusses some lessons that can be learned from EMU for regional and subregional integration projects in Latin America and the Caribbean.

As suggested earlier, the analysis presented in these final chapters must necessarily be highly speculative in nature. On the one hand, very little empirical or theoretical research has been conducted so far on the external effects of European monetary integration. This means that we are exploring relatively uncharted ground. On the other hand, EMU is not yet a reality. For the time being, it is a project, with a very high likelihood of materializing but, nonetheless, a project. Its characteristics and specific conditioning factors still have to be defined. They include the timing of EMU's full implementation, the number of countries participating, and institutional, legal, and operational factors relating to the union. Moreover, neither the design nor the means of execution of monetary and exchange rate policy by the future ECB have yet been announced. The latter will significantly affect the evolution of key variables that have to be considered for an adequate analysis of EMU's domestic and external impact.

## **I. THE PATH TO MONETARY UNION**

EMU represents the culmination of a long process towards greater economic harmonization among EU member states and, in particular, of attempts to promote exchange rate stability within the EU. After abandoning the Bretton Woods fixed parity system at the start of the 1970s, the then European Community adopted different agreements to curb exchange rate flexibility, finally establishing the European Monetary System (EMS) in 1979. A key feature of the EMS, along with certain credit facilities, is the exchange rate mechanism (ERM), whereby the countries set their currencies' par value on the basis of an accounting unit, the European Currency Unit (ECU). The ECU's value is calculated using a basket of currencies of the member countries. In practice, the *deutsche mark* has been the anchor of the EMS, owing to the relative size and strength of the German economy vis-à-vis that of other participating countries and, no less importantly, the *Bundesbank's* long tradition of maintaining price stability.

Not all members of the European Community joined the EMS, and the system was quite unstable from 1979 to 1987, with numerous realignments of central par values. In contrast, the period 1987-90, sometimes referred to as "hard EMS", was characterized by a narrowing of exchange rate bands to 2.25% on each side of the official par value for the old members of the EMS, as well as the inclusion of new members (Spain in 1989, the United Kingdom in 1990 and Portugal in 1992), whose currencies were allowed to fluctuate within a larger band of 6% on either side of central parities. By 1992, EMS membership extended to all of the then 12 EU members, except Greece.

This period of relative stability within the EMS fostered intense debate on the possibility of pursuing full economic and monetary union, and strengthened political support for the project. EU members finally agreed on a gradual approach, envisaging three stages:

- Stage one, beginning in 1990, would involve steps toward greater economic harmonization among EU member states, using existing institutions such as the European Council of Ministers of the Economy and Finance (ECOFIN) for intensified coordination. Such coordination would be pursued in parallel with the full liberalization of capital movements in the majority of EU countries. It was assumed that realignments in exchange parities would be minimized, since all countries were located in the narrow exchange rate band of the EMS.
- Stage two, to begin in 1994, foresaw the creation of a European Monetary Institute (EMI) to coordinate EU economic and monetary policies, as well as gradual convergence of member states' principal macroeconomic indicators in preparation of the third and final stage of EMU. The degree of convergence would be measured on the basis of the so-called *convergence criteria*, involving specific targets for consumer price inflation, long-term interest rates, exchange-rate stability and fiscal accounts (see Chapter 2 for a more detailed explanation).
- Stage Three (originally planned to start in 1997) would see irrevocably fixed exchange rates between the participating member states, the shift to a single currency and a uniform monetary and exchange rate policy under an autonomous European System of Central Banks (ESCB). The latter will comprise the ECB and the national central banks (NCBs) of the participating countries.



The Maastricht Treaty, formally signed by the Heads of State or Government of the EU on 7 February 1992, establishes the legal framework for EMU. Many argue that the decision adopted in Maastricht to speed up monetary integration was primarily a political one. One example mentioned in this regard was the German strategy to promote political support for German re-unification by means of fostering the process of European integration. But while political considerations may have played an important role at the outset, it can be argued that one of the main driving forces behind EMU today is the private sector in Europe. Big industry, in particular, sees EMU as a vital instrument for improving its productivity and international competitiveness.

### ***Exchange-rate instability in the early 1990s***

Stage One of EMU progressed much less smoothly than initially expected. Political difficulties in ratifying the Maastricht Treaty were compounded by the regional spill-over effects of German re-unification. The latter's economic repercussions on the German economy forced the *Bundesbank* to pursue a tight monetary policy. Meanwhile, higher capital mobility in the early 1990s made it increasingly difficult for national governments to manage the issue of exchange controls. In September 1992, in the face of particularly restrictive German monetary policy, various EU member states were unable to follow the *Bundesbank* and had to realign their currencies.

This led to a crisis in the EMS, starting with the devaluation of the Italian *lira* on 14 September 1992. It subsequently led to large devaluations of the Spanish *peseta*, the Portuguese *escudo* and the Irish *punt*, as well as the demission of the *lira* and the British *pound* from the EMS and the abandonment of the ECU peg of Sweden and Finland (which had not yet become members of the EU). Finally, in order to prevent a devaluation of the French *franc*, the bands of the EMS were widened from 2.25% on either side of central parities to 15% on 2 August 1993.

### ***Restoring stability, and looking ahead***

The crisis in the EMS sounded an alarm regarding the shape that EMU should take. The events led some to question the EMS itself, given the wide bands within which currencies were allowed to fluctuate. Others, however, believed that the exchange rate turbulence of the early 1990s did not reflect problems inherent to the system so much as indirect, temporary repercussions from one-off occurrences, such as German re-unification. After March 1995, when the Spanish *peseta* and the Portuguese *escudo* were once more devalued, no changes in parities took place and exchange rate fluctuations calmed down. In that year, moreover, Austria was the first of the new EU member states to enter the EMS. Finland followed in December 1996, at which time Italy also re-entered the EMS. Currently, only three of the EU's 15 member states - the United Kingdom, Sweden and Greece - remain outside the system.

Despite the EMS crisis, stage 2 of EMU went ahead, beginning in 1994 with the creation of the European Monetary Institute. The EMI, located in Frankfurt, has replaced the former Committee of Governors of the EU Central Banks and has taken over the functions of the European Monetary Cooperation Fund, which previously had managed the credit facilities of the EMS. Often referred

to as the forerunner of the ECB, the EMI's mandate is to contribute to the fulfilment of the conditions necessary to reach stage three of EMU, in particular the convergence of the main macroeconomic indicators among participating countries. The institution reports regularly on progress achieved in this regard, and has also been entrusted with undertaking the necessary preparations for the establishment of the ESCB, the conduct of a single monetary policy and the creation of the single currency.

By 1996, the majority of EU members were still unable to fulfil all the convergence criteria. The European Council of Heads of States or Government (henceforth: European Council) therefore decided that it was too early to move to stage three of EMU. This last and final stage of EMU, in which monetary union will be accomplished, is now expected to start on 1 January 1999, with whatever states are eligible for membership. The latter will be decided by the European Council in early 1998. It is planned that by the end of that year, the Council will also decide on the membership and the establishment of the ESCB, in which the ECB will play a key role.

Beginning in January 1999 - according to current plans - the ECB will start conducting its single monetary policy in the new European currency, the *Euro*. The national central banks will use the *Euro* in all their monetary and exchange operations, and governments will issue debt denominated in *Euros*. In early 2002, the ECB will start issuing *Euro* banknotes and exchanging the national banknotes and coins against *Euros*. It is envisaged that by July 2002, monetary union will be complete with the *Euro* banknotes becoming the only legal tender in the European currency area. The countries unable to enter the third stage initially, and those that do not wish to do so, may decide to keep their currencies linked to the *Euro* through a mechanism similar to the ERM, the ERM2.

## **II. PREPARING FOR EMU: MACROECONOMIC AND INSTITUTIONAL ISSUES**

The Maastricht Treaty establishes specific conditions and a timetable for the transition to monetary union. It also spells out the blueprint of the future ECB. The treaty does not, however, provide any guidelines on national fiscal policy after the introduction of EMU. This has recently led to renewed debate concerning the stability of the monetary union and, in particular, its common currency. As a result, member states agreed in December 1996 on a Stability and Growth Pact to ensure post-EMU fiscal prudence. Meanwhile, with the 1998 deadline fast approaching, much attention is being given to whether or not EMU aspirants will be able to fulfil the strict convergence criteria established at Maastricht as a requisite to joining the monetary union.

### **The Convergence Criteria**

According to the Maastricht Treaty, and given the current timetable for EMU, four basic criteria have to be fulfilled by the end of 1997 for admitting a country to the monetary union (Article 109j):

- A consumer price inflation rate no more than 1.5 percentage points above the average for the three countries (at most) with the lowest inflation rates.
- Average nominal long-term interest rates no more than 2 percentage points above those for the three countries (at most) with the lowest inflation rates.
- Participation in the EMS under normal bands and no exchange rate realignments for at least two years.
- A general government deficit of less than 3% of GDP and a gross debt to GDP ratio of less than 60%. Exceptions apply if an “excessive” deficit is temporary, or if an “excessive” deficit and/or debt ratio is declining at a “satisfactory” pace.

The Maastricht Treaty, moreover, specifies that convergence should also be measured by the balance-of-payments situation, the integration of markets, unit labor costs, and other price indices. Such issues have often been neglected in the current debate.

The purpose of the above criteria is to prevent the monetary union from being destabilized by the premature admission of a country whose economic fundamentals are not yet compatible with a fixed exchange rate. Obviously, a central requirement then is that trend inflation rates are the same. The first three criteria are intended to ensure this: one covering the recent past, with the next two rules intended to be more forward looking in nature. While long-term interest rates are positively correlated with inflationary expectations, a recent devaluation can be expected to increase inflationary pressure in the near future.

Some economists have argued that these criteria may not be sufficient to ensure a stable EMU. First, convergence in long-term interest rates may simply reflect the credibility of the intention to move to monetary union, and therefore to lock future short-term interest rates in different countries even more closely together. Second, even if inflation rates may have converged, the real exchange rate could still be some way from sustainable levels - meaning that macroeconomic equilibrium may not yet have been achieved. Third, the criteria will immediately lose their importance with the introduction of a new currency. Fourth, the irreversible fixing of the exchange rate against a stable anchor currency can be a highly efficient stabilization program in itself. Some economists argue that if this is the case, ex-ante stabilization as required by the Maastricht criteria would have unnecessary economic costs for high inflation countries.

The criterion on government financial positions is not a “convergence” criterion in the strictest sense (government debts, for example, can vacillate between 0 and 60% of GDP). It is also different to the extent that, in contrast to the inflation and interest rate variables, fiscal variables will matter even after the full establishment of monetary union (although, as mentioned, the Maastricht Treaty does not specify any targets beyond the date of entry into EMU). The intention during the transition phase is to ensure that no country joins the monetary union while its public finances are in such a state that they might destabilize the union. It has been argued that highly indebted member states, if admitted

to the union, might try to reduce their real debt burden by striving for a monetary policy in EMU which produces higher than expected inflation rates.

This last criterion is the most intensely discussed, for two reasons:

- Of all the criteria, it provides the largest room for interpretation and flexibility. While there is now a consensus that with respect to criteria 1 and 2, the averages of the three countries with the lowest inflation rates should be used to calculate a reference rate and that participation in the EMS is easy to observe, the terms “excessive” and “satisfactory” used to define the fourth criterion lack a precise quantitative definition.
- There is uncertainty about whether or not the fiscal criteria will be met by the majority of countries in the run-up to 1999.

### *Progress on meeting the convergence criteria*

Forecasts for 1997 are of utmost importance because of the approaching “deadline” of 1998. The European Council has to take its final decision on the extent of convergence achieved by EU members in early 1998. At that time, the EMI will prepare the final convergence report based on actual data for 1997. The European Commission will also prepare an official report. The European Council of Ministers of Economy and Finance will forward a recommendation to the European Council based on its evaluation of these reports. The Organization for Economic Cooperation and Development (OECD) also regularly monitors EU countries' compliance with the convergence criteria, and independent analysts have sometimes preferred to base their research on OECD figures, given this institution's perceived neutrality with respect to European integration.

### *Inflation, interest rates and exchange rates*

The **inflation** criterion reveals the most clear cut trend towards convergence: the average for all current EU members decreased constantly from 5.6% in 1991 to 2.6% in 1996. The most dramatic reductions in inflation rates can be observed in those countries which initially had the highest inflation rates (Greece, Portugal, Sweden and the United Kingdom) and in Finland which, by 1996, became the country with the lowest inflation rate in the EU.

There has also been a general trend towards lower long-term **interest rates**, although the difference in rates between the country with the highest rates (Italy) and that with the lowest rates (Luxembourg) hardly changed between 1991 and 1996. Of all EU member states, Portugal and Greece showed the greatest progress towards lower long-term interest rates. With the exception of Luxembourg, however, the reduction of interest rates consistent with declining inflation rates was temporarily reversed as a result of the EMS-crisis (1992-93), which drove up real interest rates until devaluation expectations were reduced by nominal devaluations.

The state of and prospects for convergence with respect to the inflation and interest rate criteria are quite good. According to the EMI's latest convergence report, in 1996 only five EU countries failed to meet at least one of both criteria. For 1997, both the Commission and the OECD expect only one country (Greece) to report too high inflation and interest rates. Sweden, the United Kingdom and Greece will not meet the **exchange rate criterion** because these three countries remain outside of the EMS. Moreover, according to the Maastricht Treaty, EMS participation is required for two years before the decision on EMU is taken. Therefore, the entry of Italy and Finland into the EMS in late 1996 is in principle too late. However, the political reactions to these events seem to indicate that the exchange rate criterion could be interpreted in the sense that EMS participation with wide bands and for two years before the start of EMU is sufficient to fulfil the criterion.

### *Fiscal criteria for EMU*

In contrast to developments on the inflation and exchange rate front, **fiscal indicators** initially did not show a clear trend towards fulfilling the Maastricht criteria. On the contrary, fiscal balances deteriorated until 1993. The EMS crisis, however, led to a new policy scenario and, starting in 1994, the trend towards higher fiscal deficits has been reversed. The most prominent examples of this upward and later downward trend are Greece and Sweden. Noticeable exceptions are Luxembourg and Ireland which have shown a permanent fiscal surplus, while Germany has fluctuated around the 3% rate and Italy, starting from a very high level, has shown an overall trend towards reducing the deficit.

The recent reduction of fiscal deficits has not been sufficient to achieve a lower level of **public indebtedness**. Italy exemplifies the lagged impact of an improvement in the current fiscal situation on the level of indebtedness. While its deficit decreased from 10.2% in 1991 to 6.6% of GDP in 1996, indebtedness increased from 101.4% to 123.4% of GDP over the same period. Only if the primary fiscal surplus (equal to the fiscal balance before interest payments) is sufficient to reduce the debt stock significantly, and the interest burden decreases, can fiscal consolidation gain pace. This is what has happened in Denmark and Ireland. Both have already been marked as cases of "sufficient adjustment", meaning that although public debt in these countries is significantly above 60% of GDP, the reduction of the debt ratio shows a sustainable convergence towards the reference rate.

Overall, there has been slow progress of convergence with respect to the fiscal criteria. In 1997, three countries - Denmark, Ireland and Luxembourg - are likely to fulfil both the public deficit and public debt criteria. According to the Commission's projections, France could be added to the list while Germany and Spain would at least fulfil the deficit criterion.

To sum up, at present, only Luxembourg seems to fulfil all convergence criteria, while Denmark and Ireland are able to do so only due to the "sufficient adjustment" interpretation with respect to fiscal performance. All other countries face serious challenges with respect to at least one of the preconditions for EMU membership established at Maastricht.

## The European Central Bank

The ECB will be at the heart of the European System of Central Banks. The Statutes of the ECB, laid out in the Maastricht Treaty, show strong similarities to the German *Bundesbank*. However, the blueprint for Europe's new central bank system also includes elements of the United States Federal Reserve System, or "the Fed". One similarity concerns the legal independence of the "regional" central banks from local government: the Federal Reserve Banks in the United States and the NCBs in the future EMU. More important for practical monetary policy, the Chairman of the Board of Governors of the Fed and the President of the ECB have quite a strong position. They both represent the bank and have the decisive vote in the Board and in the Council in the case of a stalemate.

Similarities to the *Bundesbank* concept are revealed when looking at the ECB's planned decision-making process, its structures for the implementation of monetary policy and its degree of independence. The **decision-making process** takes place in a Council in both the future ECB (Governing Council) and the *Bundesbank* (*Bundesbankrat*). These Councils consist of the members of the Executive Board (*Direktorium* in the case of the *Bundesbank*) and the presidents of the "regional" central banks, i.e. the NCBs in the case of the ECB and the central banks of the German *Länder* (*Landeszentralbanken*). Each member of the Council has one vote and decisions are taken by simple majority. This seems to be similar to the set-up of the Federal Open Market Committee (FOMC). However, the decisive difference is that the FOMC consists of seven members of the Board of Governors and only five members from Federal Reserve Banks. This implies that the FOMC is dominated by the Board of Governors, whereas the Council of the *Bundesbank* is dominated by the members of the regional central banks, just as that of the future ECB will be dominated by the national central banks (assuming that a majority of EU members participate in EMU).

Regarding the **implementation of monetary policy**, in both the *Bundesbank* and the future ECB, the Board is the main executive power. In Germany, the *Direktorium* implements all open market and foreign exchange market operations and leaves some discretion to the *Landeszentralbanken* only in the case of measures which have an exclusively regional impact. In the ECB, the implementation of all measures of monetary policy will in principle fall under the responsibility of the Executive Board.

There are differences in the relative **independence** of the Fed, the *Bundesbank* and the ECB. In the Fed, members of the Board of Governors are appointed by the US President and approved by Congress, and are obliged to target monetary policy at achieving not only price stability but also full employment, balance-of-payments equilibrium, and real growth. Additionally, the Fed has to support the general economic policy of the government. The latter is also the case for the *Bundesbank* and the future ECB, but only to the extent that the primary target, price stability, is not in danger.

The *Bundesbank* and the ECB are also similar with respect to financial and functional independence, having their own financial sources and not being controlled by parliament. Additionally, the personal independence of the members of the Council is fairly guaranteed. In Germany, the appointment of

a new member of the *Direktorium* involves the government, the Council of the *Länder* (*Bundesrat*) and the President of the Republic while the presidents of the *Landeszentralbanken* are appointed by the respective *Länder*. In the case of the ECB, the members of the Executive Board will have to be appointed by the European Council by means of a unanimous vote. The presidents of the NCBs are appointed by the respective countries according to their national procedure. The term to be served by the members of the Executive Board is eight years, without possibility of re-election; other members of the Governing Council should have a minimum term of five years. The members of the *Direktorium* and *Bundesrat*, including the president of the *Bundesbank*, serve a maximum of eight years (two terms). Additionally, credits to the government are strictly prohibited for the ECB while they are only restricted for the *Bundesbank* (and allowed for the Fed).

All in all, according to its statutes, the ECB will be even more independent from political influences than the *Bundesbank* is at present. Its institutional structure in a sense mirrors the view of those who have always argued that the ECB's economic policy should be independent from political considerations and that it should concern itself with price stability in the region, as a contribution to stronger European economic development. Skeptics, however, have argued that the power that could be wielded by the future ECB would be excessive, and that, given its political independence, it might fail to pay suitable heed in policy formulation and implementation to other economic policy objectives, particularly economic growth and employment, or to regional differences among EMU members. Therefore, they argue for the presence of a political counterweight to the ECB.

There is intense debate, moreover, on how monetary policy should be pursued *in practice* by the Bank. One of the main aspects to be determined is whether the ECB is going to commit, as a final objective, to inflation targets (like the Bank of England) or to an objective of monetary aggregates (like the *Bundesbank*). In view of the need to produce a "Community" price index and to estimate demand for money for a series of countries still to be determined, based on a nonexistent currency, obviously the intermediate and final objectives and the instruments of monetary policy have yet to be defined precisely and operationally. With respect to operational details, moreover, there is still some disagreement on precisely what degree of power the ECB should exercise over the national central banks. It should also be noted that the ECB would play a minor role in the prudential supervision of the financial institutions of the member countries, which introduces a question mark regarding its role as lender-of-last-resort.

There is some ambiguity on the institutional level regarding responsibility for the EMU's exchange rate policy, since it will depend on both the ECB and the European Council of Ministers and it is not clear how this would operate or how disagreements between the two authorities would be settled. There are also different views concerning the desired direction of future exchange rate policy. Some feel that the ECB should focus on its objective: price stability in the members of the EMU. More specifically, this position maintains that using the external value of the *Euro* as an economic policy tool to improve the competitiveness of the EMU, promote exports, and spur economic growth, would run counter to the need to create credibility and confidence in the *Euro*, and therefore to the objective of price stability. In short, this position argues that the *Euro* should act as what it is: one more price in the economy.

The argument on the other side is that exchange rate policy is an economic policy tool which the ECB should not forego since it is important in spurring competitiveness and economic activity, particularly in EMU's tradable goods sector. This argument adds that since this sector will be much smaller than it is today, more active use of the exchange rate will have only a slight effect on inflation. Some argue that this indecision regarding the role of exchange rate policy might lead to some volatility on exchange markets. Short-term volatility may also result from uncertainties regarding the operational details of the mechanism (ERM2) that will link the currencies of the "ins" (those countries that join EMU) with those of the "outs".

Ultimately, exchange rate policy (and behavior) will also depend on the fiscal policies of countries participating in EMU. While the Maastricht Treaty spelled out strict fiscal criteria for entering the monetary union, it did not, as mentioned, contemplate such criteria for the period after EMU-entry, meaning that member states would have ample room for maneuver in following looser or tighter fiscal policies once they join the union. This could influence the nature of the ECB's exchange rate policy (or, alternatively, how restrictive its monetary policy will be).

### **The Stability and Growth Pact**

It was precisely because the Maastricht Treaty did not define post-EMU fiscal guidelines that many EU governments became convinced of the need to introduce a new dimension to EMU: a stability pact. The main argument put forward in this respect was that a stable European currency needed an agreement on fiscal stability beyond the targets provided by Maastricht, since the possible pursuit of unrestricted fiscal expansion by countries after entry into EMU could create a problem for the stability of the common currency: for example, market participants might anticipate monetary policy becoming more expansive in order to lower the real debt burden of highly indebted countries or even to bail them out. Although the Maastricht Treaty explicitly rules out the latter option, some centers of public opinion questioned the credibility of excluding a bail-out. The intention of a stability pact was, therefore, to penalize excessive deficits in order to discourage governments from becoming overly expansionist in their fiscal policy stances. This would presumably lead to an environment that would make it easier for the ECB to conduct a stable monetary policy.

Governments differed on the exact content of such a stability pact. Proponents of a "harsh" pact proposed that governments failing to keep their budget deficits below 3% of GDP would have to place a deposit with the European authorities. If the excess borrowing continued, the funds would be forfeited. Fines would be calculated at the rate of 0.2% of GDP plus another 0.1% for every percentage point by which the deficit exceeded 3% of GDP; a deficit of 6% of GDP would have attracted the maximum fine of 0.5% of GDP.

In the end, EU members agreed on a somewhat *softer* solution at their December 1996 meeting in Dublin. The compromise, entitled "The Stability and Growth Pact", defines automatic exceptions



rather than automatic fines, particularly in cases where “excessive” deficits occur in connection with a recession or very slow economic growth. The pact outlines three approaches in this respect:

- In case of an economic decline of less than 0.75% of GDP, the countries agreed that “as a rule” they will keep the fiscal deficit below 3% of GDP, i.e. the rules for “excessive” deficits (Art. 104c of the Maastricht Treaty) apply as before, and a fine is likely to be applied if deficits exceed 3% of GDP.
- In case of an economic decline between 0.75% and 2% of GDP, countries can plead “exceptional circumstances” in order to avoid a fine which may be as big as 0.5% of GDP. In practice, this means that a decision procedure containing six steps and involving the European Commission and the Council of Ministers is set in motion which provides considerable scope for political discretion.
- In case of an economic decline of more than 2% of GDP, EMU members will be free to allow themselves to run fiscal deficits above 3% of GDP, in which case the provisions of Art. 104c do not apply at all.

The pact was only agreed after intense political debate among EU governments, and some policy-makers remain unconvinced of the benefits that the pact will have in practical terms. A number of economists have, moreover, questioned the need for such regulation of fiscal policy-making, and fear that the pact may even be counterproductive. Generally, they argue, the regulation of fiscal policy is only necessary for a stable monetary policy if some assumptions are fulfilled:

- One assumption is that monetary policy can actually reduce the debt burden via a surprise inflation. Such a surprise inflation can reduce real interest rates, but only in the short-run. It will at the same time increase the cost of refinancing public debt by increasing long-term interest rates and by shortening the term structure of public debt. It would be rather difficult for a highly indebted country to convince other EMU members to share this burden; it would at least be more difficult than to influence the decisions of the country’s national central bank.
- The argument in favor of a stability pact also assumes that each member of the Council of the ECB will represent their national preferences or the interests of their national

government. This argument runs counter to what is said to be the *Bundesbank's* experience, where independence quickly leads new Council members to cease to represent the preferences of their respective supporting group in favor of adopting the preferences of the institution. But even if one follows the above argument, and assumes that members of the ECB Council will represent national preferences, the decision-making process makes it rather difficult for highly indebted countries to influence monetary policy. This is because the six members of the ECB's Directorate have to be appointed by a unanimous vote in the European Council. The latter makes it rather likely that the members will come from the more stability-minded countries. Together with the six presidents of their national central banks they would represent 12 votes in the ECB's Council - a simple majority even with all EU members on board would be 11 votes. This implies that the more stable countries could easily dominate the decision-making process.

- Proponents of the stability pact also have to assume that capital markets cannot discriminate between borrowers with different credit standings and, therefore, are unable to force highly indebted countries to adjust early. However, critics of the pact expect that the ability of the capital market to fulfil this task will improve with currency unification because this step will eliminate exchange rate risks and improve capital mobility.

Some analysts even argue that the stability pact could backfire - since its very existence implies that there must be some doubt about whether or not the ECB can follow a monetary policy targeted at providing price stability in Europe. It therefore diminishes the credibility of the ECB. The existence of a stability pact would also increase the pressure on monetary policy to achieve other targets, such as full employment, if it effectively rules out the use of fiscal policy to a considerable extent. Moreover, it could deepen recessions for countries with a fiscal deficit of close to 3% of GDP before recession. To prevent the deficit from rising above the ceiling, the government would need to cut spending and raise taxes - aggravating the slowdown - or to pay a fine which further increases the need to cut spending and raise taxes.

Nevertheless, while the stability pact may raise some doubts, one should not overlook the fact that it confronts one of the main problems associated with the convergence criteria, namely that the fiscal targets established at Maastricht were not forward-looking. In as much as it has focussed policy debate on post-EMU fiscal policies, it has laid the ground for constructive dialogue among future EMU participants on how to conduct such policy in a mutually beneficial way.

### III. PERCEIVED BENEFITS AND COSTS OF EMU AND THE ISSUE OF FUTURE MEMBERSHIP

There has always been uncertainty about the economic benefits or costs of monetary integration, related either to the process of transition to a monetary union or to running the monetary union itself. According to many analysts, a well-functioning EMU would bring a number of benefits to the participating countries. Among other things, it would translate into falling commercial and financial transaction costs resulting from the replacement of national currencies by the *Euro*. This would spur intra-European competition, boost productivity and improve the functioning of the single European market. Monetary union would also provide small and medium-sized enterprises with greater opportunities to extend their commercial activities beyond national borders, due to the elimination of the exchange rate risk within the union. In terms of its external economic relations, EMU (and particularly a large EMU) would be far less vulnerable to exchange rate shocks than EU economies are now individually, given that, once they join EMU, much of their foreign trade would be reclassified as domestic.

EMU could, moreover, provide a significant stimulus to the development of the European capital market, with important implications for the international financial system. EMU would probably increase the negotiating power of its member countries in international economic and political fora. Finally, the circulation of a single European currency could have an immense symbolic effect with regard to fostering the concept of European unity.

Possible costs related to the *transition process* have been mentioned earlier in this report. In order to be eligible for membership in EMU, potential members first have to stabilize prices and to consolidate government finances. This requires restrictive monetary and fiscal policies and it implies potential costs in terms of higher unemployment, at least temporarily, if relative prices do not adjust quickly. While there is little doubt about this, the problem is whether to relate these costs either to the sins of the past or to the current problem of transition to EMU. Just as there is little doubt about the costs of stabilization and consolidation, so too there is little doubt about the positive effect of stable prices and a consolidated budget on economic growth. Hence, countries with high inflation and high fiscal deficits would have had to bear economic costs in the future, irrespective of the monetary integration process. A perceived cost may thus, in the longer run, translate into a clear benefit for national economies.

A different dilemma for transition stems from the fact that economic performance and market expectations are interdependent. In the case of a highly indebted country, for example, interest rates on that country's public debt will tend to decline if the market expects that country to qualify for entry into EMU. Hence, for that country, fiscal consolidation and price stabilization in the run-up to EMU will be much easier. This is basically related to the benefit of maintaining an external anchor for domestic monetary policy, which allows a less stable economy to "import" some of the credibility of a stable one. But this externality has a potential drawback, too, in that announcements of stabilization and consolidation may not be time-consistent. In other words, once a country is eligible for membership in the monetary union there may be no incentive to stick to preannounced policy

reforms. The stability pact, however, attempts to reduce this type of risk. Moreover, one may look at the Maastricht criteria as a chance for countries in need of adjustment to overcome the resistance of important pressure groups and to push ahead with reforms that increase the long-term growth prospects of the country. This would be another “indirect” benefit resulting from the EMU process.

A major concern regarding the functioning of the *monetary union itself* is related to the limited macroeconomic policy instruments that will be available to deal with the substantial differences that exist among the members of the union (in terms of their economic growth and development level, employment, labor mobility, labor and social security legislation) and EMU’s economic policy response to negative shocks. Economists have pointed out that, to facilitate efficient adjustment to such shocks, EMU members may have to develop a range of very focalized instruments to complement broader policy measures. This is particularly important given that, in a monetary union, governments are left with only two broad policy instruments for real adjustment: fiscal and labor-market policy - one of which (fiscal policy) will be somewhat restricted by the stability pact.

Currently, individual EU governments can use the exchange rate as a macroeconomic policy instrument in order to adjust national investment and production to a changing economic environment. In a monetary union, they will no longer be able to do so. However, the exchange rate is only an efficient instrument in this sense if (i) an economic shock is country-specific and if (ii) there is some exchange rate illusion to be exploited. As regards the first point, one may assume that with further progress in European integration of goods and factor markets, the patterns of production, consumption and investment become less and less country-specific, implying that shocks are more likely to be either sector-specific or affect a region rather than a country. As regards the second point, it can be argued that with further progress in European integration of goods and factor markets, workers and employees will also become more aware that a devaluation of their national currency reduces real wages because it increases the price of traded goods, a substantial component of the consumption basket. Hence, wages, the most important component of non-traded goods prices, have to be stable for the devaluation to have an effect on real wages and on the real exchange rate. If these arguments are true at least to some extent, it again becomes difficult to evaluate the costs of EMU.

As mentioned previously, there are different views regarding the independence of the future ECB. For most countries of the EU, the ECB will imply a significant change to their national arrangements, where central banks are often an integral part of the overall demand management to smooth business cycles. In contrast, the ECB is expected to give priority to price stability irrespective of the state of the real economy. Again, there are two possible interpretations to this situation.

- The proponents of a passive monetary and fiscal policy would interpret the independence of the central bank as an advantage because they do not believe in the possibility to smooth business cycles by monetary policy or by a more active fiscal policy than implied by the built-in stabilizers. More important as a task for

fiscal policy is the provision of a policy package adequate enough to promote investment and foster structural adjustment. This, however, requires a strictly decentralized fiscal policy in order to allow governments to compete.

- The proponents of an active monetary and fiscal policy would argue that the elimination of monetary policy as an instrument to influence the business cycle puts more pressure on fiscal policy to fulfil this task. Hence, there is a need for a centralized or at least harmonized European fiscal policy or a rather more flexible interpretation of the ECB's target system.

In general, the debate can be reduced to an argument between two economic concepts. While the adoption of a Keynesian view leads to the support of an active use of exchange rate, monetary and fiscal policy to guide real adjustment, the neo-classical view gives first priority to wage adjustment as well as decentralized structures for wage bargaining and fiscal policy decisions.

### **Future EMU Membership**

Variations in the perception of costs and benefits relating to EMU have been very manifest in recent discussions among EU member states on measures to reduce the *risks* related to the introduction of a new currency (the stability pact) and on the best design for economic policy in order to reduce the *costs* of maintaining a common currency (with the proposal of introducing a political "counterweight" to the independent ECB). Support for EMU is not equally strong in all member states. Coupled with the uncertainties over who will meet the Maastricht criteria by the end of 1997, and how these criteria will be interpreted, it thus remains fairly unclear which countries will join EMU in 1999 (the "ins") and which countries will not (the "outs"). The latter will either participate in a new exchange rate mechanism (ERM2, which is to ensure exchange rate stability between their national currencies and the *Euro*) or will remain completely outside the formal monetary integration process.

Different views on who should form part of the monetary union from the outset are closely linked to countries' perceived capacity to comply with the initial macroeconomic conditions for entering and then remaining in EMU, as well as their ability to adjust to external shocks. Country-specific variations in this regard are viewed by some as "analytical" justification for carrying out monetary unification in two stages. In the end, the political decision on who will be eligible to participate in the third stage of EMU has to be taken in 1998 by the European Council with a qualified majority, that is a minimum sum of votes of 62 out of 87.

One thing is almost certain: EMU will not go ahead without France and Germany, who form the nucleus of what is often referred to as the **core group**. Austria, Belgium, Luxembourg and the Netherlands also typically belong to this group of countries which form the so-called *deutsche mark* (DEM) zone. (Denmark, which also forms part of the DEM zone, is not considered to be part of the core group, since its willingness to participate in EMU remains unclear).

Despite a shared commitment to EMU among the core group, there are disagreements on several key issues relating to both the convergence criteria and the eventual functioning of the monetary union. Some countries in this group favor strict adherence to the convergence criteria, which means that they would be reluctant either to agree on initiating stage three of EMU if these criteria were not fulfilled by their group or to accept other countries into the union which did not yet fulfil the criteria. These countries, moreover, support the complete independence of the ECB. Other countries are strong proponents of an active exchange rate and fiscal policy as well as of a strong influence of governments on the decisions of the central bank.

Support for EMU and, in particular, the introduction of a common currency, is very pronounced among those countries belonging to the **convergence group**: a group of countries which initially were far from fulfilling the criteria for entry into EMU but have made substantial progress during the past years: Italy, Ireland, Finland, Portugal, Spain, and to some extent even Greece. These countries are very interested in participating in EMU, not least because of the expected benefits this might entail in terms of consolidating their current stabilization efforts. Irrespective of their individual performances, all countries in the group have shown a strict commitment to the process of monetary integration even in the light of significant short-term economic costs in terms of high interest rates and high unemployment. Except for Greece, they do not favor a scenario of a small monetary union concentrated around only the core countries, and if necessary are likely to push hard for a relaxation of some of the convergence criteria in order to allow for a large initial membership of EMU.

The United Kingdom, Sweden and Denmark currently maintain an **outsider** position with respect to the process of monetary integration - a position that could nevertheless change in the future. For the time being, they do not participate in the EMS and/or have an opt-out clause for participation in EMU. They are also the strongest proponents of the concept of decentralized policy making in the EU.

Just some years ago, the idea to restrict entry into EMU by promising a later entry, for example in 2002, with the physical introduction of the new currency, was highly plausible. But now the progress of convergence outside the core group has already reached a level which makes the scenario of a small EMU more difficult to imagine. In addition, the negotiations on the design of ERM2 indicate that such a scenario might not be acceptable for a number of potentially affected countries. In effect, it is plausible that the convergence group might lose part of the credibility they gained by the market perception of their likely entry into EMU. Interest rates, debt service, and, hence, public deficits might rise in these countries, as a result. This would imply that entry in 2002 would be harder to

achieve than entry in 1999. Hence, the countries of the convergence group are likely to exert maximum political pressure for being taken in if EMU starts in 1999.

### **Technical and Legal Aspects of Transition**

Most technical and legal requirements for EMU have to be fulfilled at the end of 1998. But the implementation of these measures will only gain speed after the European Council decides on membership. However, the general requirements have already been laid down.

First, the instruments and the targets for monetary policy have to be defined. The latter are likely to involve a mixture of both a money supply target and a direct inflation target. As to the conduct of monetary policy, the EMI has already outlined a model, according to which the main instruments would be a variety of open market policies complemented by lending and borrowing facilities that help to support a band around market interest rates. Minimum reserves requirements will be of minor importance. These policies still have to be harmonized in order to exclude any possibilities for arbitrage due to institutional differences.

Second, the statutes of national central banks have to become compatible with the statutes of the ESCB. This requires their independence in the first place. Up to now, only Denmark's national bank passes this test and even the *Bundesbank* still fails to meet all requirements of independence: although this has not tended to occur in practice, the German government can legally postpone the implementation of monetary policies decided by the *Bundesbankrat* (Council); the minimum term for the members of the Council is less than five years; and the priority for achieving price stability is not stated clearly. In addition to independence, NCBs have to be ready to act as an agent of the ECB.

Third, public authorities have to make sure that a legal framework is in place so as to ensure the status of the *Euro* and its irrevocably fixed conversion rates against national currencies. Between 1999 and 2002, the legal framework has to guarantee the freedom to transact in either national or European monetary units. This would allow the private sector to optimize individual transition schemes. Therefore, it must also be guaranteed that between January 1999 and January 2002, contracts in national currency will be converted into contracts in *Euros* using the conversion rate, while the contracts as such maintain their full validity in law. The difficult question will be how to translate this into legal terms so that it is binding for non-EMU and even non-EU inhabitants.

Fourth, the conversion rates have to be defined at the beginning of 1999. Hence, exchange rates will have to be locked in at that time. Exactly how they will be locked in poses something of a dilemma. If the authorities leave the fixing of rates until the last moment, speculation may cause some exchange rate turbulence in the very months or weeks before EMU starts. If instead the rates are announced in advance, everything would depend on the credibility of Europe's monetary authorities. If they retain the market's confidence, speculation could help pin exchange rates at the preannounced levels; if not, the preannounced parities might be attacked just as the old EMS was.

In the midst of the difficulties encountered by EU member states in their path towards closer economic union, one should not forget that the transition process has brought a number of important tangible benefits. The need for convergence has created a serious momentum for economic reform in countries like Ireland, Portugal, Italy and Spain. The governors of these countries' central banks have shown a particularly firm commitment to price stability. This provides hope for the case that a large monetary union, including the "core group" and those countries which are successfully converging towards this group, will be able to convince international capital markets that the *Euro* will be a strong currency.



#### IV. INTERNATIONAL ASPECTS OF EMU

European interest in EMU's extra-regional repercussions is fairly recent, and there is as yet little research on which to base an informed debate on the issue. This has several explanations. First, until very recently there were serious doubts regarding the feasibility of carrying out the EMU project, particularly within the suggested time frame. There has also been some concern over a possible restrictive bias in the formulation and implementation of EMU economic policy. All this may explain Europe's concentration on domestic rather than external economic effects.

Second, it is important to remember that EMU, and particularly a large EMU, would be far less vulnerable to exchange rate shocks than EU members are now individually, given that much of their foreign trade would be reclassified as domestic commerce, traded in local *Euro* currency. This is because the bulk of EU members' current external trade takes place *among* the member countries, which in itself underlines their strong interdependence. Today, over 70% of the total foreign trade of Portugal, Belgium, and Luxembourg is with EU countries; Ireland and the Netherlands rank close behind with 65%. The lowest percentages apply in Germany, Great Britain, and Finland, with about 50%. In a monetary union, such intra-EU trade would no longer constitute an "external" component of commercial relations. Hence, EMU would have a coefficient of imports to GDP similar to that of the United States (10%) - much lower than that of any current member state in the EU. The lower importance of foreign trade in EMU, compared to the present situation, may be an additional explanation why the EU is primarily concerned with the domestic implications of EMU.

An EMU of 15 members may not initially materialize, but even if EMU were to include just seven countries (Germany, France, Belgium, the Netherlands, Luxembourg, Austria, and Ireland), the coefficient of imports to GDP would still be significantly lower than today, though almost twice as high as that for an EMU with 15 countries. In the latter case, trends in the "external sector" and in related policies, particularly exchange rate policy, would be considerably more important for the EMU.

##### *EMU and the global economy*

EMU will strengthen the growing presence and importance of political and economic blocs in the world. In particular, it will have an impact on the international monetary system, confirming the trend observed in recent decades toward the development of a multipolar international economic order. In the future, EMU member countries could speak with an increasingly single voice in institutions such as the International Monetary Fund and the World Bank. The relative weight of the EU would thus be greater than at present, on account of its voting power in those institutions and the potential coherence and uniformity of its approach.

One particularly important point for evaluating EMU's likely impact on the international economy relates to the uncertainty that exists at present regarding which "vision" will prevail in its political and institutional design and in the formulation and implementation of its monetary and exchange rate policy. The direction that the new economic institution will actually take, which for the moment is

still being debated, will be the determining factor when the time comes to evaluate the impact of EMU. Equally important will be the decision as to what countries will participate in the union from the start. That decision may influence private investors' perceptions regarding the monetary policy that will be pursued by the ECB, which, in turn, could induce some adjustments in markets. It will also determine the initial economic scale of the monetary union, which in itself will affect EMU's exchange rate policy.

### *The Euro in international transactions*

Analysis of the *Euro's* external impact has so far focussed on two main issues. First among these is the question of how significantly the *Euro* would compete with the dollar as an international currency, both in public and private use. Studies have sought to examine the possible behavior of the official and private sectors with respect to changes in their portfolio of international financial assets and liabilities. Analysts have also examined the possible international role of the *Euro* as a unit of account, transaction mechanism or store of value, as well as its likely impact on the currency (or currencies) in which international commercial and financial contracts are denominated.

A second special area of interest relates to the possible evolution of the *Euro's* value vis-a-vis the dollar, although, as indicated previously, fluctuations in the "European" exchange rate would have less of an impact on individual countries within the union. Both issues - the *Euro's* roles as an international currency, and its value - are examined in more detail below.

### **The Euro's Role as an International Currency**

Although its role is diminishing, the dollar is still the most important international currency both as a unit of account, means of payment and store of value. It plays the dominant role even in Asia, where the *yen* is neither an explicit nor implicit anchor for any national currencies. The dollar's predominance is evidenced by the following data:

- According to some estimates, in the early 1990s almost 50% of **world trade** was denominated in dollars, around 15% in *deutsche marks*, and just 5% in *yen*.
- In 1995, the dollar was used in approximately 42% of all **foreign exchange transactions**, whereas the *deutsche mark* and the *yen* accounted for 18% and 12% respectively
- The dollar also dominates in **official international reserves**, although it has lost ground in the past two decades, falling from

just over 70% of reserves worldwide in the second half of the 1970s to an estimated 60% in the first half of the 1990s. The *deutsche mark's* share rose over the same period from 8% to 15.5%. The estimated share of the five main European currencies (including the *deutsche mark*) increased from 14.5% to 22.5%, while that of the *yen* jumped from 1.5% to 7.5%.

The creation of a single European currency should strengthen the trend toward **greater diversification in international currency holdings and their use**. This process is nevertheless expected to occur gradually, since it will take time for public and private economic actors to gain confidence in the qualities of the *Euro* (in terms of stability, liquidity, etc.). This inertia might initially prolong the dominant international role of the dollar.

The importance of the *Euro* as an **international trade invoicing currency** should increase relative to that of the current EU currencies, since the combined GDP of the EU member states is similar to that of the United States and three times that of Japan. Furthermore, the currencies of large exporting countries tend to be used more in the denomination of foreign trade contracts than their relative importance as exporters would suggest. For example, around 48% of world trade is denominated in dollars, while the United States' share of world exports is only around 15%. The EU's share of world exports (20%, excluding intra-EU trade) is considerably higher than that of the United States.

It is, however, less likely that the *Euro* will quickly be used in a larger share of **foreign exchange transactions** or in the **international denomination of commodity prices**, owing to the inertia mentioned earlier.

On the other hand, the *Euro* could quickly become more important (than European currencies are today) as a currency for denominating **international financial assets**. This would mainly result from the size, depth, and liquidity of the monetary union's capital market, and the expected stability of the value of the *Euro* once the ECB is operating.

## **The Future Value of the Euro**

### ***The behavior of private European investors***

With the conversion of national currencies into *Euros*, private economic actors in Europe will probably have some excess of *Euros* (domestic currency) in their portfolio. Consequently, they may wish to pursue a portfolio diversification strategy in the direction of an increase in demand for assets denominated in currencies other than the *Euro*.

Any initial doubts about the ECB's anti-inflationary "credentials" would also work in this direction. All things being equal, either or both of these effects would point towards a weakening of the *Euro* against the dollar (relative to its initial value at the time of conversion).

### *The official sector*

EMU's effect on the *Euro*'s external value will also depend on the behavior of central banks. In this respect, a distinction must be drawn between those central banks functioning within EMU, on the one hand, and those outside the monetary union, on the other.

Even after adjusting their international reserves downwards owing to the redenomination of reserves maintained in the currencies of their member countries, **EMU central banks** are still expected to hold an excess of dollars. For one thing, they will no longer need foreign exchange to protect domestic currencies within the EMS. For another, they will also need far fewer dollars because EMU imports would be smaller than at present. For example, if all 15 countries of the EU enter the monetary union over 60% of their foreign trade would be reclassified as domestic. Compared to the present situation and discounting for reserves maintained in the currencies of EMU members, it is estimated that the foreign exchange reserves (including gold) of the 15 countries as a percentage of their new, lower level of "foreign" imports would double. This means that EMU reserves as a whole would be three times greater than equivalent holdings of international reserves by the United States. Since close to 90% of those reserves are denominated in dollars, it is reasonable to assume that the central banks would not only reduce excess reserves but would also diversify the remaining reserves towards a lower dependence on dollars. This would tend to weaken the dollar vis-à-vis the *Euro*.

However, if a smaller number of countries were to join EMU initially, there would be fewer "excess" reserves. Furthermore, once the *Euro* is created, the international reserve policies of the European central banks will be defined by the ECB. It may be expected that the ECB would try to avoid causing any major impact on international foreign exchange markets. It is also unlikely that the ECB would permit a sudden "one time" devaluation of the dollar, due to the impact this policy would have on the competitiveness of European exports. In sum, while the excess supply of dollar reserves in EMU central banks should cause the price of the dollar to drop, this would probably happen only very gradually, over an extended period of time.

**Central banks outside EMU** may be expected to realign their international reserve portfolios in favor of the *Euro*. This realignment would increase demand for the *Euro* and appreciate its price in comparison with the dollar, further strengthening the above mentioned trend towards a higher *Euro* to dollar value. This process, should it occur, would be gradual, in tandem with the consolidation of the ECB's anti-inflationary policies and the increased internationalization of EMU's capital market.

Thus, if we consider the foreseeable behavior of **both the private and official sectors**, one can surmise that the role of the *Euro* as an international currency will be more important than the current role of Europe's national currencies. This phenomenon would manifest itself more clearly in the

countries of the EU that do not join the monetary union at the outset, as well as in Central and Eastern Europe and other countries with traditionally strong ties to the EU. Furthermore, it is likely that these countries would use the *Euro* more extensively than they have hitherto used the *deutsche mark* as an anchor for their exchange rate policies.

Accordingly, the international role of the *Euro* would probably be felt first and with the greatest intensity in Europe's sphere of influence - areas where commercial and financial ties with the EU are strongest. A likely outcome of this would be the conformation of a *Euro-zone*, comprising these areas. The *Euro's* role *worldwide* would probably increase once the credibility of the ECB is consolidated, though at a gradual pace for the reasons given above.

In sum, it is probable that opposing forces will affect the external value of the *Euro*:

- The dollar could depreciate as a consequence of its surplus supply in the reserves of central banks. This would strengthen the *Euro's* value against the dollar.
- It is also likely that the *Euro's* larger role as a currency in which international trade is denominated will strengthen its value.
- However, until the monetary union's economic policies (monetary, fiscal, and exchange) are clarified - particularly considering the high unemployment rates prevalent in Europe and sharp differences in growth among its regions - and until the ECB's credibility is consolidated, a perceived "abundance" of *Euros* in private investment portfolios would lead to portfolio reallocation and result in the weakening of the *Euro*.
- Nevertheless, if initial EMU membership is limited to the countries with the most conservative monetary policies, and/or if the ECB manages to impose its authority from the start, then the market may take a much more favorable view of the strength and credibility of the *Euro*.

Although it is very difficult to quantify the combined effect of these opposing forces, one may, on the basis of current information, guess that the *Euro* will appreciate in the medium term. However, an appreciation would probably be gradual and perhaps not very significant. It is expected,

moreover, that as the date for monetary union nears, the market will try to guess which and how many countries will become initial members of EMU, and to anticipate the ECB's monetary and exchange policies.

Furthermore, it is important to stress that the evolution of the *Euro* in relation to the other main currencies, particularly the dollar, will not depend solely on changes in the holding or allocation of official and/or private reserves. The net result of the ECB's monetary policy and the fiscal policies of EMU members, in conjunction with the macroeconomic policies of other countries, particularly the United States, will also be very important. Indeed, the size and significance of the future EMU suggest that it would be wise to expand and step up international economic coordination and cooperation in these matters. The purpose of doing so would be to prevent major macroeconomic distortions or imbalances among the world's main economies. Such imbalances would not only directly impact medium- and long-term growth in these economies, but would also indirectly affect growth in developing countries, including Latin America and the Caribbean.

As mentioned earlier, the creation of the *Euro* may increase Europe's economic importance and its international negotiating power, since EMU members will be less vulnerable to fluctuations in the external value of the *Euro*. Moreover, the size of EMU's capital market and the expected greater predominance of the *Euro* in official and private international portfolios - compared to that of current EU currencies - imply that EMU monetary policy will play an increasing role in determining the international interest rate structure. Finally, the new conditions created by EMU should make Europe's trading and financial partners more sensitive to the union's economic policies.

## **V. IMPLICATIONS FOR LATIN AMERICA AND THE CARIBBEAN**

Europe's experiment of commercial and financial integration, while not without problems, is on the threshold of entering a new and advanced stage of development, highly sophisticated in nature, exceptional for its depth and extension, and with profound political and economic implications at the national, regional, and international level. EMU will no doubt have implications for European economic relations with Latin America and the Caribbean, in terms of both trade and investment flows.

### **EMU and the Latin American and Caribbean Economies**

During the 1990s, Latin American and Caribbean exports to the European Union have averaged US\$32 billion a year, accounting for 19% of the region's total exports and 28% of its combined exports to the EU, Japan, and the United States. The average annual growth of exports to the EU has been in the order of 4.5%, in value terms.

During the same period, the region's imports from Europe averaged US\$30 billion annually, equivalent to 17.5% of total imports and 27% of the region's combined imports from the EU, Japan, and the United States. Annual import growth has averaged 12% in value terms.

As these figures clearly demonstrate, the EU is an important trade partner for Latin America and the Caribbean. Its relative significance is even greater if Mexico is excluded from the regional average, owing to the predominant role of the United States in the latter's commercial relations. If Mexico is excluded, the EU is the market for almost 30% of total Latin American and Caribbean exports.

During the 1990s, however, the region's exports to the EU have been considerably less dynamic than its exports to non-European markets. Europe's share in Latin American and Caribbean total exports has fallen, from some 24% in 1990 to less than 17% in 1995. The region's imports from the EU have stabilized at 17.5% of total imports, lower than the 1990 figure of over 20%. It should be noted that Latin America and the Caribbean accounts for only a small share of EU extra-regional imports (5.5%), that share has moreover declined slightly in the 1990s. In contrast, EU exports to Latin America and the Caribbean have risen slightly in the 1990s, and now account for almost 6% of the EU's total extra-regional exports.

European direct investment in Latin American and Caribbean countries has also risen in absolute terms during the 1990s, mainly as a result of the substantial progress made in the recipient region in terms of structural reform, economic liberalization and greater stress on macroeconomic balances. Europe's share of total FDI inflows to Latin American and Caribbean countries from the United States, Europe and Japan accounts for approximately one quarter.

The effect of the future EMU on Latin American and Caribbean foreign trade, and particularly on the region's exports, will depend not only on **economic activity and growth in the EU**, but also on the **evolution of the external value of the Euro**, in particular vis-à-vis the US dollar, to which most Latin American and Caribbean currencies are closely linked.

## ***Factors influencing macroeconomic growth in Europe***

As regards aggregate demand, it is worth considering both monetary and fiscal policy developments. With respect to **monetary policy**, it is likely that, during the transition period prior to the creation of the *Euro* in January 1999, interest rates might continue their current downward trend. Falling rates would mainly be the result of the convergence of interest rates (particularly long-term rates) of countries such as Italy and Spain towards those registered by Germany and other so-called “core” countries, which currently have Europe’s lowest interest rates. The convergence would indicate that the market is betting in favor of wider membership in the original EMU.

Furthermore, the slow recovery which characterizes most future EMU countries in the current phase of their economic cycle, combined with the fact that inflationary pressures are under control, suggests that if there are changes in national monetary policy in the foreseeable future, they may tend towards relaxation. This would, therefore, strengthen the trend towards lower interest rates, particularly long-term rates.

A further point to consider in relation to the creation of the *Euro* are the changes that are occurring now in the European banking sector, and which will accelerate in 1997 and 1998. The sector is one of the first that will have to “adapt” to the future *Euro*. Adaptation will largely consist of greater competition among (probably) larger and/or merged banks, leading to lower spreads between lending and borrowing rates, and consequently a lower market interest rate.

There is some consensus that, in its first years of operation, the ECB will have to establish and consolidate its credibility as a monetary authority with a clear anti-inflationary mandate. To do so, the ECB might be expected, at least at the outset, to pursue a restrictive monetary policy. This would probably lead to a somewhat higher average European interest rate than that prevailing prior to the creation of the *Euro*.

While uncertain, the net effect on interest rates resulting from developments in the transition period, on the one hand, and the ECB’s initial monetary policy, on the other, would most likely not lead to any significant changes compared to current average interest rate levels. In the longer term, a stable *Euro* would permit the ECB to relax monetary restrictions and to follow a monetary policy that does not check the economic growth of EMU.

As regards **fiscal policies**, EU member states are making a major effort to comply with the requisites of the Maastricht Treaty. In some countries, however, the expectations and actions of private financial players have actually helped to bring about a significant drop in fiscal deficits caused by high public debt and interest rates, mainly through financial inflows that have contributed to a fall in rates, coupled with relative appreciation of national currencies against the *deutsche mark*. Hence, some European observers question the speed of convergence of interest rates in several Mediterranean countries, noting that this may be due more to market expectations (reflected in lower fiscal deficits, given the high public debt in those countries) than to more structural and durable fiscal efforts.



Finally, on the **supply side**, the *Euro* should reduce transaction costs for EMU countries and increase the transparency of the single market. With the *Euro*, exchange rate instability inside the EMU will cease to exist. This will be of significant advantage since in the past the effect of such instability was highly negative, due to the fact that the benefits to countries that devalued their currencies were less than the costs in countries that did not. These arguments, coupled with the perception of solid and sustainable macroeconomic balances and possible advances in structural reforms, should generate confidence and spur investment in EMU countries, contributing over the medium term to faster economic growth within the monetary union. Some nevertheless argue that such a scenario may be too optimistic and that, as a result of restrictive fiscal and monetary policies - compounded by inflexible labor markets - the prospects for economic growth in EMU might be rather more limited.

### *The external value of the Euro*

As for the exchange rate implications, we can distinguish between several stages. The first stage continues up to January 1, 1999, assuming that EMU is not postponed. According to most observers, the postponement or paralyzation of EMU could have a very negative impact, with major exits of capital from the EU, requiring highly restrictive national monetary policies and, consequently, a contraction of economic activity. The second stage commences with the launching of the *Euro* in January 1999 and continues until the ECB's credibility is consolidated. The third stage would be when EMU is fully operational, with its final membership fully determined, with monetary and exchange policies both known and inspiring confidence to the different economic players, and in which the stocks of assets and liabilities in international portfolios will have adjusted to the *Euro*.

Although it is very difficult to project what changes may occur during the different stages, since they will depend greatly on the perceptions and behavior of private international financial actors, it seems reasonable to expect that the dollar will continue to be strong throughout the initial stage (that is, throughout 1997 and 1998). This is based on two different assumptions:

- The expectations and uncertainty surrounding the formation of a common currency such as the *Euro* will increase the demand for dollars and for other non-EMU currencies (including those of possible "outs"). This would mainly be at the cost of the *deutsche mark*, and would indicate a degree of uncertainty among market operators whether the future ECB will follow a solid anti-inflationary policy. Lower confidence in the future *Euro* (and in the current *deutsche mark*) could also be sparked by expectations of a "large" EMU membership.

- A second point of view is that the recent strength of the dollar, particularly in relation to the *deutsche mark*, is not linked to expectations regarding EMU but is explained by fundamentals. The United States and much of Europe are in different stages of their economic cycles, and will probably continue to be in the near future. The cycle in the United States and in the United Kingdom is tending toward higher interest rates. In continental Europe, the cycle is toward constant or slightly lower rates, particularly in Germany, France and countries most closely linked to them economically. Generally speaking, in the near future Europe would likely follow a fairly restrictive fiscal policy and a more expansive monetary policy, which would lead to a stronger dollar and a weakening of the main European currencies. Of course, if the current phase of the cycle were to end quickly and the European economy were to benefit at the start of 1999 from the low interest rates foreseeable over the next 18 months, while the United States were to enter into a flatter stage in its economic cycle, then the European currencies would strengthen just when EMU is supposed to start.

Moreover, at least until early 1998 when the European Council will decide on future EMU membership, there could be greater exchange rate volatility between the currencies of the industrialized countries stemming from uncertainty regarding the definition of EMU and the operation of ERM2, as well as the specific manner in which the ECU will be converted. This volatility could continue in the future, given EMU's lower degree of external vulnerability and, consequently, a perceived lower relative importance within EMU of the external and exchange rate implications related to such volatility.

As to the second stage, it is generally argued that the *Euro* will strengthen as a consequence of the anti-inflationary bias of the ECB during the early years of EMU (particularly if EMU begins with a restricted number of participating countries). However, it is important to understand that the concrete policy of the ECB will depend to a large extent on the "initial" value of the *Euro* in relation to the dollar. If the dollar consolidates its strength, and particularly if its value increases further, the ECB will find it less costly to lend credibility to the *Euro*, since it would begin to operate in an environment that is relatively more favorable regarding the competitiveness of EMU exports.

Subsequently, since EMU will be relatively less vulnerable to external economic developments, it is reasonable to assume that there will be no great urgency to depreciate the *Euro* to stimulate EMU exports. This, coupled with the need to achieve credibility for the ECB's monetary and exchange rate policy, suggests that, from the European standpoint, the *Euro* should strengthen against the dollar - although probably from an over-depreciated initial value. (As mentioned previously, the international value of the *Euro* will of course also depend on the fiscal policies of EMU countries and the actions of economic, monetary, and fiscal authorities in the United States and Japan.)

As EMU consolidates itself, the trend to a strong *Euro* should become more evident, particularly considering the growing attractiveness of the EMU capital market for private and public investors. France has already publicly announced that it will redenominate its existing stock of public debt in *Euros*, while Germany has informally stated its intentions to do so. Redenomination of these two countries' public debts should give the market significant depth and liquidity from the outset.

In short, and given the highly speculative nature of an analysis of this kind, two tentative conclusions can be drawn:

- Once EMU is fully operational, the *Euro* should become an important, stable currency with a tendency to strengthen gradually against the dollar. This, coupled with expected growth in the European market, could translate into higher export earnings for Latin American and Caribbean countries.
- In the more immediate future, however, the current trend of stagnant regional exports to the EU could continue, since it is not likely that EMU countries' demand for Latin American exports will rise immediately. This is due to the current low levels of growth in European economies, and the fact that the *Euro* is unlikely to appreciate initially against the dollar.

### *Foreign investment*

Unlike the differences in opinion regarding the impact of the future EMU on economic activity and the *Euro/dollar* exchange rate, there tends to be consensus that the creation of the *Euro* will enhance the relative significance of the European capital market within the international financial system.

A stronger European capital market should provide Latin America and the Caribbean with better opportunities for capturing financial resources and supplementing internal savings. With a capital market of the size, depth, homogeneity, and liquidity like that which the *Euro* is expected to form,

Latin American and Caribbean governments and private firms will have more and better opportunities to obtain the financing they require, at a lower cost and better terms than at present.

The new market would be even more beneficial for Latin America and the Caribbean if European investors diversify their portfolios owing to excess holdings of European financial instruments denominated in *Euros*, while at the same time having fewer options for risk diversification within EMU. Should the above occur, then it would be reasonable to expect that European investors would increase their demand for assets in emerging markets, including increased investment in a number of Latin American and Caribbean countries.

This outcome would be even more likely if the interest rates of the future EMU revolve around “low” values such as the current German rates, which would spur capital flows from Europe to other markets. Growing pressure to diversify European pension funds would also promote investment in emerging markets.

This positive scenario should not be understood nor interpreted as a suggestion that Latin American and Caribbean countries should slacken their efforts to continue with stabilization and structural reforms. Responsibility in national macroeconomic management, promotion of domestic savings, and concern with boosting and adequately financing investments are necessary conditions for the region. Greater access to cheaper credit on more convenient terms, and the ability to diversify the currencies in which new capital and/or external debt is held due to the creation of the *Euro*, should be viewed as a supplement to the proper formulation and responsible execution of economic policies in Latin America and the Caribbean.

Moreover, some degree of financial “deviation” could occur, which would decrease the trend toward investment abroad by European investors, and increase their demand for instruments from other EMU countries due to the elimination of exchange risk as a result of the creation of the *Euro*.

In general, however, it is expected that with the development of the European capital market, Latin American and Caribbean central banks and private companies will be able to manage their financial assets and liabilities better. More favorable conditions for allocating private and official portfolios can help to reduce the vulnerability of the external sector in many Latin American and Caribbean countries. The establishment of powerful monetary blocs such as EMU will in all likelihood increase the probability that commercial and financial contracts will be denominated in currencies other than the dollar, creating challenges for improving and perfecting the region’s capacity to manage exchange risk coverage. The size of the *Euro* market should contribute to this phenomenon, through a reduction in the cost of protection against exchange risks.

### ***The conformation of large trading blocs: challenges for Latin America and the Caribbean***

The likelihood that three large blocs will emerge, centered around the United States, Europe, and Japan, poses two major challenges for Latin America and the Caribbean. First, as was suggested

earlier, the region will have to devise a strategy for negotiating its position in areas of international coordination and cooperation, where the EU will conceivably have a greater voice.

Second, should the three large blocs fail to coordinate their economic policies adequately, then the economic cycles of the industrialized countries could become even more unsynchronized than at present. This could have systemic implications stemming from a more self-centered stance of the three blocs, which would be more equal in terms of power and economic influence and less dependent on international economic developments than they have been thus far. With these possibilities in mind, it might be worth studying what would be the potential impact of events such as a future global recession or greater interest and exchange rate volatility in the industrialized countries on Latin American and Caribbean development.

But quite apart from its “external” effects, European monetary integration may be worth studying as a process in itself, particularly for those regions of the world where integration plays a key role in national foreign policy considerations. The Latin American and Caribbean region is of course a case in point.

### **Monetary Integration: Lessons for Latin America and the Caribbean**

Latin American and Caribbean countries are currently engaged in a variety of integration projects at both the regional and subregional level. Some of these projects have been underway for many years. It is evident that the region’s efforts in this regard have not had the same objectives nor the same far-reaching results as those achieved by Europe after World War II. It should be remembered that the EMU project has emerged with a probability of realization and success only after 40 years of commercial integration among EU member states, leading first to the establishment of a free trade area, then to a common market and, beginning in 1993, to a single European market allowing for the unhindered movement of goods, services, capital and people across the EU. This process has been accompanied by ever closer inter-governmental cooperation on a variety of aspects pertaining to foreign policy, justice and home affairs.

Latin America and the Caribbean are currently a long way from displaying a similar level of integration in terms of depth, fluidity, and pace. There are, moreover, no plans at present for so deep an integration as to suggest that monetary integration should become a logical sequential objective. While there are agreements in the field of international payments and reciprocal credit mechanisms, they far from constituting the makings of a monetary union. Clearly, in terms of integration, more basic objectives remain to be accomplished in areas such as commercial integration, harmonization of environmental policies, interconnection of transport and communications infrastructure, labor and capital mobility and harmonization of tax and other policies.

Nonetheless, the region should take advantage of the opportunity it now has to observe the current developments in Europe that are related to the establishment of EMU. It can learn lessons from the European experience which can be applied to the analysis, design, and implementation, when the

time is ripe, of closer, deeper integration among Latin American and Caribbean countries and subregions.

Europe has faced obstacles in the process of monetary integration, which it has gradually overcome as national governments have strengthened their commitment to the project and made major advances in preparing their countries for EMU. The institutional design used for technical and political dialogue among EU member states - a dialogue conducted within a context of commitment and cooperation in moving toward European monetary integration - is in itself worthy of study, since Latin America and the Caribbean can learn much from it.

The process towards monetary union involves a significant transfer of power from the national central banks to the institution that will issue the common currency. For this transfer to occur, a great deal of **political will** is necessary within the countries that seek to integrate their monetary systems. Indeed, as mentioned earlier, it is the political commitment of EU member states that has been one of the main driving forces behind the EMU project.

Moreover, a monetary union such as that emerging in Europe requires a considerable degree of **similarity** both in institutional matters (independent central banks, for example) and with respect to macroeconomic behavior (exchange rate linkages between member countries, minimal inflation and interest rate divergence, and limits on central government deficits and public debt. Although Latin American countries have recently advanced in these areas, particularly in bringing down inflation rates and in pursuing greater fiscal discipline, marked differences still remain between their economies.

It is anyway unclear whether the Latin American and Caribbean region should follow the European experience in monetary integration even at a later stage of its integration process. The creation of the *Euro* is still a formidable challenge; neither its implementation nor its success as a single currency are as yet assured. Indeed, as mentioned previously, some analysts maintain that the main reason for the creation of a single European currency lies in political considerations specific to the continent, rather than economic concerns as such.

It is also worth reflecting on the **economic conditions** necessary to justify the creation of a monetary union, considering that doubts have at times been raised about the adequacy of conditions in Europe itself:

- *Labor mobility* between EU countries is considerably lower than in the United States, which makes it difficult to cope with shocks that hit countries unevenly. Increased labor mobility is hampered by a variety of issues ranging from cultural differences, including language and customs, to complications that arise in transferring workers' accumulated benefits from one country to another,

particularly in the case of older workers. In the face of an economic shock, the inflexibility that marks most European labor markets complicates the feasibility of carrying out a less costly adjustment process.

- In contrast, the current high volume of intra-European *trade* works in favor of European monetary integration. Furthermore, extensive *capital mobility* in Europe tends to facilitate monetary union, although it should be kept in mind that while this is a useful mechanism for financing any given imbalance and helps to cushion adjustments, it does not replace the need for adjustment in the event of a lengthy or structural shock. One benefit of monetary union, the elimination of nominal exchange rate volatility, should be weighed against potentially greater volatility in interest rates.
- A further element to consider in a monetary union is the *type of shocks* that could affect member countries. In Europe, many countries would face shocks of a similar nature, which makes them good candidates for EMU.

In short, the early start of EMU and the creation of a single currency serves as a splendid **learning opportunity** for Latin American and Caribbean countries engaged in regional or subregional integration schemes. It would be both desirable and feasible for the region to undertake closer studies of the monetary and macroeconomic aspects of European integration, including their possible impact on the region's trade, capital flows, and foreign direct investment with Europe.

To this end, it could be useful for the Latin American and Caribbean central banks to participate more regularly and actively at meetings of the Bank for International Settlements (BIS) in Basel. Not long ago, Brazil and Mexico became the first Latin American members of the BIS. The BIS could serve as a venue for the region's monetary authorities to study exchange, monetary, and financial issues, and share experiences with other developing countries. For example, the BIS could be a good forum for learning more about the recent bilateral agreements on monetary coordination between non-European countries (between Australia, Hong Kong, Indonesia, Malaysia and Thailand, in November 1995 and between Philippines and Singapore in April 1996). These are aimed at providing currency stability in the event of crises, without requiring a formal institutional structure.

Meetings at the BIS also allow for the exchange of ideas and experiences with European countries, which would further facilitate the monitoring and understanding of EMU developments. Along a similar line, more and more Latin American and Caribbean countries are now participating in the different bodies of the OECD in Paris, and are strengthening their links with the European Commission in Brussels, which itself plays a vital role in the preparations for EMU and actively monitors its development.

The approaching establishment of EMU can be a good opportunity for initiating a regional dialogue among Latin American and Caribbean countries, in which European counterparts could be invited to participate. This dialogue could begin with a systematic exchange of ideas and information related to future criteria for macroeconomic convergence or coordination among members of the region's different integration schemes.

## **SUMMARY AND CONCLUSIONS**

The commitment among EU member states to pursue economic and monetary union represents a major advance in the process of European integration. Once accomplished, EMU will be of great historical, political, and economic significance not only in Europe, but worldwide. In return for the political benefits stemming from closer European integration and unity, EMU member countries will cede a considerable part of their sovereignty in economic policy-making to a Community institution, the ECB, whose policies, in turn, will be determined by all members of the union.

The path towards EMU has not been easy, and slow economic growth in most EU countries has made it difficult to comply with the criteria for fiscal convergence. It is nevertheless true that such requisites, which are a necessary condition for joining EMU, have allowed national economic authorities to take politically difficult decisions regarding fiscal adjustment.

Indeed, quite apart from the debate surrounding EMU, there is a broad consensus in Europe on the need to balance fiscal accounts, and to trim and redefine the role of government. Some governments have seen EMU as a powerful ally in deflecting domestic political criticism from what have often been harsh economic reforms.

The most immediate challenges facing EU member states in their pursuit of monetary integration are:

- to reach consensus on the interpretation of the convergence criteria - rigid versus flexible. The interpretation of the convergence criteria will influence decisions regarding future EMU membership. The dilemma is that a small monetary union including the core countries may not find a qualified majority in the European Council in early 1998, while a large monetary union could win a majority of votes but might fail to meet the fiscal convergence criteria.



- to reach consensus over the blueprint for economic policy making in a European currency area - centralized versus decentralized, active versus passive monetary and exchange rate policy. The design of economic policy, which complements the ECB's attempt towards stabilizing a European price level, will determine the precise economic impact of creating a single currency. With only two broad policy instruments left for real adjustment (fiscal and labor-market policy), EMU governments may have to develop a range of focalized instruments to facilitate adjustment in the face of economic shocks.

As to the **international repercussions** of European monetary union, economic history reveals that any changes linked to the implementation of projects such as EMU appear only gradually. The process of moving away from the dollar as the primary currency for commercial and financial relations, as well as for international asset management, has been going on for a long time and has not caused major disruptions. EMU represents an advanced stage in a process that has been consolidating itself successfully over time, and which is already an important reality: European integration. The first steps have already been taken toward a single currency, based on the EMS and the role of the *deutsche mark* as the anchor of the system. In the long run, EMU's weight in international monetary aspects should be similar to its importance in the global economy and in international trade. However, this will occur gradually, both owing to the inertia that marks international currency operations, and the need for the markets to become fully confident of the stability of the *Euro*.

Any conclusions drawn at the beginning of 1997 regarding the impact of EMU on **Latin America and the Caribbean** can only be highly speculative. On the one hand, there is uncertainty and lack of detail regarding the start of EMU, its initial membership, the functioning of ERM2, the specifics of the conversion of the ECU to the *Euro*, and concrete developments in the economies of the EU and other industrialized countries in the coming months. More importantly, contradictory views exist in influential European circles regarding the formulation and implementation of the ECB's monetary and exchange rate policies.

Tentative as they may be, the following conclusions might serve as the basis for future discussions on EMU's external impact, while also encouraging further analysis of the issues involved.

- Latin America and the Caribbean should take advantage of the opportunity provided by the past experiences of the EU, as well as those pertaining to the future EMU, to learn about the institutional and economic aspects of macroeconomic and financial integration.
- The political weight and economic significance of the future EMU will gradually alter the power structure, functioning,

policies, and alliances of the international monetary system. It is important for Latin American and Caribbean countries to both study and prepare themselves for this scenario, particularly given the fact that their outward-looking development strategies are likely to result in greater trade and financial diversification in the future.

- On a strictly economic level, EMU will help further to delineate the roles played by economic blocs in the international economy. Owing to their size and nature, the blocs will be less sensitive to the external economic repercussions of their macroeconomic policies. This could lead to more frequent lack of synchronization in their economic cycles and greater volatility in the exchange (and possibly interest) rates of the main currencies, particularly the dollar and the *Euro*. Latin America and the Caribbean should ready themselves to deal in the coming years with a potentially higher degree of instability in the prices of the main currencies and, possibly, in international interest rates.
- It is nevertheless hoped that the implementation of EMU, its economic scope and its significance in international trade and finance, as well as the foreseeable growing international importance of the *Euro*, will facilitate greater coordination and cooperation in macroeconomic, monetary, and exchange rate issues than has existed thus far, all the more so because the existence of a single European currency (instead of 12 or 15) would make coordination much easier in practical terms. This would ultimately help to improve the overall operation of the international monetary system and eliminate some of the potentially less attractive repercussions of monetary blocs.

- The above only confirms the need for Latin American and Caribbean countries to continue with national stabilization and structural reform aimed towards solid and sustainable economic development. Responsibility in domestic macroeconomic management, promotion of internal savings, and concern with boosting and financing investments are necessary conditions for economic development in the region.
- The economic consequences for Latin America and the Caribbean of the creation of the *Euro* are uncertain, although it can be argued that they will be minor, at least at the outset. This is based on the fact that, initially, the European economy is not expected to grow at a very different pace than in the past, despite the introduction of EMU. The impact of the *Euro* on the dollar is also very difficult to predict, although significant changes are not expected relative to the current evolution of the ECU. Although there will probably be more European financing available for emerging markets in general, major changes in foreign direct investment by the EU in Latin America and the Caribbean cannot be expected in the short term.
- However, as the importance and solidity of the *Euro* consolidates, major opportunities will manifest themselves for Latin American and Caribbean official and private economic actors to reallocate their portfolios of international assets and liabilities, and thereby protect themselves against future weakness in the dollar and exchange risks in general. Further, as the role of the *Euro* grows as a currency in which international trade is denominated, transaction costs and the costs of covering exchange risks will be lower for EMU's external trade partners. In more general terms, the size, depth, and liquidity of the capital market of the future

EMU will help to reduce Latin America and the Caribbean's external vulnerability.

- It is likely that EMU will grow faster in the medium term than its national economies have in recent years, owing to lower costs, greater transparency and internal competition, as well as the stimulus EMU provides to participating countries to undertake economic reforms to help spur their economies. A unified and growing market encompassing the EU countries should have a favorable impact on Latin American and Caribbean exports. Moreover, if a strong *Euro* consolidates over the medium term, Latin American and Caribbean countries, which will probably continue to be linked mainly to the dollar, could benefit from higher export earnings.