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The Euro's Place in the World Monetary System

The European Union is striding ahead on schedule towards European monetary union (EMU). Eleven member states will introduce the euro for book-keeping purposes on 1.1.1999, assigning responsibility for monetary policy to the European System of Central Banks. On 1.1.2002, the euro will also be in circulation as notes and coins, and the participating countries will abandon their national currencies by 30.6.2002 at the latest. But what part will the euro play in the world monetary system? And what conclusions do we need to draw?

The politicians have had their way, and the euro is being launched on schedule. The European Central Bank (ECB) got down to work on 1st July 1998, and from 1st January 1999 onwards the European System of Central Banks (ESCB, consisting of the ECB and the present national central banks) will assume sole responsibility for "currency policy" in the participating countries. This currency policy has two components. Monetary policy is concerned with the euro's real domestic value, and with maintaining the stability of that value. Exchange-rate policy addresses the currency's external value. In the long term at least, the theory of purchasing power parities teaches us that these two aspects of a currency's value are inseparably linked, so a currency's exchange rate with others will reflect the purchasing power in its home market relative to foreign markets. Thus if the euro is stable within its own area, it follows that it will be a strong currency in the world at large and, in the long term, the objectives of monetary and exchange-rate policy will not be in conflict with one another.

However, in the short term and possibly in the medium term too, a currency's internal and external values may fail to conform to the predictions made by the theory of purchasing power parities. Exchange rates sometimes find levels that do not conform to the economic fundamentals. An overvalued or undervalued currency will have negative consequences for the real economy, by distorting the terms of trade and the differentials between domestic prices and those of imports or exports. Corrective action to redress such relative price distortions may in turn have negative feedback effects on a currency's domestic value, jeopardizing monetary stability. Under these circumstances, conflicts do indeed arise between internal monetary and external exchange-rate policies.

If a conflict really does arise between monetary and exchange-rate policies, the question is which of the two objectives will have to give way to the other, and how much. The EC Treaty (Treaty of Maastricht) is quite unequivocal on the relations between internal and external goals relating to the euro: Article 105 (1) states that "The primary objective of the ESCB shall be to maintain price stability". This shows unmistakably that monetary stability will always take priority over any exchange-rate objectives. Exchange-rate policy is thus "demoted" to become no more than an instrument of monetary policy. Exchange rates may only be influenced in the pursuit of general economic goals (such as the promotion of full employment) if this is "Without prejudice to the objective of price stability" (Article 105 [1], clause 2).[1]

The Treaty of Maastricht also goes into more detail on the workings of a common exchange-rate policy for the euro participants. In this part of the document, in contrast to the clauses dealing with monetary policy as such, the wording is less clear. A distinction is made between policy that does and policy that does not involve a formal exchange-rate system (see the Summary on the next page).

The euro will be launched on 1st January 1999 without being part of any such formal system. It will be allowed to fluctuate "freely" *vis-à-vis* third currencies such as the US dollar, the yen and other national currencies, including the British pound. What "freely" means in practice is that there will be managed floating according to the following procedure (see Article 109 [2] of the Treaty): "... the

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[1] The Treaty does not closely define what is actually meant by "price stability". The term is normally interpreted to mean an annual increase in the retail price index of no more than 2% (cf., e.g. Deutsche Bundesbank: Geldpolitische Strategien in den Ländern der Europäischen Union, in: Monatsbericht, January 1998, pp. 33-47). If actual or prospective inflation rates are substantially below this mark, that would leave some room to manoeuvre for the use of exchange-rate policy to boost employment.

Council, acting by a qualified majority either on a recommendation from the Commission and after consulting the ECB or on a recommendation from the ECB, may formulate general orientations for exchange-rate policy in relation to these currencies [i.e. those not linked to the euro via a formal "system"]. These general orientations shall be without prejudice to the primary objective of the ESCB to maintain price stability." It will be up to the ECB to implement the strategic exchange-rate policy prescribed by the Council in its day-to-day foreign-exchange operations. In particular, the central bank will be obliged to call a halt by refraining from intervening to support exchange rates if the objective of monetary stability is in any jeopardy.

Summary of the Exchange-rate Policy Provisions in Article 109

Casa a):	**No formal exchange-rate system in place**
Step 1:	– Recommendation by the EU Commission after consulting the ECB or – Recommendation by the ECB
Step 2:	Recommendation by the "Euro-11" council[1] (the finance ministers of participating countries), which is non-binding
Step 3:	The Council of Ministers (representing all EU member states) passes a resolution by qualified majority to institute "general orientations for exchange-rate policy"
Step 4:	The ECB implements these or (The conflict scenario:) The ECB believes monetary stability is in jeopardy and refuses to implement the orientations.
Casa b):	**Establishment/operation of a formal exchange-rate system in conjunction with outside countries**
Steps 1 and 2:	As above
Step 3:	The Council of Ministers (all members states) takes a unanimous decision to establish the system
Step 4:	Changes of central rates within the system are proposed: – on the recommendation of the EU Commission and after consulting the ECB or – on the recommendation of the ECB
Step 5:	The Council of Ministers passes a resolution by qualified majority to change central rates.[2]

[1] This body, made up of the finance ministers of the member states participating in monetary union, is so far constituted as an informal grouping only, and the Treaty of Maastricht does not make any provision for it.

[2] The ECB is in a considerably stronger position when it comes to the proposed exchange-rate mechanism with the EU member states outside the euro area (EMS II). Changes in central rates or fluctuation bands relative to the euro will be undertaken "by mutual agreement" among the European Commission, the ECB, the ministers responsible in the euro-area countries, their counterparts in the other countries participating in the exchange-rate mechanism, and the governors of those countries' central banks. EMS II will operate in such a way that the ECB and the other participating central banks will be able to exercise their own discretion in suspending intervention operations (which "...will in principle be automatic and unlimited") if they believe the objective of maintaining stability is being undermined, and will then be able to put a realignment of exchange rates on to the agenda. (European Council on 16 and 17 June 1997 in Amsterdam, Presidency Conclusions – can be accessed on the Internet at: http://www.euro-emu.co.uk/offdocs/amsterdam2.shtml).

Dangers of a Strategic Exchange-rate Policy

Certainly, the EU Council which met in Luxembourg on 12th/13th December 1997 declared that recourse to exchange-rate "orientations" would only be taken "in exceptional circumstances" and that, as a general rule, a given exchange rate should simply be seen "as the outcome of all other economic policies".[2] On the other hand, this does not amount to a binding promise. One can quite easily envisage a situation in which, following prior agreement at an informal "Euro-11" meeting, the Council of Ministers might call upon the ECB to intervene in the markets. As long as the fundamental data remain unchanged, the external value of the euro is unlikely to stray too far from its long-term equilibrium exchange rate.[3] Nevertheless, well-placed signals in the form of intervention on the foreign exchanges may indeed prove effective for some period of time – say, six months or a year. So, given the short timespan in which political decision-makers tend to look ahead, they may have enough incentive to plead "exceptional circumstances", especially when elections are looming.

Governments that have a "devaluation tradition" might wish to apply the same instrument for the euro area as a whole. "General orientations for exchange-rate policy" only require a qualified majority, which means 62 out of a total of 87 votes in the EU Council of Ministers. Advocates of devaluation would not find it easy to attain that qualified majority. On the other hand, it will be clear that a veto lodged, say, by Germany alone would not be sufficient to hold up such a move, and objections could be outvoted.

The Treaty of Maastricht leaves open the possibility that the euro might be tied into an exchange-rate system at some future time. The procedure is clearly prescribed in Article 109 (1) of the Treaty, which states the conditions (particularly the assurance that stability will be safeguarded) under which "the Council may, acting unanimously on a recommendation from the ECB or from the Commission, and after consulting the ECB ...[and] ... the European Parliament, ... conclude

[2] Resolution of the European Council on Economic Policy Coordination in Stage 3 of EMU and on the Treaty's Articles 109 and 109b (passed in Luxembourg, 12th/13th December 1997).

[3] Cf. Ronald MacDonald: What Determines Real Exchange Rates? The long and the short of it, IMF Working Papers 97/21, Washington D.C. 1997.

Table 1

Major World Currency Areas Compared

	Population (millions)	Share in total GDP of OECD countries (%)	Share in world trade (%)	Share of exports in GDP (%)	Convertible currency reserves ($ billion)
USA	267	32.5	19.6	8.2	49.1
Japan	126	20.5	10.5	9	172.4
EU 15	370	38.3	20.9*	10.2	349.8

* Not including intra-EU trade.

Source: European Commission: Economic Papers, No. 125 (November 1997), p. 36.

formal agreements on an exchange rate system for the ECU in relation to non-Community currencies." If the euro does become part of a formal currency agreement, the "Council may, acting by a qualified majority on a recommendation from the ECB or from the Commission, and after consulting the ECB in an endeavour to reach a consensus consistent with the objective of price stability, adopt, adjust or abandon the central rates of the ECU within the exchange rate system." (Treaty of Maastricht, Article 109 [1]). Thus entry into an exchange-rate system requires a unanimous decision by the Council, whereas changes in central rates only require a qualified majority.

The real question is, what shape will the euro area's *de facto* exchange-rate policy take, on the basis of these formal provisions? This in turn can be divided up into two particular questions which will be addressed below, namely:

1. How much pressure will national representatives in the ECB and the ESCB exert to try to use the exchange rate as an instrument of employment policy? And how great is the danger that – despite the pledges made in the Treaty – the implementation of exchange-rate policy could jeopardize monetary stability?

2. To what extent should the ECB strive to tie the euro into an exchange-rate regime relating it to the US dollar, Japanese yen and other currencies, as a second-best solution offering one way of reducing the political pressure to use the exchange rate as a means of (temporarily) reducing unemployment, with concomitant risks to the stability of the currency's internal value?

A New World Setting for Economic Policy

Without doubt, say top officials, the launch of the euro "will bring a real caesura for the world monetary system", and it may even be the most important policy-making event "in the entire post-war period".[4] The euro area will become the world's largest economic bloc (see Table 1). In many respects, it will move up to be on a par with the USA, whose dollar has held an unchallenged position for decades. That, according to the EU Commission's Agenda 2000, will place Europe in a central role in the economic and monetary fields.[5] So, in a highly integrated, indeed globalized, world economy the signs are that there will be substantial impacts on the economic affairs of other countries, both real and monetary. The relative weighting of the EU within the world economy will be so great that fluctuations in economic activity within the euro area will also have an immediate influence on markets elsewhere in the world where the member countries do their purchasing and selling.

The Euro as a Transaction Currency

Up to now, the US dollar has played the dominant role in the settlement of trading and financial transactions (see Table 2.1.a). Still today, 47.6% of trading transactions are invoiced or otherwise settled in dollars, as against just 15.5% in deutschmarks. Whether or not the euro turns out to be a world currency will depend on whether it is used in an intermediary role as the transaction currency when neither of the parties involved comes from an EU member state. At present, the dollar is the only currency playing a worldwide role: the value of trade conducted in US dollars is almost four times as high as that of the USA's exports. The German currency has some way to go to achieve this level of "internationalization"; the value of goods and services traded on a D-mark basis is just 60% above the level of Germany's exports.

An issue of direct importance for EU countries' trade with the rest of the world is whether firms in the member states are able to settle their transactions in their own domestic currency. That would put them in the comfortable position of being able to pass on exchange risks (or the cost of hedging them) to their trading partners for the duration of their contracts. Three quarters of German exports are now settled in deutschmarks. The proportion of national currency use is much lower in other EU member states; even a large nation like France only receives payment for 55% of its exports in francs.[6] That proportion could rise considerably once the euro is in use.[7]

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[4] Otmar Issing: Mögliche Auswirkungen der Europäischen Währungsunion auf die internationalen Finanzmärkte, in: Deutsche Bundesbank: Auszüge aus Presseartikeln, 6th December 1996.

[5] EU Commission: Agenda 2000 – Vol.1: A Stronger and Wider Union, Brussels, 15th July 1997, (p. 44 in the German version).

Table 2
The Euro Compared with Other World Currencies

1. The euro as a transaction currency

a) Settlement volumes in international trade transactions

	1980		1992	
	% of world exports	International-ization rate*	% of world exports	International-ization rate*
US $	56.4	4.5	47.6	3.6
D-mark	13.6	1.4	15.5	1.4
Yen	2.1	0.3	4.8	0.6

*Internationalization rate = Proportion of world trade settled in the currency divided by its country's share of world exports.

b) Settlement volumes on foreign exchanges
(gross daily volumes, in %)

	April 1989	April 1992	April 1995
US $	90	82	83
D-mark	27	40	37
Yen	27	23	24
Others	56	55	56
Total*	200	200	200

*The figures show gross turnover, involving two currencies per transaction, which is why the total proportion comes to 200%.

2. The euro as a portofolio investment currency

a) Share of international bonds in circulation
(as % of world total)

	Year-end 1981	End 1992	End 1995	(End 1996)
US $	52.6	40.3	34.2	(38)
EU currencies	20.2	33.0	37.1	(35)
of which: D-mark	n. v.	10.0	12.3	
Yen	6.9	12.4	15.7	(16)
Other	20.3	14.3	13.0	

b) Share of private-sector investment portfolios

	Year-end 1981	End 1992	End 1995
US $	67.3	46.0	39.8
EU currencies	13.2	35.2	36.9
of which: D-mark	n. v.	14.7	15.6
Yen	2.2	6.9	11.5
Other	17.3	11.0	11.8

3. The euro as a reserve currency

a) Composition of world official reserves, by currency
(%)

	1975	1985	1995
US $	79.4	64.9	61.5
Yen	0.5	8.0	7.4
Swiss franc	1.6	2.3	0.5
EU 4	12.0	20.1	20.1
of which: DEM	6.3	15.2	14.2
GBP	3.9	3.0	3.5
FRF	1.2	0.9	1.9
NLG	0.6	1.0	0.5

b) Exchange-rate arrangements
(showing number of participating countries)

Currency pegged to:	1990	1996	% of world GDP in 1994
US $	25	21	1.53
French franc	14	14	
Other single currency	5	9	
SDR	6	2	
Basket of currencies	35	20	
EMS	9	12	0.25
Managed floating	23	45	
Flexible floating	25	52	
Other system	7	6	
Total	149	181	

Sources: European Commission: Economic Papers, No. 125 (November 1997), p. 46, supplemented by data from: Deutsche Bank Research: EWU-Monitor, No. 33, 17 June 1997.

The dollar tops the league of foreign-exchange transactions (see Table 2.1.b): 83% of all transactions on the exchanges in April 1995 involved the dollar as one of the currencies, while 70% involved at least one of the EU currencies, and 37% the deutschmark. If those figures are adjusted to eliminate trading among the euro's precursor currencies, the dollar's role becomes still more prominent: it would then have been on one side of 92% of transactions, while the euro would have featured in just 56%.[8]

The Euro as a Portfolio Investment Currency

The dollar also stands well above any other currency for investment and securities-issuing purposes (see Table 2.2). More than one third of all international bonds in force in 1996 were denominated in US dollars, against just one sixth in yen and only 12% in deutschmarks. Similar proportions can also be found in private investment portfolios. The euro, however, can be expected to play a more significant role than the "sum of its parts". In the short run, it is true, uncertainty regarding the quality of the euro and the independence of the European Central Bank around the time of the launch of the new currency may well provoke a considerable shift in the weightings of both privately held and official investment portfolios away from, say, deutschmarks and in favour of dollars, which will not be converted back into euros for some time. However, in the medium term the euro is likely to be roughly on a par with the dollar.[9] One factor making this likely is that the combined relative share of international bonds denominated in present-day EU currencies roughly matches that of dollar-denominated paper.

In the medium to long term, the single markets in euro-denominated bonds, equities and derivatives are likely to be just as large and just as liquid as the dollar markets of today.[10] The very size of these markets is likely to attract international institutional investors and borrowers, who have had to rely on the dollar markets

[6] Philipp Hartmann: The Future of the Euro as an International Currency: A Transactions Perspective, Centre for European Policy Studies (CEPS), Research Report No. 20, Brussels 1996, p. 12.

[7] Ibid.

[8] The source of the figures was: Bank for International Settlements (BIS): 67th Annual Report, Basle 1997.

[9] Ibid. However, McCauley believes the euro will not play quite such a large part. He forecasts that the euro will have a higher weighting than the deutschmark does today, but a smaller one than is currently enjoyed by all of its component currencies combined (Robert N. McCauley: The Euro and the Dollar, BIS Working Papers No. 50, November 1997).

[10] Alessandro Prati and Garry J. Schinasi: European Monetary Union and Capital Markets: Structural Implications and Risks, IMF Working Paper WP/97/62, Washington D.C., May 1997.

Table 3

The Euro as a World Currency in the Year 2010

(in %)

Settlement of trade transactions	35
World currency reserves	25 - 30
International Investments	30 - 40
International financing	30 - 35

Source: Deutsche Bank Research: EWU-Monitor, No. 48, 17 March 1998, p. 9.

in the past as the only truly major capital market in the world. In their desire to reduce risks by diversifying their portfolios (whether exchange, inflation, or general political risks), they can be expected to place part of them in euro-denominated paper. An overall reduction in risk is likely to lower the cost of raising capital in euros, and that too will make it a more attractive investment currency.

The Euro as a Reserve Currency

The proportion of European currencies held in worldwide convertible currency reserves is much lower than the amount of dollars (see Table 2.3.a): 61.5% of reserves are held in dollars, 14.2% in deutschmarks, approx. 6% in other European currencies, and 7.4% in yen. In other words, the dollar plays a far more significant worldwide role than one would expect in terms of the size of the USA's economy. Today's EU is just as much of an economic force as the USA, on either of two measures: the 15 EU member states together have a gross domestic product of $8,400 billion and a 20.9% share of world trade (not counting trade among one another), while the USA has a GDP of $7,300 billion and a 19.6% share of world trade (see Table 1).

However, it is misleading to draw conclusions from a country's share of world trade for the relative role its currency ought to be playing as a reserve currency. In modern, developed economies, the main call upon reserves is to engage in market intervention to even out exchange-rate fluctuations. The main feature a central bank will be looking for is thus the existence of liquid markets in the currency concerned, allowing them to adjust their portfolios with ease. The dollar is at present the only currency fulfilling this need, with the deutschmark and yen trailing some way behind.[11] On the other hand, by banishing the segmentation of European markets to the past, the euro is likely to gain some ground in this role relative to the dollar.[12]

All in all, the euro is likely to take on a relatively equal role to that of the dollar in many areas (see Table 3). Once the ECB has established its reputation and once large, homogeneous European financial markets have developed, subtle changes in the geopolitical balance of power are also likely to occur. The euro area will be a much less open economy than those of its member countries today. The average share of exports in the GDP of EU member states has been around 30% in recent years, but anything up to 60% in smaller countries such as Belgium or Ireland. This is why so much attention is currently paid to exchange rates, for if these fluctuate too strongly the feedback effects in the real economy can be extremely unpleasant. Once the euro is in operation, the EU-wide ratio of exports to GDP will be down to just 10%, only slightly higher than in the USA or Japan (see Table 1). Once the external economy accounts for a smaller share of GDP, the detrimental effects of devaluation become less pronounced, particularly the inflationary effect of higher import prices. However, these effects do not disappear altogether.

Once trading and capital transactions among EU member states have effectively turned into domestic transactions, the disciplinary influence of international capital markets will be reduced accordingly. In other words, the member states that have signed up for the common currency will become less interdependent with the rest of the world. This new-found autonomy relative to countries using other currencies could theoretically be abused by specific interest groups to put forward a strategy of exchange-rate protectionism.

The risk of a conflict arising between the stability objective (the supreme goal of the ECB and its monetary policy) and the employment objective (likely to be the dominant politico-economic issue) – and of the conflict being "resolved" by applying an exchange-rate policy that would, at best, boost employment in the short term – is likely to be all the greater, the longer policy-makers postpone tackling the euro area's structural problems. This is well illustrated by two alternative crisis scenarios:

Scenario 1: Asymmetric Shock

One of the fundamental objections raised to the euro arises from empirically supported criticisms that the euro area will not constitute an "optimum currency area". This being so, it is said that external shocks are likely to be "asymmetric" in their impact on the real economies of different member states. For example,

[11] Peter M. Garber: The Use of the Yen as a Reserve Currency, in: Monetary and Economics Studies, Vol. 14, No. 2 (December 1996), pp. 1-22.

[12] Michael P. Leahy: The Dollar as an Official Reserve Currency under EMU, in: Open economies review, Vol. 7 (1996), pp. 371-390.

an increase in the price of crude oil might have more pronounced employment effects in other EMU participating countries than it did in Germany.[13]

One predictable, politically induced asymmetric shock facing the EU member states is the accession of the first group of Central and Eastern European countries scheduled for the next decade. These countries will chiefly compete with existing EU member states that possess a comparative advantage in relatively labour-intensive products, such as Spain, Portugal and Greece (the government in Athens is now aiming to achieve EMU participation by the year 2001). In addition, the newly acceding nations are likely to have a substantial advantage in export markets thanks to their currencies' weakness relative to the euro. Meanwhile, the weaker EU economies that have to compete with them will be sitting in the same boat from the monetary-policy viewpoint as the EU's stronger economies.

What can be done to cushion this kind of asymmetric shock? The conditions of EMU participation are such that neither an exchange-rate adjustment *vis-à-vis* these countries' most important trading partners (the other countries of the euro area) nor a monetary policy geared to their own specific needs will now be an available option. The usual line of argument is that three other fields will need to act as the conduits of economic adjustment, i.e.:

- ☐ the factor and goods/services markets,
- ☐ the fiscal budget,
- ☐ transfer payments received from other EU member states.

However, it is easy to conceive of a situation in which all three of these conduits would be blocked. In particular, the deregulation of the labour market which would promote employment in general appears virtually unenforceable for domestic political reasons in Continental EU countries. At the same time, public-sector budgets will now be subject to the constraints of the Stability and Growth Pact,[14] which imposes a ceiling on the net government borrowing requirement of 3% of GDP. Assuming that the penalizing mechanisms do actually work when the time comes, the Pact will substantially restrict the scope for national budgetary policy within the EU. This problem is all the greater in as far as the subsidies that conserve obsolete structures and also the inefficient welfare systems still in place can only be dismantled or reformed over a relatively long period. That means that a large part of a government's budget is already spoken for. If the EMU participant countries (or rather, their governments) cannot even manage to balance their budgets when they have "normal" levels of economic activity, the automatic stabilizers will be still less effective once a crisis comes along.

There is yet another factor adding up to a "triple whammy" for these countries: because the other EU members are also compelled by the Stability and Growth Pact to cut back on government spending, they are liable to be less willing to make generous transfer payments to help them out. Indeed, this willingness is not particularly great in the first place, since national governments normally want to spend money on things that will make an impact on their own domestic political scene, keeping their own potential voters happy.

So if an asymmetric shock does occur, there is one way out which may appear quite simple to the EU countries: if the euro were to depreciate against the dollar and the yen, that would boost those industries that are heavily involved in world markets, thus indirectly stimulating the whole economy.

Scenario 2: Symmetric Shock

It is also quite possible to imagine European governments resorting to a devaluation strategy in the event of symmetric shocks to their economies.[15] For example, a sudden EU-wide fall-off in the demand for capital goods bringing a recession in its wake and pushing up unemployment levels still further might

[13] The literature on optimal currency areas and the asymmetric absorption of external shocks is so extensive that we shall refer here merely to the brief summary in: Christian Schmidt, Thomas Straubhaar: Maastricht II: Are Real Convergence Criteria Needed?, in: INTERECONOMICS, Vol. 30, No. 5, 1995, pp. 434-442, and to the recent publication by: Otto G. Mayer, Hans-Eckart Scharrer (eds.): Schocks und Schockverarbeitung in der Europäischen Währungsunion (HWWA Institute publications, Vol. 38), Baden-Baden 1997.

[14] European Council on 16 and 17 June 1997 in Amsterdam, Presidency Conclusions. Can be accessed on the Internet at: http://www.euro-emu.co.uk/offdocs/amsterdam2.shtml.

[15] There is still some controversy as to the relevance of asymmetric shocks. Certain authors doubt whether exogenous shocks really affect economies on a country-by-country basis and prefer the view that they affect whole industries in different countries simultaneously (cf. Michael Funke, Ralf Ruhwedel: Asymmetrische Schocks und die Zukunft der Europäischen Währungsunion, in: Otto G. Mayer, Hans-Eckart Scharrer, op. cit., but see also the critical commentary on this by Manfred J. M. Neumann in: ibid.) Another controversial point is whether monetary union as such makes industries more highly concentrated, thus accentuating differences in regional development (for an exemplary discussion, see Paul Krugman: Geography and Trade, Cambridge, Mass. 1991) or whether, on the contrary, the fact that participating currencies are permanently pegged to each other will not in itself promote the diversification of economic structures (cf. EU Commission: One Market, One Money, in: European Economy, No. 44, 1990; Lucca Antonio Ricci: Exchange Rate Regimes and Location, IMF Working Paper WP/97/69, Washington D.C. 1997).

lead them to see a devaluation of the euro as the golden road out of the crisis. For if they faced up to the truth of the situation – and the same would apply in the event of a more deep-seated, supply-side shock caused by technological factors – the EU governments would have to be prepared to push through measures to liberalize their goods and factor markets, especially by reforming the institutional framework in the labour market and their social welfare systems. However, measures of this kind do not start to bear fruit until the medium term, and in the short term they generate socio-economic adjustment costs with hardly any benefits to counter-balance them. Hence they are liable to be difficult to implement in the politico-economic arena.

Experience has shown that popular resistance is much lower when it comes to interventionist spending programmes, such as subsidies for obsolescent industries, whether out of national coffers or those of the EU. Yet here too, it is important to note that the Stability and Growth Pact, if it works, will cap the revenue side of government budgets, which in turn should lead to greater discipline on the spending side. So, once again, in the event of a recession affecting all EMU participants the external value of the euro will offer a policy instrument promising relatively rapid effects that are easy to sell to the public in politico-economic terms, never mind how short-lived the benefits might be.

Winners and Losers

Whether it will be politically possible within the EU to assert an employment-oriented exchange-rate policy for the euro depends on the overall interplay of politico-economic forces, and hence on the relative amounts of influence the potential winners and losers of a devaluation of the euro are able to exert. There are two interest groups with a particularly keen interest in a weak common currency in terms of its external exchange rate. The first consists of import-substituting industries, mainly old-established branches of the economy such as mining and agriculture, for which a currency devaluation operates in much the same way as import tariff barriers. Other industries which might find a weak currency advantageous are those selling a major proportion of their output on world markets outside the EU, without being very dependent on inputs from non-EU countries (e.g. the mechanical engineering and aerospace industries).

Among the potential losers of a weak euro would be industries relying on intensive inputs from outside the euro area, such as energy producers and the computer industry. However, the majority of consumers will also be on the losing side, as they will have to pay higher prices for imported goods and services. Indirectly and in the longer term, the entire euro area will count as a loser, by virtue of the inflationary pressure created by higher import prices, which can hardly be reined in by monetary policy without generating other welfare costs.

It is readily apparent from a glance at politico-economic literature on the demand for and supply of protectionist measures that the interest groups more likely to gain the upper hand in political processes are in fact those which favour devaluation.[16] These groups generally represent "old" industries, are organized to pack a powerful punch, have long-established contacts with political decision-makers, have more funds in their "war chests", and are able to point out their importance as major employers (in the past, at least!)

Here is an example of what could happen. During the *franc fort* period which commenced in 1987, France has had the value of the franc closely tied to the deutschmark without its citizens having any direct say at all in the policy pursued by the Deutsche Bundesbank. The country did not cut its exchange-rate policy to promote short-term employment. By way of contrast, France *will* have direct influence over the common monetary and exchange-rate policies pursued in the euro area. The country may wish to use this new-found element of monetary sovereignty to push for an employment-oriented exchange-rate policy *vis-à-vis* other currencies such as the US dollar, and that in turn could jeopardize the internal stability of the euro. Even last year, France's former president Valéry Giscard d'Estaing advocated a weak euro in the interests of trade policy.

The points discussed so far have shown how "domestic" structural and adjustment problems within the euro area could lead on to a devaluation strategy. That would inevitably provoke counter-responses on trade and exchange-rate policy by other world trading powers, particularly the United States. So, in turn, the euro could ultimately be an acid test for the entire multilateral system of world trading relations. Once a second major international currency has established itself alongside the US dollar, that may change the way the game is played not only in world monetary and exchange-rate policies but also in world

[16] As just one example, see B. S. Frey: Internationale Politische Ökonomie, Munich 1985.

economic policies in general. This will heighten the risk of political conflict between the major economic blocs. Meanwhile, the danger is that multilateral components of the world economic system will be further weakened. Moreover, the frequently voiced expectation that the advent of the euro will bring a reduction in exchange-rate volatility may prove to be illusory due to the use of competitive devaluation strategies.

The Contrary View: An Optimistic Scenario

Nevertheless, the build-up of domestic economic and political tension posited above is by no means inevitable. An optimistic scenario allows for things to turn out quite differently.

In this scenario, marked progress occurs in the geographical convergence of economic development. Structurally relatively weak regions benefit from direct investment. That also injects human capital into these regions, generating positive externalities known as "spillover" effects which, according to New Growth Theory, bring a sustained enhancement of economic growth in the relatively underdeveloped areas. Simultaneously, falling transaction costs and the overall improvement in the stability of prices in the euro area stimulate specialization and the division of labour. That is to say, the euro-area economies benefit from the overall improvement in economic welfare that open markets bring.

The macroeconomic efficiency gains make it easier to finance the necessary structural adjustments. The situation is also helped along by the disciplinary impact of the Stability and Growth Pact and the elimination of exchange risks within the euro area. These factors result in sustained low interest rates. Governments now no longer make such a heavy call on the capital markets, so there is less crowding out of the private sector than there used to be, and the risk premium on interest rates in traditionally high-inflation countries is reduced accordingly. These two effects act as stimuli for investment, and hence for economic growth in general.

Even the asymmetric shocks that are so often discussed might in fact prove to be jumpable hurdles. In reality, these shocks tend to be asymmetric with regard to different industries or sectors rather than to different countries.[17] New competitors from South-East Asia are less likely to have specific effects on the economies of, say Germany or Italy, than on the steel or other heavy industries when contrasted with the insurance industry. Absorbing such shocks is not a European task, or even a national one. Rather, action needs to be taken in those regions where a greater proportion of jobs are in problem industries. Measures need to be taken to promote occupational mobility by improving training and retraining facilities, and also geographical mobility towards regions with higher economic growth. Monetary union may prove to be just the catalyst that is needed to spur on these processes. Certainly, it will prevent national governments from delaying flexibilization measures unduly by devaluing their currencies instead. In other words, the common currency ought to accelerate structural change, which in turn will reduce the potential damage that asymmetric shocks could do.

Thanks to sustained macroeconomic stabilization, convergence in the real economy and a limited occurrence, if any, of asymmetric shocks, the extra demands on economic policy-makers caused by monetary union would be only slight in this scenario. It also envisages that the union will facilitate political cooperation: politico-economic actors will gain confidence in one another, and the insecurity felt in certain quarters will be reduced. Meanwhile, uncooperative partners will be penalized by the majority. All this will entail substantial progress in developing the European Union's political structures.

Internal economic reforms, so the scenario goes, will progress. In a Hayekian discovery procedure, intensified institutional competition within the European Union will lead to more liberalized labour markets, and to more efficient social welfare and taxation systems. The more favourable operating environment thus created will improve competitiveness in the tradable goods sector. Conditions throughout the economy will grow more favourable, but especially for services which can generate considerable employment. Monetary union, in this scenario, will set off an economic boom phase within the euro area, automatically "taking the wind out of the sails" of the interest groups advocating protectionism and the devaluation of the currency.

An International Corset for the Euro?

Taken together, the pessimistic and optimistic scenarios painted above show that if the euro area enters into choppy economic waters there are likely to be strong politico-economic forces pushing for a devaluation of the euro, whereas if it flourishes economically there will be a positive climate for a stable world monetary system. Developing the notional causality in these relationships, one could

[17] Cf. Michael Funke, Ralf Ruhwedel, op. cit.

also view things from the other end: if a stable exchange rate between the euro and outside currencies presents no problem when the economy is doing well but the euro exchange rate might be misused for protectionist competitive devaluation when times get tough, why not voluntarily integrate the euro into an international system of currencies right at the outset? If many of the socialist or social democratic governments currently in power in EU member states might be tempted at some stage to pursue employment-oriented exchange-rate policies, would it not be better to make a "pre-emptive strike" to attain the second-best solution of an international currency system which would prevent the exchange rate's being used as a more general instrument of economic policy, even to the detriment of the prime objective of stable money?

If there are internal obstacles to reform which cannot be overcome for politico-economic reasons, leading to the exchange rate's being used as an instrument to boost employment, this particular release valve could be closed by committing the euro to an international currency regime. An international agreement would provide an appropriate external framework which might guard the EU and the rest of the world against interest groups with a protectionist orientation and against short-termist, employment-oriented exchange-rate policies. However, there would have to be enough flexibility built into such an international currency system to obviate external pressures undermining the internal value of the euro.

Of course, there are some crucial questions that need to be addressed. How, for example, could we arrive at an international currency system that ensured the euro were committed to a certain external rate of exchange without this acting in the manner of a cartel? Under what circumstances would politicians not just see this "pre-emptive strike" as a means of reaching a cosy agreement to neutralize market forces, but also actually be prepared to refrain from resorting to exchange-rate adjustments as a policy instrument and to get actively involved in making a new international currency system work?

Here yet again, an essential requirement is for the ECB to have a strong, independent position. Two points are vitally important if the hopes that the voluntary integration of the euro will inhibit interventionism are to bear fruit, namely:

1. Apportioning responsibility: whichever party leads a set of negotiations is invariably in a strong position. The party can lay emphasis on particular aspects, and can have its own say in setting the agenda. Once a package of measures has been put on the table, it is more difficult for individual negotiating governments to reject it out of hand and risk a collapse of the entire negotiations. With this in mind, the EU member states ought to entrust the negotiations on their behalf to a body that has no trade-policy interests to pursue, and indeed one that has a strong interest of its own in ensuring that the international environment is stable. The European Central Bank meets these criteria. It is pledged to the objective of maintaining price stability, and an effective worldwide currency system could make its work easier. Moreover, the central bank will have available the largest pool of expertise in international cooperation beyond the EU's borders, which would ensure it had a strong negotiating position. Hence there is a lot to be said for commissioning the ECB to conduct these negotiations. Article 109 (3) of the Treaty of Maastricht provides for the Council of Ministers to make such a decision by qualified majority vote.

2. Timing: a voluntary commitment on the euro's external exchange rate will be all the easier to achieve the more homogeneous the constellation of interests within the EU happens to be. That in turn is most likely to be the case in the early years just after monetary union is up and running. It is likely to become much more difficult once the first of the Central and Eastern European countries have joined, the economic upheavals discussed earlier have started to occur and the new member states have their own say in the Union's decisions. If possible, negotiations ought therefore to begin without delay, now that the European Central Bank has been constituted. Another reason why talks should get under way quickly is that a new round of world trade negotiations in the WTO is scheduled to commence in 1999. The sensible way forward would be for the EU, the USA and Japan to simultaneously propose a currency approach which would safeguard free trade, via the International Monetary Fund.

A strong euro relative to outside currencies could prove to be a stabilizing element in the international financial system as a whole. However, it would be virtually impossible to achieve this without some form of international cooperation on currencies. At the same time, a voluntary exchange-rate commitment *vis-à-vis* the outside world might weaken protectionist forces within the EU. That will be all the more necessary if the critics of EMU ahead of its realization are proved right about the upheavals they said would occur in the real economy.