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Paul J. J. Welfens\*

## Facing the Euro: Prospects for Growth or Stagnation?

*The introduction of the euro has been overshadowed by the controversy over the appointment of the president of the European central bank and the possible implications for the bank's policies. The effects of the launching of the single currency on growth and employment depend on a multitude of factors, however. Professor Welfens analyses the potential benefits of EMU and discusses the problems to be solved.*

European Monetary Union will be a complex and a fragile transition process which raises many issues.<sup>1</sup> The Euro brings with it the risk of increasing wage pressure in Euro countries with relatively low per capita incomes where workers translate the full price and wage transparency established by the Euro into higher wage demands. Such developments clearly could further raise the unemployment rate and force the EU to step up the structural funds and the cohesion fund, which represent some 40% of EU expenditures and distort the market allocation process. In countries with high unemployment rates and large state banks or industrial holdings (Spain, Italy, France and Greece) there could be pressure on banks to extend soft loans to ailing firms. This would not only undermine economic growth but could lead to a banking crisis in the case of adverse economic shocks or a shift towards restrictive monetary policy by the ECB. A slowdown in economic activity immediately after 1999 as well as major banking problems could cause a Euro devaluation, which would undermine the prospects of the Euro's becoming a major international reserve currency. Developments of this kind, implying economic stagnation in the EU, are clearly undesirable. Given the worldwide increase in international capital mobility and the increasing likelihood that regional instability creates negative global spillover effects,<sup>2</sup> a weak Euro or even a Euro currency crisis (a massive devaluation vis-à-vis the US dollar) should be avoided by means of prudent policies.

If such problems can be avoided, EMU could bring major benefits to the EU and the rest of the world. The EU may expect five benefits from monetary union:

- Savings on transaction costs which recently were estimated to reach about 1% of GDP in Germany.<sup>3</sup> Major exporters should particularly benefit from this so that blue chips from the tradables sector will record higher stock market prices and windfall profits.
- Lower inflation rates as compared to the average inflation rates of the period 1957-95, thus creating positive wealth effects; starting from an inflation rate of about 2%, the starting conditions are favourable for establishing a solid record under the European Central Bank. Given the fact that disinflation causes output and employment losses, the fact that the inflation floor of 2% was reached in 1997 implies improved conditions for long-term growth in the EU.
- Lower long-term real interest rates that might, however, require specific steps beyond simple monetary integration; a lack of policy credibility on the part of the European Central Bank and an inconsistent policy mix in the early EMU stage could lead to a rise in real interest rates in the Euro area beyond simple business cycle effects. Assuming that there will be no major credibility problem and taking into account the savings in transaction costs which are relevant for banks and bond markets, low long-term interest rates can be anticipated in the Euro area. Since short-term interest rates in most EU countries except Germany are likely to fall in late 1998, the yield curve could be rather steep in the beginning assuming that rising investment will raise long-term credit demand in the Euro area. Investment is likely to pick up since the

<sup>1</sup> See e.g. P. B. Kenen: *Economic and Monetary Union in Europe. Moving Beyond Maastricht*, Cambridge 1995; P. J. J. Welfens: *European Monetary Integration*, 3rd ed., Heidelberg and New York 1996.

<sup>2</sup> See P. J. J. Welfens and H. Wolf (eds.): *Banking, International Capital Flows and Economic Growth*, Heidelberg and New York 1997.

<sup>3</sup> See IFO: *Ifo schnelldienst*, No. 9, 1997.

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switch to the Euro implies less exchange rate risk in Europe and hence reduced overall investment uncertainty. Welfens and Jungmittag<sup>4</sup> found for Germany (and the Netherlands) that the investment output ratio is negatively affected by exchange-rate volatility, implying that the Euro would raise the investment output ratio by half a percentage point in Germany or roughly 3%.

□ Higher investment and growth, partly reflecting a higher marginal product of capital in the monetary union due to the fact that the integrated and fully transparent goods and stock markets will reinforce the selection function of capital markets.

□ A real exchange effect vis-à-vis the USA and Japan, which cannot be predicted with certainty.

The EU's two main problems are, firstly, the high level of EU structural fund expenditures, which undermine the potentially rising role of market forces in factor allocation after 1999, and secondly, the high unemployment rates, which hovered around 10% in most EU countries, with Denmark, Austria, the UK, the Netherlands and Portugal being positive exceptions. High unemployment rates not only mean political conflicts and hence the risk of instability which could translate into the Euro currency market, they also imply high deficit-GDP ratios and in the case of a recession in any case the risk of violating the 3% margin established in the Stability and Growth Pact. This case would, of course, create political conflict in the EU. There are no viable policy options in most EU member states to reduce the unemployment rates in a short space of time, since they largely reflect structural problems in Western Europe.<sup>5</sup> Indeed the ongoing globalization of the economy implies a considerable risk that jobs for unskilled labour will be relocated from EU countries to Eastern European or Asian countries whose price competitiveness has increased as a consequence of the heavy depreciations suffered by most Asian countries in 1997. At the same time low import price increases are likely to reinforce low EU inflation rates in the run-up to EMU.

### Theoretical Aspects of EMU

The main theoretical aspects with respect to EMU are:

□ the link between the nominal volatility of exchange

<sup>4</sup> See P. J. J. Welfens and A. Jungmittag: Political Economy of EMU and Stabilization Policy, in: P. J. J. Welfens (ed.): European Monetary Union, Heidelberg and New York 1997, p. 331-392.

<sup>5</sup> See J. T. Addison and P. J. J. Welfens (eds.): Labor Markets and Social Security, Heidelberg and New York 1998.

rates (and money supply growth) and investment growth and employment;

□ the real exchange-rate effects of EMU and the induced changes of foreign direct investment inflows into the EU;

□ the welfare effects of EMU and the associated income and wealth effects;

□ the problem of fiscal policy coordination in the absence of political union and the consequences for the efficiency of stabilization policy;

□ the appropriate fiscal and monetary policy mix in the EMU area and the overall effectiveness of a stabilization policy;

□ the need for national and supranational policy reforms as a means of improving market-clearing mechanisms.

While the first three topics are more theoretical in nature, the last four refer to the political economy of EU integration.

The switch to EMU raises several important issues. Only the strategic ones can be addressed here, however. One important issue is exchange-rate volatility, given that investment and growth are known to be influenced by uncertainty and volatility. EMU will reduce this exchange-rate volatility and hence encourage investment. Since foreign direct investment became increasingly important in OECD countries after 1985, emphasis should be placed on the link between FDI and the real exchange rate (of the DM or the Euro) in the context of EMU. This already points to the welfare effects, as higher (lower) net EU FDI inflows will contribute to higher (lower) employment and income after 1999. Clearly, there are also critical policy issues which mainly concern the assignment of fiscal policy to the national and supranational levels and the coordination of fiscal policy under a new regime – including aspects of the stability pact. These issues naturally are subject to conflicts between governments, trades unions and employers' federations.

### Redistribution and Transfer Aspects of EMU

In the EU transfers are mainly allocated via agricultural subsidies, the cohesion fund set up for Spain, Portugal, Greece and Ireland – countries with less than 90% of EU average per capita income (not on the basis of purchasing power parities but of nominal figures – in the context of the Maastricht

**Table 1**  
**Regional Per-Capita Revenue Positions Before**  
**and After Intragovernmental Transfers**  
(Average = 100)

	1995			% of EU average <sup>1</sup>	1986		
	Net contribution Total	Net contribution per capita	Rank		Net contribution Total	Net contribution per capita	Rank
	ECU m	ECU			ECU m	ECU	
Germany	13,431	164.6	(1)	106.7	3,742	61.3	(2)
UK	4,720	80.7	(6)	98.2	1,438	25.3	(4)
Netherlands	2,005	129.7	(2)	100.4	-217	-14.9	(8)
France	1,727	29.6	(9)	107.2	561	10.1	(5)
Sweden	937	105.5	(5)	95.3	-	-	-
Austria	905	112.9	(3)	109.3	-	-	-
Italy	614	10.7	(10)	101.7	195	3.4	(6)
Belgium	311	30.6	(8)	110.4	284	28.7	(3)
Finland	165	32.3	(7)	92.5	-	-	-
Luxembourg	45	110.6	(4)	128.2	59	160.3	(1)
Denmark	-306	-58.6	(11)	112.0	-421	-82.2	(10)
Ireland	-1,887	-526.8	(15)	85.3	-1,230	-374.4	(12)
Portugal	-2,381	-241.8	(13)	67.9	-219	-22.1	(9)
Greece	-3,489	-333.0	(14)	60.0	-1,273	-127.8	(11)
Spain	-7,218	-184.0	(12)	76.1	-95	-2.5	(7)

<sup>1</sup> Based on PPP.

Source: European Commission: Court of Auditors Report; in: *The Economist*, 23. 11. 1996, p. 32.

Treaty and the EU structural funds which go to regions with a per capita income of less than 75% of the EU average and to regions with declining industrial output or rising unemployment rates.

In 1995, the highest per capita net contributions were paid by Germany (165 ECU), the Netherlands (130), Austria (113), Luxembourg (111), Sweden (106), the UK (81), Finland (32), Belgium (31), France (30) and Italy (11), while Denmark (59), Spain (184), Portugal (242), Greece (333) and Ireland (527) received per capita net payments. The people of Germany, who face the special burden of German unification and the restructuring of eastern Germany, would find it largely unacceptable if net contribution rates were to increase as a result of EU monetary union. Paradoxically, this indeed will be the case if the choice of members for the starter group widens the intra-EU regional income gaps and the gaps between rich and poor EU member countries. This points to the need to achieve intra-EU economic convergence by means of market forces. However, on the basis of new growth theory, it may indeed be anticipated that the growth poles in the EU could expand further, especially those which have a dynamic financial centre and other related services which will benefit from EMU. A rather compact starter group could find

it easier to achieve low interest rates for both EMU and the EU countries with a link to the Euro via the EMS II system. To the extent that low interest rates are of prime importance to high debt countries and countries still catching up with the EU's leading country, the issue of low interest rates could be a top policy priority after the start of EMU.

The debate about fair transfers in the EU will emerge as an important topic in the context of EMU. The results of the present regime indeed point to a need for reform. Due to its relatively large agricultural sector Denmark, as a country with a per capita income much above average (112.0 on a purchasing power parity basis – EU average = 100) – which is exceeded only by Luxembourg – received net contributions in 1995; this is not compatible with a fair intra-EU transfer mechanism. Apart from this anomaly, the high per capita share of Ireland is surprising at first glance. Thanks to high economic growth rates in the decade 1987-96 Ireland improved its relative income position and reached 85.3% of the EU average. Greece with a PPP per capita income of 60% of the EU average obtained only 333 ECU per capita, Spain whose per capita income level of 76.1% is close to that of Ireland obtained only 184. If Ireland is still to receive money from this special cohesion fund in 2002 – the envisaged date of the full introduction of the Euro – Finland, Sweden and the UK (likely to be at par per capita income values then with Ireland) could also try to obtain transfers from a new enlarged fund. As regards the UK this would be a strange paradox because the UK was always reluctant to join the EMU from the beginning; it would be difficult to explain why such a country should get special support from the cohesion fund. In any case it is a political problem if one of the large countries obtains net payments from the EU club. This Ireland-UK problem could indeed help to prevent the use of a cohesion fund in future.

Capital markets in the EMU area will be highly integrated and could stimulate economic growth via lower interest rates. However, contrary to the results obtained by crude macroeconomic modelling economic growth is not only the result of low real interest rates but also of the dynamics in the creation of new innovative firms and of more standard newcomers that undertake less own research but employ modern equipment (acquired technology). Both types of new firms are important for economic growth and they both require access to capital markets which are fairly underdeveloped in continental Europe compared to the USA and the UK. Here supplementary initiatives at

both the national and the supranational policy level are required in order to stimulate growth and employment creation – thereby also reducing government deficits. While such special initiatives could help to reduce the unemployment overhang of the 1980s and 1990s in the EU the ability to maintain full employment is mainly related to sound macroeconomic policies, more differentiated and flexible wage rates (with lower wage costs for unskilled labour) and higher regional labour mobility within each EMU country. Labour mobility in fact fell in most EU countries in the 1980s, so that a higher regional variance of unemployment rates is observed.

A major problem concerning intragovernmental transfers exists within some EU member countries. Germany itself has a very strange system which is not incentive compatible and could set a dangerous precedent for future intra-EU transfers unless the German system were to be reformed quickly.

If local, regional or national public initiatives for promoting innovative SMEs were successful one should expect a transitory increase in regional per capita differentials, where regions attracting innovative newcomers would enjoy a relative increase in per capita income and tax revenues, while regions less active and attractive to technology-oriented start-up companies would fall back. In a federal system this should then encourage poor regions to imitate the successful policy strategies of the leading regions. Moreover, workers would move from poor to rich and expanding regions, thereby reinforcing pressure for policy adjustment in poor regions (and falling prices of land would help to attract new investors). In Germany, this mechanism works poorly – indeed there are

inverse incentive effects – as there is a system of federal transfers and interstate transfers that almost fully offset the outcome of market forces and the first round impacts of newcomer dynamics, i.e. public transfers strongly change the ranking of regions on a per capita revenue basis. For example, before intragovernmental transfers the top six ranks in terms of per capita revenue were held by Hamburg, Hesse, Baden-Württemberg, Bavaria and North Rhine-Westphalia which became Nos. 4, 12, 15, 16 and 14 respectively (out of 16 states) in the post-transfer league; the six states with the lowest per capita revenue prior to intragovernmental transfers were Saarland, Brandenburg, Saxonia, Mecklenburg-Pomerania, Saxony-Anhalt and Thuringia, but after transfers they rank as Nos. 3, 8, 9, 5, 6 and 7 respectively. Position number one is taken by Bremen, which together with the Saarland obtains special federal transfers because of its excessive debt burden, which is largely due to a poor record of regional policy management (Figure 1).

#### Stabilization Issues

Stabilization policy in EMU will be rather difficult, regardless of the composition of the initial EMU core group. Assuming that centralized monetary policy will focus mainly on the goal of price stability, there are five main options, disregarding fiscal policy, for coping with asymmetric shocks as well as with EMU-wide shocks:

□ Increased cost flexibility could help to absorb adverse shocks. Cost flexibility has somewhat increased through the process of outsourcing and corporate downsizing in the 1980s and early 1990s.

Yves Hervé/Robert Holzmann

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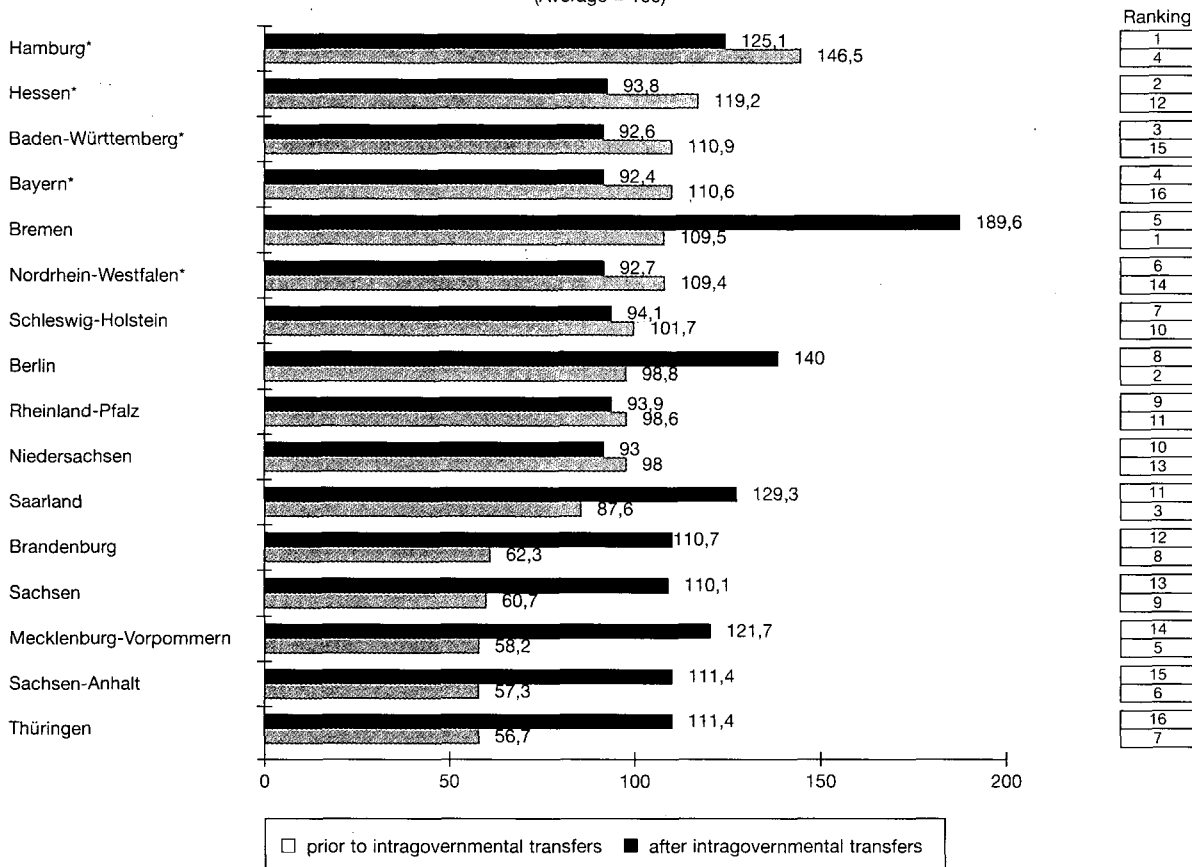
However, the long-term development into a high-technology society with many skilled workers and high R&D costs, which are often fixed costs, means that cost flexibility can hardly be increased very much.

□ Higher wage flexibility obviously could help to absorb shocks. Without special tax incentives and tax reforms there are no prospects of achieving higher intertemporal or higher regional wage differentiation, including higher wage dispersion. Tax reforms and labour market reforms are needed to achieve such higher flexibility.

□ Rising labour mobility could be achieved within EU countries, but certainly less so across EU countries. New tax incentives for regional mobility and the removal of impediments to mobility could help increase mobility. This would still leave the EMU area far behind the USA with regard to overall labour mobility.

□ Increasing supranational EU transfers could be used to compensate regions with declining demand. Such a policy would, of course, be highly undesirable, because it would raise EU budget costs at the expense of the EU taxpayer. EU taxpayers face extreme difficulties in controlling the effectiveness and efficiency of EU regional policies. Compared to local, regional or national elections the marginal impact of an EU voter is even more limited, so that the incentive to be well-informed when voting is very small. Following this reasoning, the transparency of regional policies, as well as of other policy fields, should be increased through mandatory standardized reporting procedures, including a policy summary report for all citizens (similar to a company report to its shareholders). Furthermore, the increase in EU transfer funds could be limited by new rules for the maximum amount (relative to GDP) which a country of a certain income group – evaluated at PPP level – could receive

**Figure 1**  
**Regional Per Capita Revenue Positions Before and After Intragovernmental Transfers**  
 (Average = 100)



\* Net contribution to the equalization fund.

Source: Länderfinanzausgleich – Föderale Armenspeisung, in: Wirtschaftswoche, No. 21, 15. 05. 1997, p. 25.

as transfers. Based on NUTS-2 regions the analysis by the European Commission<sup>6</sup> points to the limited success of regional policy: between 1983 and 1993, the Gini coefficient increased slightly from 0.149 to 0.153. However, at the national level, cohesion increased, since the per capita GDP of Spain, Portugal, Greece and Ireland increased from 66% of the community average in 1983 to 74% in 1995.

□ Higher price flexibility could help to absorb demand shocks. In the single market including a monetary union, price transparency is increased and higher price flexibility can indeed be expected in a more competitive setting – as long as intra-EU mergers and acquisitions do not restore the high market shares previously enjoyed by large firms in the national markets.

Taking into account the pro-competitive effects of increased price transparency price flexibility will increase in the EMU area in the medium term. In fully integrated EMU markets there will be an erosion of market power for internationally oriented firms. The crucial question is whether wage flexibility will increase to a similar degree as price flexibility.

The EMU area will mean for all the countries involved that they can no longer be considered as small open economies whose firms are price-takers in international markets; the EFTA countries were typically in such a position, which implied heavy resistance by firms from the tradables sector to accept wage increases above productivity gains. There is a risk that the switch to EMU will entail higher nominal wage pressure, since wage transparency will increase and trades unions in low wage EMU countries will press for strongly rising wages. An accommodating monetary policy could then lead to rather high inflation rates. With a high unemployment rate in the initial EMU stage anti-inflationary policy would hardly be credible. While one may criticize that the EU countries' governments embarked upon budgetary consolidation rather late, EU countries were even worse in seriously tackling the

unemployment problems. Most firms in the EMU area consider sales in the domestic market to be connected with at least some market power. Such firms will speculate that nominal wage increases will translate into higher product prices, so that firms' resistance to wage claims exceeding productivity growth could be rather weak: firms anticipate higher prices so that ex post the wage-price ratio will increase less strongly than nominal wages. This argument follows the reasoning by Calmfors and Driffill,<sup>7</sup> who argue in favour of a hump-shape relation between union density and wage pressure. Also, Welfens<sup>8</sup> emphasizes the degree of economic openness and the implications for wage restraint in small open economies. Garrett and Way<sup>9</sup> argue that only if trade unions from the exposed sector dominate wage bargaining may one anticipate sufficient wage restraint and considerable flexibility in the presence of adverse shocks. Considering the fact that trade unions in Austria and Finland are mostly in the exposed sector and thus dominate trade union behaviour Garrett and Way argue further that both countries are well positioned to join monetary union. However, wage pressure in Sweden in the 1990s, which was dominated by the tradables sector, showed that insufficient productivity growth by the non-tradables sector can be a serious problem, too.

Real convergence will remain a problem in Europe because the relative price of nontradables  $P_n$  to tradables  $P_t$  typically rises as real per capita income  $y$  increases. Since purchasing power parity and competition imply the law of one price for tradables in the form  $ePt^* = Pt$ , a strict monetary policy by the ECB in line with price stability will create a problem. The overall price level  $P = (P_n)\exp\beta(ePt^*)\exp(1-\beta)$ , so that – almost – the only nondeflationary way of bringing about a rise in the relative price of nontradables is an exchange-rate appreciation for country  $i$ . EMU member country  $i$ , however, will have the problem that there is a common exchange rate for all Euro countries. Only a fall in the absolute level of tradables prices could bring about a rise in the price ratio  $P_n/P_t$ . In a world with heterogenous goods this could be achieved in a nondeflationary way only if the share of tradables with economies of scale is increasing over time – i.e. along with the rise of real per capital income. The alternative of enforcing price reductions on tradables via a rising unemployment rate clearly would not be desirable in the Euro area because it would create problems for the country concerned, impair export prospects for Euro partner countries and raise the pressure for higher EU transfers.

<sup>6</sup> See Europäische Kommission: Erster Kohäsionsbericht, Brussels 1996.

<sup>7</sup> See L. Calmfors and J. Driffill: Bargaining Structure, Corporatism and Macroeconomic Performance, in: Economic Policy, Vol. 3 (1988), p. 13-61.

<sup>8</sup> See P. J. J. Welfens: Growth and Full Employment in the European Union, Discussion Paper No. 201, Westfälische Wilhelms-Universität, Münster 1994.

<sup>9</sup> See G. Garrett and C. Way: The Sectoral Composition of Trade Unions, Corporatism, and Economic Performance, in: B. Eichengreen, J. Frieden and J. von Hagen (eds.): Monetary and Fiscal Policy in an Integrated Europe, Heidelberg and New York 1995.