

Overview

Despite thorough preparation, major challenges lie ahead

The launch of the euro on 1 January 1999 has created the world's second largest single currency area in terms of economic size after the United States. The euro area comprises 11 countries which account for some 16 per cent of global GDP, has a total population of 290 million and is substantially less open to foreign trade than its constituent member countries with imports accounting for about 15 per cent of GDP. In comparison, the share of global output produced in the United States is around 20 per cent, with a slightly lower population and degree of trade openness. Despite thorough preparation, it is inevitable that there is a fair amount of uncharted water ahead. On the one hand, a sophisticated institutional framework has been established prior to the adoption of the single currency, co-ordination of economic policies has been strengthened and there are long-standing initiatives to promote close economic integration. On the other hand, long lasting monetary unions among major sovereign nations have never been observed before, without strong political integration. Moreover, the euro area economy is not a well-known entity and past behavioural regularities may change with the advent of the euro. It is difficult, therefore, to predict with confidence the economic effects which will prevail after the introduction of the euro. The purpose of this book is to examine the challenges that the area will confront and the initiatives which would help ensure a successful monetary union.

Current macroeconomic conditions are fairly favourable...

The preparation of EU economies for the launch of the euro took place during difficult economic times. But the efforts have helped put in place a set of fairly favourable macroeconomic conditions. Following several years of relatively sluggish growth, output in the euro area is estimated to

have risen by 2.9 per cent in 1998, slightly faster than potential. The pick-up in activity was initially led by robust export growth, but since the second half of 1997 has been underpinned by the recovery of domestic demand, as rising household income and corporate profits have stimulated consumer and investment spending. With activity rising, labour market conditions have improved. Employment is estimated to have risen by just over 1 per cent in 1998, its fastest pace since 1991. Nonetheless, unemployment remains high at 11 per cent of the labour force and large differences persist across member States. Given considerable spare capacity and falling commodity prices, inflation has continued to fall and is currently at its lowest level in over 30 years.

... and may continue to be so over the next couple of years

Favourable prospects are expected to prevail beyond the launch of the euro, although the risks attached to the near term outlook are unusually large and mostly on the downside. The fairly easy monetary conditions, less fiscal restraint and comfortable balance sheet positions in the euro area are forces underpinning the nascent recovery. Higher consumer and investment spending are likely to give the main impetus to growth. Weaker business confidence readings at the end of 1998 and in the first few months of 1999 may, however, limit the strength of investment spending outlays. In contrast, external demand is not expected to contribute much to growth due to the slow-down in economies outside the euro area and the recent fall in euro-area competitiveness. The major risks to these projections concern external developments. Heightened uncertainty and investor nervousness have already spilled over into lower business sentiment. If conditions do not improve in Japan and economic contagion continues to spread to other emerging economies, it could trigger a negative impact on financial and equity markets and hit confidence further, leading to lower consumer spending and particularly hurting investment plans. This would in turn be sufficient to stall the euro area recovery.

**EMU excludes
sovereign
monetary
and exchange
rate policy...**

For individual countries, membership of EMU implies the loss of the sovereign interest rate and exchange rate instruments. This is the main potential cost of joining a monetary union. How big this cost is depends on the frequency and nature of the shocks that will hit the euro area in coming years. The cost is highest if situations arise where substantially disparate monetary conditions would be called for in different countries due to economic disturbances that have uneven impacts across the area (*i.e.* asymmetric shocks). However, the monetary arrangements in place prior to the launch of the euro already imposed such constraints to a substantial extent; and it is likely that at least some asymmetric shocks are more easily absorbed in a monetary union where monetary policy should adopt the stance most appropriate for the area as a whole than under the previous arrangements, which were at times shaped by domestic German policy considerations. Furthermore, even in the case of asymmetric shocks, with monetary conditions constrained to respond to the average conditions in the area as a whole, fiscal instruments can be applied at national levels to promote macroeconomic stabilisation. In the case of shocks that affect all countries more or less equally (*i.e.* symmetric shocks), the loss of monetary autonomy implied by EMU is in principle of less concern, because the area-wide policy would likewise tend to deliver monetary conditions that are appropriate for each country. However, this need not be strictly the case if the transmission mechanism for monetary policy operates significantly differently in the euro area, because then a uniform policy response would not yield uniform impacts. Such differences in transmission mechanisms are likely to weaken over time as monetary union takes hold. Finally, in the case of supply shocks – whether country specific or area-wide – changes in relative prices and production patterns are generally needed. While macroeconomic policies can buffer the income effects of such shocks and buy time for the needed adjustment to take place, they cannot by themselves assure the necessary structural changes. From this perspective, the question is whether EMU provides a more or less favourable environment for the needed supply side adjustments to take place. It is difficult to advance firm conclusions on this point, though almost surely it is policy reforms in individual

countries that are the most important instruments for improving adaptability.

... but offers economic benefits

The introduction of the euro delivers a number of benefits. These include reduced transaction costs associated with trade and financial interactions with other euro area countries, no intra euro area exchange rate risk, greater overall price stability and sharpened price transparency. Lower exchange rate risk also implies that interest rate risk premia should be small, and therefore lower borrowing costs in many countries. These benefits will complement the single market in goods and services and are likely to reinforce the long-run efficiencies associated with the single market. The European Commission estimated nine years ago that the direct static benefits of monetary union linked to lower transaction costs could be around $\frac{1}{2}$ a per cent of EU GDP, equivalent to around \$40 billion a year. Recent studies have estimated larger gains (up to 1 per cent of GDP). EMU is also likely to generate endogenous consequences such as more transparent prices unleashing stronger competitive forces, possibly fewer policy induced shocks compared with the past as a result of the stability-oriented macroeconomic policy framework and it may serve as a catalyst to speed-up structural changes. These indirect and dynamic benefits are difficult to quantify, but could be more important than the static gains.

The primary objective of monetary policy is price stability

The Maastricht Treaty states that the primary objective of monetary policy is to maintain price stability. And without prejudice to the objective of price stability, the single monetary policy should support general macroeconomic policy. At the start of 1999 the European Central Bank (ECB) assumed full responsibility for monetary policy in the euro area. Responsibilities related to prudential supervision of financial institutions and the stability of the financial system continue to lie with the competent national authorities. The separation of the two functions of monetary policy management and banking supervision ensures a high degree of independence of monetary policy from the stability needs of the financial sector, but stronger co-ordination of supervisory functions would appear desirable. Central bank independence is likely to reduce problems of time

inconsistency and to foster credibility of policy announcements. This in turn should make it more likely that price stability – defined in October 1998 as a year-on-year increase in the Harmonised Index of Consumer Prices for the euro area of below 2 per cent – will be maintained. The ECB will face a number of challenges over the next few years. The immediate challenge is how to calibrate monetary policy under conditions of higher “model” uncertainty. The transmission mechanism of monetary policy for the area as a whole is quite uncertain and it could operate differently in different regions of the euro area. There are several potential sources of differential regional responses to a common monetary policy. These include differences in: the composition of output; the degree of openness; the level of development and structure of the financial market; sectoral balance sheet positions; and the flexibility and institutional features of labour and product markets. Some of these will disappear only in the long run. Uncertainty about the effects of monetary policy could imply that monetary policy is not sufficiently pro-active when this would be needed. The intensity of these concerns is likely to ease over the coming years as practical experience with managing monetary policy in the euro area is accumulated and as more is learnt about the transmission mechanism.

Fiscal policies will be formulated in the context of the Stability and Growth Pact

Fiscal policy of countries in the euro area will remain largely under the responsibility of national authorities according to the principle of subsidiarity – a presumption in favour of national sovereignty. However, policy will be formulated in the context of the provisions of the Stability and Growth Pact which, given current budgetary positions of most euro area countries, imposes tight constraints on fiscal policy, especially in the large euro area countries. Despite significant progress on budget consolidation in the run-up to EMU, establishing the full ability to pursue counter-cyclical budgetary policies will in most countries require further sustained consolidation efforts in the years ahead. Based on various empirical approaches it seems that a deficit close to balance over the cycle should provide an adequate fiscal cushion necessary to comply with the Stability and Growth Pact’s 3 per cent deficit limit in the event of a recession. But such targets, which are based on the

extrapolation of past behaviour, could be subject to greater than usual margins of uncertainty with the “regime change” of EMU. Furthermore, greater ambition in medium-term fiscal targets is warranted by the size of public debt in some countries and by the future fiscal burden associated with population ageing.

The institutions and processes for macroeconomic policy co-ordination are already well in place

The Stability and Growth Pact does not address the issue of whether macroeconomic spillovers in EMU are important enough to justify additional co-ordination of policies over the cycle. In part it will depend on the nature of the shock encountered by the economy. If the shock is country-specific, temporary and does not impinge on the euro average, the appropriate instrument is national fiscal policy, and there is no clear case for co-ordination. If the shock has implications for euro area-wide inflation, the primary instrument should be monetary policy. Monetary policy should also take into account the implications of the fiscal policy stance for prospective price developments, especially if spillovers between monetary and fiscal policies are significant. In particular, it is likely that such spillovers will show up in large exchange rate fluctuations. The institutions and processes for dialogue and co-ordination are already well in place. First, the excessive deficit procedure should bring significant peer pressure to bear on budget policies. Second, there are the “Broad Economic Policy Guidelines” which allow the Council to make country-specific recommendations on both macroeconomic and structural policies, and which reflect the Community’s policy consensus. Third, there are the high-level EU policy groups such as Ecofin (Economics and Finance Ministers), the Economic and Financial Committee and the Euro-11 Group (a subgroup of Ecofin specific to EMU).

Exchange rate target zones could compromise the credibility of monetary policy

The extent to which the exchange rate of the euro should be an issue of direct policy concern is an unsettled question. Past movements in euro area competitiveness measures have been fairly volatile. High volatility of the euro could generate protectionist trade policies and exacerbate output fluctuations. Such concerns have led some commentators to advocate target zones for the value of the euro *vis-à-vis* the dollar and the yen. Even supposing target zones between

these currencies were agreed it is not clear that wide fluctuations in the euro could be avoided. Given the relatively low weight of the dollar and yen in the euro effective exchange rate, large fluctuations could still be associated with bilateral movements in other currencies. There are a number of problems related to the implementation of target zones. For instance, it would be difficult to get participants to agree on the central exchange rate parity as well as the width of the band. Secondly, a repercussion of subordinating interest rate policy to exchange rate stability is that some volatility would be shifted from the exchange markets to money and bond markets. Furthermore, interest rate moves to keep exchange rates within bands may not necessarily be consistent with the ECB mandate to maintain price stability. There is thus a risk that credibility of monetary policy may be lost, raising risk premia and undoing part of the benefits of monetary union. Even in the absence of target zones, monetary policy should obviously be responsive to exchange rate developments in so far as these impact on inflation prospects.

It will be important to raise the euro economy's adaptability, and reduce its susceptibility to shocks and policies with uneven impacts across the monetary union

The ultimate success of EMU depends upon whether adjustment can take place without putting undue strain on economic activity. In general, a greater degree of labour and product market rigidity prolongs the adjustment process and leads to a bigger impact on output and employment in order to alter relative prices. To reduce regional economic fluctuations and permit a higher potential rate of economic expansion it is important to raise the euro economy's adaptability and reduce its susceptibility to shocks, including policy actions with uneven impacts across the monetary union. In general terms, a monetary union is less susceptible to asymmetric disturbances the more its regions are integrated with each other and diversified within themselves. There are three key forces that promote closer integration. These are the degree of trade interdependence, the degree of intra-industry trade, and closer income linkages, such as increased foreign direct investment or closer financial market interactions. Over the past 20 years each has risen sharply and promoted a closer synchronisation of business cycles across euro area countries. This process has

also been facilitated by macroeconomic convergence prior to the launch of the euro.

Close economic integration and less specialisation are two criteria likely to reduce the incidence of asymmetric shocks...

A close degree of integration does not, however, necessarily lower the susceptibility to asymmetric shocks. Some economists have argued that closer integration could result in greater regional specialisation and thus heighten the area's exposure to idiosyncratic shocks. Specialisation may have been limited by national obstacles to trade and high transportation costs. As the Single Market Process is fully implemented, technological innovations reduce these barriers and EMU makes prices more transparent, the incentive to reap scale economies and agglomeration benefits may rise and production could thus become more concentrated in the regions closest to the largest markets. Whether EMU is likely to spur greater regional specialisation or promote more homogenous production structures is an empirical question. Summary measures of specialisation do not show a clear cut trend and the level of specialisation depends critically on the level of aggregation. The common monetary policy may also lead to greater output fluctuations. The variance of inflation has historically been significantly greater than output growth variability in most EU countries. A single monetary policy will limit the size of inflation variability between regions, but with the exchange rate option no longer available and considerable structural differences, output volatility could rise unless relative prices adjust more rapidly than in the past.

... and "shock absorber" mechanisms can limit the potential cost of asymmetric shocks

While it is difficult to judge whether output volatility will rise, the euro area countries will undoubtedly continue to experience economic disturbances that affect a single country or subsets of regions. Such country or region specific supply and demand disturbances could be sources of tension within EMU unless they can be easily absorbed. There are a number of "shock absorber" mechanisms which can limit the potential cost of foregoing national monetary policy independence. Among them the principal ones are more flexible factor and product markets, fiscal policy and greater integration of capital and credit markets which would permit consumption smoothing. Following the traditional optimal currency area theory the emphasis here is on the flexibility

of production factors, especially labour, to absorb shocks and the policies which may influence this adjustment channel. Greater overall labour market flexibility would support job mobility and accelerate the pace of wage and price changes at the regional or country level in order to achieve real exchange rate corrections following an adverse shock. If these mechanisms are weak or slow, the necessary adjustments would fall more on employment.

Labour mobility and wage flexibility are important in monetary unions

There is no guarantee that EMU will set forces in motion that would automatically lead to a better functioning of euro area labour markets. The sooner countries implement policies that foster greater labour market flexibility, the more prepared they will be to absorb future shocks. The experience of those countries which have already moved in the direction prescribed by the OECD *Jobs Strategy*, such as the Netherlands and Ireland, suggests that significant gains in terms of better labour market performance can be reaped. The overall EU approach to employment policy is similar to the OECD *Jobs Strategy* in that it stresses the importance of adopting a comprehensive plan and emphasises structural initiatives. The main features of the EU approach are the introduction of Employment Guidelines adopted by the European Council and National Action Plans prepared by member States which set out country-specific employment policy plans consistent with the Guidelines. In December 1998, the European Council endorsed a second set of 22 Employment Guidelines for 1999, divided into four pillars covering employability, entrepreneurship, adaptability and equal opportunities. Some areas of labour market policy receive more focus than others. For instance, training and retraining are stressed. Other aspects, such as wage flexibility, the rules governing eligibility and controls on job search or restrictive employment protection legislation, while receiving little emphasis in the Employment Guidelines, are dealt with in the Broad Economic Policy Guidelines, which outline the overall economic policy strategy of the Union.

Labour mobility is low in the euro area

Even though every citizen of the Union has the right to work or reside in another member State, very few people chose to do so. The number of EU nationals resident in another

member State is only 5.5 million out of 370 million, equivalent to 1½ per cent of the population. Labour market adjustment through geographic mobility at the national level is also low in most euro area countries. Rather, adjustment in Europe is largely *via* changes in activity and unemployment. In contrast, labour mobility plays a relatively important role in existing currency areas like the United States, Canada or Australia. Low mobility has also led to unemployment differentials that are large and persistent and hence of a structural nature. The failure of mobility to equalise structural unemployment reflects a range of policy-related and other factors: minimum wages are set at a single rate for all regions of a given member State so that wage adjustments cannot absorb differences in productivity across regions; high replacement rates especially at the low end of the wage scale; restrictive employment protection legislation; housing market obstacles; lack of information about job opportunities in other regions; language barriers and lifestyle differences that may offset the incentive effects of wage differentials; and a limited geographic range for job search requirements without risking the loss of unemployment benefit entitlement.

Although much progress has been achieved to reduce the legal and institutional barriers to mobility, obstacles remain...

While over the past 30 years much progress has been achieved to reduce the legal and institutional barriers to mobility, indirect obstacles continue to act as a restraining force limiting the degree of cross border and intra-country labour flows. The European Commission established in 1996 a High Level Panel to examine the factors limiting intra-EU mobility. The Panel's Report drew attention to certain flaws and lacunae in the rules and their application. These include: limited cross border portability of social protection and supplementary pension rights; an overly zealous interpretation of the requirements and excessive fees to gain legal residency status; lack of comparability and reciprocal recognition of professional qualifications; and restrictions on public sector employment. The economic incentive to move has also weakened. The key economic influences are most closely linked to high levels of unemployment overall, so that willingness to move may not translate into finding a job and income convergence among the euro area countries

has reduced average wage differentials across countries and, thus, the incentive to move.

... but mobility seems unlikely to increase greatly over the next few years

It is unlikely that labour mobility will increase greatly within the euro area over the next few years. Labour market adjustment, however, could be sharpened by greater sensitivity of real wages to excess supply and demand conditions across regions and sectors. The capacity of wages to adjust rapidly to a change in labour market conditions is critical. In the context of EMU, slow wage adjustment to changes in labour market conditions may gradually erode domestic firms' competitiveness and, unlike in the past, it will not be possible to delay adjustment through a nominal exchange rate depreciation. The OECD *Jobs Strategy* stressed labour market flexibility and the importance of setting wages in line with productivity improvements so that wages are able to adjust to reflect local conditions.

Incomes policies may help aggregate wage moderation, but may inhibit labour market flexibility

In an effort to restrain wage inflation an increasing number of countries have resorted to incomes policies. Governments have persuaded the social partners to agree on a programme of wage moderation (tripartite agreements) including, in Belgium, the imposition of legal restraints on wages growth. Although aggregate wage flexibility is important, it is generally not adequate to assure a smooth adjustment at the sector and regional level, as a high degree of centralisation may limit the scope for regional and sectoral variation in wage levels and blunt the incentive for geographic or inter-sectoral labour mobility. In addition, incomes policies are often underpinned by policy concessions which sometimes undermine labour market flexibility.

EMU could result in area-wide wage bargaining arrangements

The heightened perception of a single market that the euro will convey is likely to promote a tendency toward EMU-wide wage bargaining. A rather extreme example followed the unification of Germany where the reduction of wage differentials between the levels in the East and West faster than relative productivity gains led to lower overall employment. While this experience was somewhat unique, similar pressures to reduce differentials have surfaced in the past in Italy and Spain. To date, a few unions have tried to co-

ordinate EU wide sector agreements. These, however, relate mostly to efforts to impose minimum conditions and reflect concerns that EMU will provoke pressure for competitive wage moderation rather than pressure to emulate the leading country in terms of wage levels and labour regulations.

Product market reforms could spur more rapid and bolder labour market reforms

When markets are not competitive, adjustment may be prevented or slow. EMU, by contributing to transparency and competition should itself improve the functioning of product markets. Further enhancing product market competition and market contestability through deregulation could sharpen the links between wage and price flexibility and allow prices to adjust more speedily to economic disturbances. Moreover, product market reforms could also help reduce the opposition of vested interests or insider power to labour market reforms. For instance, countries which have stringent product market regulation tend to have restrictive employment protection legislation. This suggests that reforming product market regulation would also make it easier to ease the restrictiveness of employment protection legislation and serve as a catalyst for more rapid and bolder labour market reforms. This might well support a virtuous circle, since the full benefits of increased product market competition will only be reaped if sufficiently flexible labour markets allow a swift reallocation of labour.