SIBYLLE SCHWARZ

THE Birth OF THE Euro

BY ROBERT SOLOMON

Monetary Union in Western Europe

FOR THE FIRST TIME since the fall of the Roman Empire, much of Western Europe now has a single currency. At the beginning of January the 11-nation European Monetary Union came into being and, with it, a new currency, the euro. Though Europe's familiar national banknotes will remain in circulation for three more years, the official currency of the EMU is the euro.

Robert Solomon is a guest scholar in the Brookings Economic Studies program. For his more complete treatment of the international effects of the euro, see the Brookings Policy Brief no. 42, *January 1999.*

The European Monetary Union is the latest step in a decades-long movement toward integration in Western Europe. Soon after the end of World War II, French leaders Jean Monnet and Robert Schuman adopted European integration as the means to embrace Germany and keep it oriented to the West. German political leaders from Konrad Adenauer to Helmut Kohl and now Gerhard Schroeder have backed the policy, and France and Germany have consistently led the European integration movement. Ironically, though the motivation on both sides of the Rhine has been political, integration has been pursued almost entirely through economic and monetary means.

The Road to Monetary Union

The first step toward integration, in 1952, was the European Coal and Steel Community, a common market in coal, iron, and steel products joining Belgium, the Federal Republic of Germany, France, Italy, Luxembourg, and the Netherlands. In 1957 the same six countries formed the European Economic Community, or Common Market, a customs union that grew to its current 15 members in what is now called the European Union.

In 1979 most members of the EU formed the European Monetary System—an effort to keep exchange rates stable in the EU. The new system narrowed differences in inflation and interest rates among most EU countries, and became, in effect, a deutsche mark zone. Exchange rates were kept stable by pegging to the German currency and following the lead of the Bundesbank in monetary policy. During the mid-1980s EU member states moved further toward integration by agreeing to try to eliminate restrictions on the movement of goods, services, capital, and people among themselves by 1992. Finally, in 1989, a committee consisting mainly of central bankers chaired by the president of the EU Commission, Jacques Delors, proposed a European Monetary Union. The proposal was adopted in the 1991 Treaty on European Union, often called the Maastricht Treaty—in effect the constitution of the EMU.

Under the terms of the treaty, countries wishing to join the EMU must meet certain "convergence criteria." Efforts by EU governments to qualify for EMU membership led to further convergence of economic and monetary conditions in Western Europe. Consumer price inflation in Spain, for example, came down from 5.9 percent in 1991–92 to an annual rate of 1.4 percent in late 1998. Italy's budget deficit fell from about 10 percent of GDP in 1991–92 to roughly 2.8 percent in 1998.

Only one EU country, Greece, failed to qualify for EMU membership on the basis of the convergence criteria. Three others—Denmark, Sweden, and the United Kingdom—chose not to join.

Features of the Euro Area

The 11 countries that make up the EMU have a population about 8 percent larger than that of the United States, but their GDP is about 25 percent smaller. Individually, the economies of the EMU countries are quite "open"—in the sense that their external trade is a relatively large share of GDP—but because much of their trade is with each other, the euro area itself is a more "closed" economy. Excluding intra-EMU trade, exports plus imports amount to about 25 percent of GDP, compared with just under 20 percent for the United States (and 18 percent for Japan). The EMU has had a surplus in the current account of its balance of payments since 1993, while the United States has a large and growing external deficit.

Other differences set the EMU off from the United States. Euro area government expenditures and receipts are substantially higher, relative to the size of the economy. Unemployment is also higher (about 10.5 percent of the labor force, compared with just over 4 percent in the United States) and is believed to be largely structural—related to high labor costs, including various taxes and other charges on the employment of labor. Banking is much more important, relative to securities markets, in the euro area.

EMU central banking arrangements, known as the Eurosystem, bear some similarity to those in the United States (and also Germany). The European Central Bank (ECB) in Frankfurt, with its 6-member Executive Board, is comparable to the 7-member Federal Reserve Board in Washington. The 11 national central banks are analogous to the U.S. Federal Reserve Banks. Neither the ECB nor the Federal Reserve Board undertakes market transactions directly. Such transactions—discounting, open market operations, intervention in foreign exchange markets—are carried out by the national central banks in the EMU and the Federal Reserve Banks in the United States.

The main policymaking body of the Eurosystem is a Governing Council consisting of the Executive Board and the 11 national central bank presidents. It corresponds to the Federal Open Market Committee. The national central bank presidents constitute a majority of the Governing Council, while in the United States the seven members of the Federal Reserve Board have a voting majority.

The policy objectives of the Eurosystem, as set forth in the Maastricht Treaty, give primacy to price stability. But that objective being met, what is often ignored is that the treaty also calls on the new central bank to support the general policies of the European Union, including economic growth and employment.

The monetary policy of the Eurosystem remained unchanged from early January through early April. Its main interest rate, roughly comparable to the Federal funds rate in the United States, was maintained at 3 percent. A weakening of economic activity in the EMU in the fourth quarter of 1998—mainly reflecting a falloff in exports and gross investment—led the Governing Council to make its first change in monetary policy on April 8, when it lowered the basic interest rate to 2½ percent.

Initial Developments in the Euro Area

On January 4, the first working day of 1999, the exchange rates of the currencies of the 11 participating EMU countries were "irrevocably" linked to the euro and thus to each other. Banking and other financial assets, including government bonds, became denominated in euros. The euro began to be traded in foreign exchange markets (initially Sydney, Australia) on the evening of January 3, European time. Prices in many shops are being quoted in euros as well as national currencies, and credit card purchases may be made in euros.

The market value of the euro, $1.186 on January 4, depreciated almost steadily in foreign exchange markets to just over $1.03 in early June. The stronger performance of the U.S. economy provides part of the explanation, as does the fact that short-term interest rates, both nominal and real, are lower in the euro area than in the United States.

In any event, the weakening of the euro may have come as a surprise to those who had predicted an early rise of the euro against the dollar based on their expectation of a large worldwide shift of official and private assets from dollars to euros. So far, little evidence bears out that expectation.

Potential Problems

Although the EMU now has a single monetary policy and a single exchange rate, as does the United States, it nevertheless consists of 11 sovereign countries, each with its own budget. The 50 U.S. states also have their own budgets, but their ability to incur deficits is limited, both constitutionally and by the markets in which they sell their bonds. Washington faces no such limits.

Before EMU, central governments were regarded similarly. But now EMU member states are without their own central banks. That alone might limit their capacity to finance budget deficits. But there is another limit. A Stability and Growth Pact provides that member countries that fail to limit their budget deficits to 3 percent of GDP are subject to penalties unless GDP falls 2 percent or more in a year or special circumstances prevail.

It is clear that if the member countries could achieve near-balance in their budgets when their economies are operating at capacity, they would have latitude to incur cyclical deficits and to use discretionary fiscal policy when they move into recession. That latitude would become especially desirable if one or a few member countries were to suffer recession while the area as a whole continued to prosper. In such a case, the Eurosystem would not ease monetary policy by reducing interest rates, and the only policy tool available to the depressed countries would be fiscal policy—not only such automatic stabilizers as falling tax revenues and rising unemployment benefits, but also discretionary policy moves such as tax cuts or increased government spending.

Another justification for flexibility of fiscal policy in the EMU countries is that labor mobility there is lower than it is in the United States. Partly because of Europe's language differences, when a European region suffers a rise in unemployment, its people are less inclined than Americans to go where the jobs are.

The Euro in the World Economy

How important the euro will become as a reserve currency held by central banks around the world and as a privately held asset is uncertain. Countries in Eastern Europe that aspire to join the EU will almost surely hold euros in their reserves and will probably peg their exchange rates to the euro. But central banks in general will not dump dollars on the market in large amounts to switch to euros, for that would simply lower the value of their remaining dollar holdings. To the extent that the euro becomes an important reserve currency, the process is likely to be gradual.

For the euro to become a growing part of countries' reserves requires a supply of euros as well as a demand. The United States, whose currency comprises almost 60 percent of world foreign exchange reserves, has demonstrated this principle only too vividly: it has for years regularly supplied dollars to the rest of the world by incurring deficits in its balance of payments. Even when its current account balance was in surplus, its capital outflows exceeded those surpluses, thereby providing a net supply of dollars to other countries.

If the euro is to become a major currency for private use internationally, the same principle applies. But European securities markets must also develop further to provide attractive vehicles for both investors and borrowers outside the EMU.

Yet another question is how the euro area will be represented in various international fora. It is clear who the central bank representative is: the president of the ECB, Wim Duisenberg. But who is the counterpart of national finance ministers and the U.S. secretary of the treasury? In fact, whose phone does the treasury secretary ring when a crisis arises?

Some observers have viewed the EMU as an anti-American move aimed at so-called American hegemony. Although the EMU will be a significant economic force in the world economy, it is far from politically unified and is unlikely to speak with one voice on international issues, economic or political. The EMU does not look like a serious threat to American interests. And the possible economic benefits to Europe in terms of growth will be welcomed by the United States and other countries. Washington has always encouraged moves toward economic integration in Europe, given their political motivation over the past half-century. Americans have good reasons, both political and economic, to continue this tradition. ■