European Economic and Monetary Union

This article discusses the progress towards European Economic and Monetary Union, which begins in January 1999. Issues covered include: the operation of monetary and fiscal policy under the union; the relative size and significance of the euro area; financial market implications; and the implications for Australia.

EXECUTIVE SUMMARY

European Economic and Monetary Union (EMU) is more than just a currency redenomination involving 11 countries — it will mean the harmonisation of all financial rules, procedures, protocols and infrastructures within the European Union.

Decisions on membership of the first round of EMU and the Presidency of the European Central Bank (ECB) were taken on the weekend of 2-3 May. There will be a broad monetary union including 11 of the current 15 members of the European Union and the European Monetary System central parities have been agreed as bilateral conversion rates. The final stage of the process leading to monetary union is scheduled to commence in January 1999.

The economic and commercial weight of the euro area will be comparable to that of the United States and larger than Japan. Greater cyclical synchronisation of euro economies, combined with the size of the euro area, will make economic developments in the area more important in the world economy. The euro will be an important vehicle currency in international commercial transactions, and the independence of the ECB may over time also promote the use of the euro as an anchor currency in international capital markets. EMU will create one of the world's largest government bond markets.

Europe expects that EMU will increase intra-regional trade and investment via the elimination of exchange rate risk and banking costs associated with multi-currency trade. Greater price and cost transparency are expected to enhance product and labour market competition and drive further efficiency gains. European financial markets will be more liquid as fragmentation will be removed, thus lowering the cost of risk-free capital.

But the loss of sovereignty over monetary and exchange rate policies will reduce countries' options for dealing with asymmetric shocks and high unemployment. The capacity of the new ECB to manage monetary policy has also been questioned.

EMU will be an historic development for Europe and a significant development for world financial markets. While its influence on Australia is unlikely to be significant in the short term, a successful euro may in time challenge the role of the US dollar, and monetary policy decisions by the ECB may accordingly exert a similar influence on Australia.

BACKGROUND

European Economic and Monetary Union (EMU) involves the total reconstruction of the core economic and monetary structure of initially 11[1], possibly up to 15, separate nations into one cohesive economic block with one new, redefined market place.

As such, EMU is seen as more than just a currency redenomination involving 11 countries — it will involve the harmonisation of all financial rules, procedures, protocols and infrastructures within the European Union (EU).[2] However, as EMU is less than a political union, the one financial market will operate within a context of different taxation, legal, accounting and regulatory requirements.

Figure 1: EMU Timetable

Mid 1998	ECB to be established and first ECB Council Meeting, to be attended by the six members of the Executive Board and the 11 central bank governors of the participating countries.
1 January 1999	Monetary Union commences, introducing single monetary policy conducted in euro, and currency rates irrevocably locked to the euro — however, national notes and coins will remain legal tender.
1 January 2002	Euro notes and coins issued can be used in parallel with national currencies.
1 July 2002	National currencies cease to be legal tender — transition to the euro is officially complete.

The Maastricht Treaty (1991) provides an economic, political and legal framework for the single currency, including processes leading to the establishment of monetary union. The creation of the single market, the overriding rationale for monetary union, predated the Maastricht Treaty. The second stage in the development of monetary union started in 1994, with the establishment of the European Monetary Institute (EMI) — the forerunner to the European Central Bank (ECB). The final stage of the process leading to monetary

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1 The 11 initial participants in EMU will be Germany, France, Italy, Spain, Netherlands, Belgium, Austria, Finland, Portugal, Ireland and Luxembourg.

2 A Treasurer's Guide to EMU: Citibank 1997.

union is scheduled to commence in January 1999 with the creation of the euro and the irrevocable fixing of participating currencies' exchange rates in terms of the euro.

RATIONALE FOR MONETARY UNION

EMU is seen as necessary to cement the operation of the Single European Market. Politically it is intended to serve as the driving force behind further economic integration. Other proponents also see it as a catalyst for political union in Europe.

The benefits of EMU are expected to result from increased intra-regional trade and investment flowing from the elimination of exchange rate risk and banking costs associated with multi-currency trade. Greater price and cost transparency should also enhance product and labour market competition and drive further efficiency gains. European financial markets will be more liquid as fragmentation, based on national currencies, will be removed, lowering the cost of risk-free capital.

Criticisms of EMU relate both to its political and economic objectives. The principal political criticism relates to the loss of national sovereignty and the goal of a federal Europe. Economic criticisms also relate to the loss of sovereignty for participants in terms of monetary and exchange rate policies. In part, the economic criticisms are muted by the fact that many countries have already largely ceded monetary policy to the Bundesbank.

Other critics point to the performance of the Exchange Rate Mechanism (ERM) since 1979 (and preceding exchange rate mechanisms) noting the need to periodically adjust bilateral exchange rates within that arrangement as evidence that monetary union will lead to regional imbalances and that, over the long run, these imbalances will be unsustainable. Linked to this is a concern that Europe could become more protectionist so as to assist its failing regions.

The capacity of the new ECB to manage monetary policy within the euro zone has also been raised. It has been noted that the workings of the joint monetary economy is likely to be unpredictable initially and that serious policy errors could be made which will adversely affect the performance and credibility of the ECB.

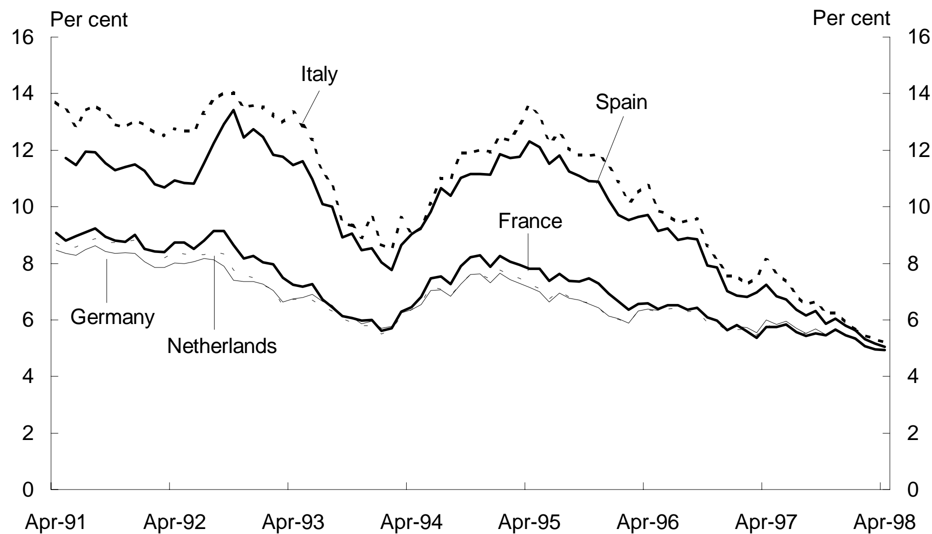
PROGRESS TOWARDS MONETARY UNION

The meeting of EU leaders on 2-3 May endorsed the establishment of a broad monetary union comprising 11 members. This decision followed the release on 25 March by both the European Commission (EC) and the EMI of their reports on the economic performance of member States in terms of the Maastricht convergence criteria.

The EC report concluded that 11 countries had achieved a high degree of sustainable convergence and recommended that these countries should be the founder members of EMU from 1 January 1999. Only Greece failed to qualify for membership in terms of the excessive deficits requirement of the Maastricht Treaty. The UK and Denmark, while eligible for membership in terms of the stated criteria, have exercised their opt out clauses from the Treaty. Sweden for domestic political reasons will also not be part of the first round of members. (The EC effectively provided Sweden with an opt out by concluding that Sweden had not met the requirement of being an ERM member.)

The EMI report, while it expressed concerns that Belgium and Italy had made insufficient progress to reduce their debt-to-GDP ratios, did not rule either country out for membership of monetary union.

Chart 1: Ten-year Bond Yields



At a more general level, the EC report concluded that sufficient progress has been made in achieving price stability and sound fiscal positions in member states for monetary union to proceed. Performance in terms of price stability has been impressive and this has supported the convergence of interest rates closer to German levels rather than at a level closer to the average of participating States. Through the year inflation rates of EU countries have converged to around the 1-2 per cent range in early 1998. (Greece is the exception, with

through the year inflation over 4 per cent.) EC data based on harmonised consumer prices show a similar pattern.

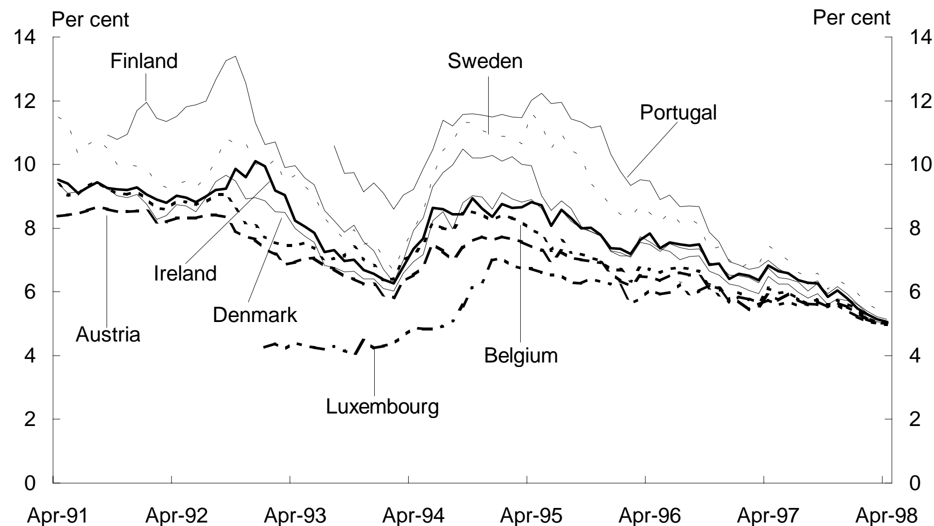


Table 1: Maastricht Convergence Criteria Outcomes

	Inflation January 1998[(a)]	Government Budgetary Position[(b)] Deficit % of GDP	Debt % of GDP	Long term interest rate[(c)]
Germany	1.4	2.7	61.3	5.6
France	1.2	3	58	5.5
Luxembourg	1.4	(+)1.7	6.7	5.6
Belgium	1.4	2.1	122.2	5.7
Austria	1.1	2.5	66.1	5.6
Netherlands	1.8	1.4	72.1	5.5
Ireland	1.2	(+)0.9	66.3	6.2
Finland	1.3	0.9	55.8	5.9
Italy	1.8	2.7	121.6	6.7
Spain	1.8	0.8	68.3	6.5
Portugal	1.8	2.5	62	6.2
Denmark	1.9	(+)0.7	64.1	6.2
Sweden	1.9	0.8	53.4	6.5
United Kingdom	1.8	1.9	76.6	7
Greece	5.2	4	108.7	9.8
Reference value[(d)]	2.7	3	60	7.8

(a) Percentage change in arithmetic average of the last 12 monthly harmonised indices of consumer prices (HICP) relative to the arithmetic average of the 12 HI of the previous period.
(b) 1997 data.
(c) Average maturity 10 years; average of the last 12 months.
(d) Reference values as the basis for assessing economic convergence as described in the Maastricht Treaty.
Source: European Commission

Similarly, ten year bond yields have converged to be within 39 basis points in April of the German ten year yield. Convergence of cash rates is not as marked as for long term yields; nonetheless, it has largely occurred, with Italy, Spain, Portugal and Ireland being the only outliers.

Progress with meeting fiscal deficit and debt requirements has been more mixed. Nonetheless, the Commission's forecast is for further improvement. The EMI is insisting that further progress be made in reducing general government deficit and debt ratios.

Fourteen member States had government deficits of 3 per cent of GDP or less in 1997. While the majority of States did not report government debt levels below the Treaty reference (60 per cent of GDP), the Commission concluded that the conditions are in place for the continuation of a sustained decline in debt ratios in future years.

THE EURO AREA

The economic and commercial weight of the euro area will be comparable to that of the United States and larger than Japan. In 1996, excluding intra-community trade, the European Union accounted for 20.9 per cent of world trade as compared with 19.6 per cent for the United States and 10.5 per cent for Japan. The average degree of openness of member States of the European Union is currently 29.8 per cent, compared with 8.2 per cent for the United States and 9 per cent for Japan. If intra-community trade is excluded the degree of openness of the euro area is 10.2 per cent, similar to that of the United States and Japan.

While the size of Europe's economy is comparable to Japan and the US, Europe's overall growth performance has generally lagged that of both countries since 1961. From 1961-73 during a period of economic catch up associated with the development of the common market, Europe's growth performance did exceed that of the US and again, between 1986-90, following the introduction of the single market (of which monetary union is an extension). Despite this relatively poor growth performance, Europe's labour and total factor productivity has exceeded that of the US. The establishment of the euro zone will put increased pressure on European labour markets, particularly through greater product market competition and will highlight labour market inflexibility and regional differences. Governments will also find it increasingly difficult to meet budgetary costs of high unemployment. That said, Europe could support higher non-inflationary growth providing labour market and welfare policies are adjusted so as to encourage increased employment (most likely in the service sector).

Table 2: Economic Size of the Euro Participants and the Zone's Relative International Size

	GDP(a)	GDP(b)	Per capita GDP(c)	Population (m)
Germany	1862.6	33.54	22.7	82.2
France	1230.9	22.17	21	58.6
Italy	1009.6	18.18	17.8	56.8
Spain	466.6	8.40	11.9	39.3
Netherlands	317.2	5.71	20.3	15.6
Belgium	212.6	3.83	20.9	10.2
Austria	181	3.26	22.4	8.1
Finland	103.3	1.86	20.1	5.1
Portugal	90	1.62	9.6	9.4
Ireland	65.7	1.18	18	3.6
Luxembourg	13.7	0.25	32.6	0.4
Total Euro	5553.2	100.00		289.3
UK	1141.2		19.3	59
Sweden	201.5		22.7	8.9
Denmark	144		27.3	5.3
Total Europe	7039.9			362.5
USA	7185.9		26.9	267.6
Japan	3825.4		30.4	125.9

(a) 1997 ECU (billion).
(b) National GDP as a percentage of euro area GDP.
(c) GDP per head ECU (thousands).
ECU=US$1.09 27 March 1998.

CONDUCT OF ECONOMIC POLICY

Responsibility for economic policy will be shared between member States, the EC and the independent ECB. The relative responsibilities are provided for in various treaties and European Council decisions. Over time responsibility for fiscal policy and structural policies are likely to be implemented on a more coordinated basis. But, for the moment, national governments are largely responsible for their allocation of budget expenditures and the structure and level of taxation. The European Commission’s budget is also less than 2 per cent of EU GDP so its capacity for sizeable fiscal transfers is limited.

Operation of Monetary Policy

The Maastricht Treaty assigned responsibility for monetary policy, including the inflation target, to the ECB. (ECB operation of monetary policy is outlined in Box 1.) An essential feature of the ECB is that it will be independent of instruction from political authorities — both at the national and the EU level.

The national central banks in the ECB Governing Council will have to be independent from January 1999. The ECB decision-making authority is to be vested in a Governing Council. This Council will comprise the governors of the

(independent) central banks of the EMU states along with the members of the ECB Executive Board (consisting of the president, vice-president and four other members). The European Council appointed the Executive Board at the May EU leaders summit.[3] Each country's ECB capital subscription will be fixed in terms of its population and gross domestic product as a proportion of the EU total.

Box 1: ECB Operation of Monetary Policy

The ECB will conduct open market transactions, offer standing facilities and is likely to require banks to hold minimum reserve accounts with it. Open market operations will play the main role in controlling liquidity growth, steering interest rates and signalling the stance of monetary policy.

The ECB's main policy instrument will be a two-week repurchase agreement executed on a weekly basis. This will be supplemented by a three-month repo offered with a monthly frequency. There will also be fine tuning instruments such as quick tender repos or foreign exchange swaps.

All open market operations will be carried out by the national central banks for the ECB. Credit institutions will be subject to reserve requirements both with the ECB and with their national central bank based on a wide range of assets (which have yet to be narrowed down).

The open market windows are to be complemented by two standing facilities aimed at providing and absorbing overnight liquidity. National central banks will operate these facilities.

The ECB's tool kit of monetary instruments is seen as being very close to that of the Bundesbank and not much different to that of most other continental European central banks that are likely to enter EMU in 1999.

The likely operation of the ECB's communication strategy is as yet unclear. The Maastricht Treaty stipulates that the ECB can be required to report on monetary policy to the European Parliament, the European Council and the Council of Finance Ministers (ECOFIN). How the ECB will convey its thinking to the market on a regular basis has yet to be determined.

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3 The President of the ECB will be Wim Duisenberg, currently President of the European Monetary Institute. The Vice President will be Christian Noyer, a former French Treasury Director. The four remaining positions will be held by Otmar Issing, a member of the Bundesbank executive board; Tomasso Schioppa, chairman of Consob the Italian Stockmarket Regulator; Sirkka Hämäläinen, Governor of the Bank of Finland; Eugenio Solans, a board member of the Bank of Spain.

Operation of Fiscal Policy

Within the context of the Maastricht Treaty and the Stability Pact[4], fiscal policy has been assigned a medium-term orientation that supports monetary policy's role in maintaining price stability. The objective is to have 'budgetary positions close to balance or in surplus in normal cyclical positions so as to allow scope to deal with all but the most severe disturbances without breaching the 3 per cent general government deficit to GDP reference value'.[5]

In the transition phase leading to monetary union this has meant that most participating States have needed to implement sizeable fiscal consolidation programs. Moreover, in order to meet the Treaty requirement in relation to the ratio of public sector debt to GDP, the process of fiscal consolidation undertaken in 1996 and 1997 will need to continue in most countries.

The European Union as a whole had reduced the relative size of its general government deficit from 6.1 per cent of GDP in 1993 to 2.6 per cent in 1997. This budgetary consolidation was achieved by reducing the ratio of total expenditures to GDP from 52.4 per cent in 1993 to 48.7 per cent in 1997. The ratio of taxation to GDP has remained fairly constant at around 46 per cent of GDP.

Despite the progress that has been made in improving fiscal positions of member States, there is still concern that the fiscal positions of some members are not sustainable over the long term and that they are not ready to enter monetary union. That said, member States have convergence programs in place and these programs will be subject to ongoing scrutiny by the EC and the European Council of Finance Ministers (ECOFIN).

IMPLICATIONS OF CLOSER ECONOMIC INTEGRATION WITHIN THE EURO AREA FOR THE WORLD ECONOMY

The European Commission has argued that the economic cycles of euro countries are likely to become more synchronised (with closer economic policy coordination) and that greater cyclical synchronisation, combined with the size of the euro area, will make economic developments in the euro area more important in the world economy. Australia will be the euro zone's 27th ranked trading partner (this excludes the UK's trade with Australia). Australia's trade weight will be around 1 per cent of the index and will be below Malaysia, Thailand and Singapore in the ranking.[6]

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4 The Stability Pact, agreed in December 1996, strengthened arrangements governing fiscal policy following the commencement of the single currency. Countries failing to meet the excessive deficits criteria may face financial penalties.

5 European Commission II/33/98-EN.

6 HSBC Markets, 'Getting the measure of the Euro', March 1998.

It has also been argued that the economic performance of the euro area will be less sensititive to exchange rate fluctuations and that this will be positive for consumer and investor confidence within the euro area. Countries in Central and Eastern Europe which are seeking to join the EU will most likely seek to stabilise their currencies against the Euro.

INTERNATIONALISATION OF THE EURO

The economic size of the euro area means that the euro will be an important vehicle currency in international commercial transactions. For instance, assuming the euro's use as a vehicle currency for international transactions would be equivalent to that of the German mark today, then 30 per cent of world exports would be invoiced in euros. This is around the current level of transactions denominated in US dollars.

It is anticipated that the international use of the euro will over time extend beyond that of a vehicle currency for invoicing trade. The depth and liquidity of the euro market will increase the euro's attractiveness as an investment asset and a reserve currency for central banks.

The independence of the ECB may over time also promote the use of the euro as an anchor currency in international capital markets. The speed with which this role for the euro develops will in part depend upon the success of the ECB in gaining market credibility. Euro zone countries, however, should benefit from the internationalisation of the currency.

In addition to lower cost of funds, euro zone members will gain seignorage benefits and efficiency savings flowing from more liquid foreign exchange markets. These benefits have been estimated to be in the order of $US15 to 30 billion. Germany, however, is likely to lose some of its current seignorage benefits based on its share of ECB capital.

FINANCIAL MARKET IMPLICATIONS

The establishment of the single currency will create one of the world's largest government bond markets. However, the 11 sovereign issuers and the benchmark risk-free yield curve will take some time to become established. From commencement in January 1999, all new government bond issues will be denominated in euro and existing government bond issues will be redenominated into euro.

European financial markets and therefore government bond markets can be expected to retain a number of country-specific characteristics owing to differences in transaction costs and tax treatment. Importantly, the exchange rate risks for euro zone residents purchasing securities issued in another part of the zone will be removed.

While the yield on government bonds in the euro area is expected to converge (this process has already happened to a great extent for 10 year-bonds), complete convergence is not expected. Yield differences for individual government securities with similar maturity and coupon rates will reflect the market assessment of default risk and also the liquidity of particular stocks.

It has been argued that the default risk on euro zone sovereign issues will increase as EMU governments will lose the power to use their central banks to finance debt servicing through liquidity creation. The Maastricht Treaty also prevents the ECB from fulfilling this role.

Overall, the level of liquidity in leading euro market securities will be high and this can be expected to lower the risk-free interest rate borrowing costs for participants. Germany, France and Italy are all making changes to the operation of their debt management arrangements in order to be seen as the benchmark issuer at various points on the yield curve. While Germany is the front runner in terms of being the natural benchmark issuer, the possibility that France (and over time Italy) might issue benchmark sovereign securities on some parts of the yield curve should not be ruled out.

While the liquidity of the euro market will attract issuers and investors, this advantage will, in part, be offset by the correlation of yields making issues less attractive for investors seeking portfolio diversification. As well, the overall convergence of euro sovereign yields towards the Deutschmark yield means that the market may become less attractive to investors seeking higher yields. This may be an advantage to sovereigns with a high credit standing issuing in currencies that are not highly correlated with the euro.

LOOKING FORWARD

At the time the Maastricht Treaty was being prepared at the start of the 1990s many commentators viewed EMU as a high-risk economic and political adventure. The likely benefits of EMU were assessed as not being worth the potential risks (or that the desired benefits could be achieved by other means). Nonetheless, European Union member states have made considerable progress in terms of economic convergence: inflation rates are low and public sector budgetary positions have improved. These achievements, however, do not necessarily mean that monetary union will be stable over the longer term, particularly now that the euro zone will be a very broad grouping of countries which do not display the characteristics of an optimal currency area.

There is a concern that speculators might disrupt the establishment of EMU in the lead up to setting irrevocable exchange rates in January 1999, or in the period prior to national currencies being removed from circulation in 2002. While the possibility of this cannot be ruled out, based on stability of ERM currencies around their central rates and convergence of government bond yields (as

shown in Table 3), it appears that financial markets have assigned a relatively low probability to such an event.

Table 3: Exchange Rate Convergence ERM Members

	ECU Central Rate per DM	% Deviation from market rate 11.2.98	Basis Point deviation from 3m euro DM	Basis Point deviation from 10 year DM
France	3.35	0.1	0	2
Italy	990	-0.3	253	32
Spain	85.1	-0.4	109	22
Netherlands	1.27	0	56	-5
Belgium	20.63	0	13	8
Austria	7.04	0	0	9
Finland	3.04	0	-16	8
Portugal	102.5	-0.1	125	28
Ireland	0.415	4.3	250	28

Source: Lloyds Bank Economic Bulletin February 1998

Furthermore, once the euro is established in January 1999, speculation will only be profitable if a country decides to leave the arrangement — speculation will not affect the size of monetary aggregates in the zone, only the composition of currency in circulation. Despite the controversy associated with the appointment of the ECB president, financial markets did not react adversely and there appears to be confidence that current ERM central rates will be the effective bilateral conversion rates at the commencement of EMU.

While it seems unlikely that financial market activity will disrupt the commencement of EMU, its ongoing operation is not assured so long as participants remain sovereign States. Unemployment throughout Europe remains high and there are considerable differences in real incomes between members. Tensions between member States may emerge because of ECB actions to control inflation, differential productivity growth rates and policies to deal with unemployment. This may mean that some participants may decide to leave at some point in the future. The Maastricht Treaty however does not make any provision for that.

Once established, EMU will have a number of powerful forces working to ensure its stability. This does not mean that there is not scope for tensions to emerge and for external shocks to place the arrangement under pressure. How the European Union addresses these tensions will be important for its trading partners and the operation of the international monetary system.

Implications for Australia

While EMU will be an historic development for Europe and a significant development for world financial markets, it is difficult to conclude that it will have major ramifications for Australia in the short to medium term.

At least for the foreseeable future, EMU is not likely to challenge the US dollar as the benchmark currency in the world, nor is it likely to lead to any change to the system of liberal capital flows or flexible exchange rates vis-à-vis the US and Japan.

There may be some indirect effects, however, on Australia as a result of EMU. Principally these relate to the impact of EMU on Europe's competitiveness, its growth performance and its monetary policy settings.

The current improvement in Europe's growth performance should be underpinned by fiscal consolidation associated with the requirement of monetary union. Moreover, structural reform and further market liberalisation are being implemented as part of the development of the single market. This should be positive for both commodity prices and Australian export volumes. However, stronger growth may lift Europe's demand for capital, slowing outflows of foreign direct investment to Australia and lifting the cost of capital. On balance, stronger growth in Europe should be positive for Australia.

At present it appears that EMU will have a benign effect on current world interest rates. Contrary to earlier market expectations, euro interest rates appear to be converging towards current German rates. This should assist in maintaining world interest rates at their current levels. While this may be positive for European growth it could make the task of managing inflation more difficult for the ECB down the track. Asset price inflation is already evident in Ireland, Spain and the Netherlands.

US monetary policy has an important influence on world interest rates because it is the primary financial market. Over the medium term a successful euro may challenge the reserve currency role of the US dollar. In this eventuality the monetary policy decisions of the ECB will be influential on world capital markets, and accordingly on Australia. At the same time, the Australian financial market might benefit from investors seeking greater portfolio diversification once the single currency is in place.