SYMPOSIUM

EMU AND THE EURO: CURRENT AND FUTURE PROSPECTS

Introduction

Philip Arestis
South Bank University London

The EMU (Economic and Monetary Union) was founded in January 1999 with the launch of a single currency, the euro, which fixed (up to six significant figures) the exchange rates between the national currencies it would eventually replace. The EMU and the euro constitute a change in the economic, social, and political spheres of Europe. Inevitably, they have been the subject of intense debate. One crucial issue that has been addressed is the following: are the EMU and the euro in the interest of Europe? Indeed, what is the likely economic impact of the EMU and the euro, and their accompanying monetary institutions, the European Central Bank (ECB) and the Eurosystem? This is precisely the focus of this special issue, which not only assesses the current situation of the EMU and the euro, but also attempts to assess their future prospects.

In the first stage the euro was used exclusively for financial transactions. All transactions will be conducted in euros beginning in the first two months of 2002 (the precise dates and arrangements vary between countries). The euro has declined through most of the period of its existence from an initial value relative to the dollar of $1.18, to parity in December 1999, an all-time low in November 2000 of $0.82, and to around $0.84 at the time of this writing (July 2001). The future value of the euro looks rather uncertain, as do the factors that might account for its behavior. This special issue aims to analyze these key issues.

An interesting theme that runs through all the papers included in this special issue is the role of institutions in the conduct of monetary policy within the EMU. It is useful, therefore, to sketch briefly the main institutional elements of the EMU before we turn to the individual papers. The institutional arrangements accompanying the EMU and the euro involve the creation of the European System of Central Banks (ESCB), which is independent of political control with its operating arm, the ECB and the national central banks. The ECB's and the national central banks' sole policy objective is price stability, defined as a year-over-year increase in the Harmonized Index of Consumer Prices (HICP) of below 2 percent over the medium term for the euro area. The dominant feature of the ECB's institutional structure is the complete separation between the monetary authorities (in the form of the central bank) and the fiscal authorities (in the shape of the national governments that the EMU comprises), where the latter are constrained to keep their budget deficit below 3 percent according to the *Stability and Growth Pact*. The euro area is perhaps unique in having a "high level" monetary authority (the ECB) and in effect no "high level" fiscal authority with fiscal policy residing at the national level (albeit constrained by the *Stability and Growth Pact*). Under these circumstances, no substantive coordination of monetary and fiscal policies is possible, and in a sense the monetary authority has the last word, as interest rates are set frequently and can be adjusted to seek to offset any fiscal policy. It is also the case that the independence of the ECB and the national central banks places heavy constraints on any coordination of fiscal and monetary policy. For example, "neither the ECB, nor a national central bank, nor any member of their decision making bodies shall seek or take instructions from Community institutions or bodies, from any government of a Member State or from any other body" [Article 7 of *The Statute of the European System of Central Banks and of the European Central Bank*]. A strict interpretation of this clause would rule out any attempt to coordinate monetary and fiscal policies. Indeed the primacy of monetary policy over fiscal policy is guaranteed by the institutional structure and rules of the ESCB.

Iain Begg argues in his paper entitled "EMU: A Success Against the Odds?" that the first two years of EMU have been mixed. However, from the perspective of the euro area economy, its beginning has been surprisingly encouraging. A coherent policy framework has progressively been put in place. Fears that an overly cautious ECB would make decisions that resulted in a stagnating economy or a policy stalemate have not materialized. It appears that the ECB has started well and that the policy system as a whole is rising to the various challenges. There is also growing evidence that, for many countries, the move to the EMU has been accompanied by shifts in supply-side behavior that augur well for the sustainability of the single currency. Although the paper's assessment of the EMU as a macroeconomic policy system in the first two years of the single currency highlights a number of shortcomings, the euro so far seems to be more successful than expected. However, further improvements to the system are likely to be required.

In the second paper, entitled "The Markets versus the ECB, and the Euro's Plunge," Jörg Bibow concentrates on the ECB's monetary policy. He argues that factors in addition to the widely-held growth differential between the euro area and U.S. economies have caused the weakness of the euro. The paper examines whether the ECB's monetary policy has played a role in the euro's plunge. It is suggested that the ECB's on-going communication problem, which causes uncertainty and confusion in the markets, is particularly severe. The special time-inconsistency problem the ECB ran into, with the implication that its aggressive interest-rate tightening weakened rather than strengthened the euro, is viewed as a serious constraint. The analysis presented is in the liquidity preference theoretical tradition, as explicitly stated by the author.

A further ECB-related problem is discussed by Guglielmo Maria Caporale and Andrea Cipollini in their contribution entitled "The Euro and Monetary Policy Transparency". They focus on the lack of transparency of the ECB's monetary policy (especially when compared with other central banks, such as the Bank of England, which has been praised on the transparency issue) as a possible explanation for the weakness of the euro. In order to obtain a time-varying measure of monetary policy uncertainty in both the euro area and the United States (so that comparisons can be made), they estimate a stochastic volatility model using policy-adjusted short-term interest rates. They also analyze directly the impact of higher uncertainty on the euro-dollar exchange rate. The empirical findings are in line with those of other studies, and show that the U.S. Fed is more transparent than the ECB. This results in higher volatility of European interest rates, capital outflows and a weaker euro relative to the U.S. dollar. The early experience of the euro has been accompanied by these occurrences, an observation discussed extensively in the literature.

The lack of transparency and the other problems analyzed in the other papers, however, are only a subset of a number of reasons that may explain the falling value of the euro. This is the thrust of the argument of the next paper, "Explaining the Euro's Initial Decline," by Philip Arestis, Iris Biefang-Frisancho Mariscal, Andrew Brown and Malcolm Sawyer, which assesses a number of explanations for the decline in the external value of the euro. In the light of this assessment, they discuss the future prospects of the euro and of, more broadly, the eurozone. The authors argue that a combination of eurozone weakness, endogenous to the inception of the euro, and of U.S. strength, most plausibly explains the decline in the value of the euro. Whilst its future value remains uncertain, the future prospects for the eurozone will remain bleak as long as the current institutional arrangements underpinning the euro remain in place.

The next three papers offer a different perspective. The contribution that follows immediately concentrates on the fiscal front, while the remaining two extend the analysis in ways that embrace the more international character of the euro and its implications for the international monetary system.

Philip Arestis, Mosahid Khan and Kul Luintel in their paper entitled "Fiscal Deficits in Monetary Unions: A Comparison of EMU and the United States," suggest that the stringent deficit criterion followed by the EMU, as embedded in the Maastricht Treaty and in the Stability and Growth Pact, is motivated by the belief that a sustainable fiscal arrangement is an important prerequisite for a viable monetary union. An empirical analysis of the issue of deficit convergence in the euro area is provided, and a comparison and contrast of the eurozone deficit with the U.S. federal deficit is undertaken. On the basis of the results of this empirical investigation, and of the analysis offered in the paper, the authors offer four main conclusions: there is evidence of fiscal convergence in most of the euro area countries; the 3 percent fiscal criterion had been met by all euro area countries immediately before the launch of the euro; the magnitude and variability of fiscal shocks in the whole of the euro area is lower than in the United States; and the euro area is prone to smaller fiscal shocks than the United States.

The objective of the contribution that follows, entitled "The Euro as a Stabilizing and Harmonizing Force in the International Monetary System: Analytical Foundations and Future Prospects," by Jean-Pierre Allegret and René Sandretto, is to examine closely the hypothesis that the euro may contribute to creating a more pacified international monetary system in the long run. The creation of the euro should lead to radical changes, which are likely to bring about systemic effects in the organization of the international monetary system. This may very well arise as a result of a new situation in the international scene characterized by shared monetary leadership. However, the emergence of a truly bipolar monetary system with the U.S. dollar and the euro as dominant currencies will not be achieved overnight. It will require a long transitional period that is likely to be very turbulent. It is argued that the most appropriate theoretical framework for such an approach is "hegemonic stability".

Finally, in an exercise to examine the creation of the euro, its performance, and its relation to the U.S. dollar and the Japanese yen, Dominick Salvatore in his contribution "The Euro: Expectations and Performance" begins by concentrating on how the euro has performed in the real world since its adoption. Clearly, the expectations prior to its introduction had been euphoric, so much so that some contributors had been predicting that the euro would have seriously challenged the dollar as a world currency. The experience of the euro since 1 January 1999 has been rather less satisfactory than expectations. This is explained by reference to two factors: the expectations were inappropriate; and there is a long-term issue involved which would depend on the evolution of the euro on the international stage and its symbiosis with the other two currencies. The latter would further depend on the process of financial integration in the EMU and on developments in the internatonal financial architecture.

The overall conclusion of this symposium is that although the project of a single European currency is not inherently flawed, a great deal of change is necessary, mainly at the institutional level. This is especially true if the euro is to become the engine of economic growth not just in the eurozone but also worlwide, and to contribute to the creation of a more effective international monetary system.