THE EURO: A SUCCESS AGAINST THE ODDS?

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The decline in the external value of the euro, spats between political leaders and central bankers about the stance of policy, and Irish dismay about being criticized by the European Union Council of Ministers for having one of the world's highest growth rates have all been seized on by critics of Economic and Monetary Union (EMU) of Europe as evidence that the doubts expressed about the single currency are entirely warranted. While there are no signs yet that these disagreements will provoke armed conflict, it is tempting to conclude from the track record of the euro so far that the concerns articulated by the likes of Feldstein [1997] are proving to be well founded.

Yet viewed from the inside, the outlook for the European Union (EU) economy improved once EMU started in 1999. Growth picked up, unemployment fell without appearing to trigger inflation and, despite having been affected by the U.S. slowdown, the EU is suddenly being seen as the global region most likely to sustain the momentum of world economic growth. Whether this is because of, or merely coincident with, the introduction of the euro is a fascinating and tantalizing question. The aim of this paper is to look behind the headline critique of the euro to explore whether it has, in fact, been more of a success than its early external performance implied. This entails looking not just at the gyrations on the foreign exchange markets, but also at the degree to which the new macroeconomic policy framework in the EU has evolved and whether it can be expected to sustain the improved economic performance.

The next section of the paper looks briefly at some theory and expectations of how EMU would evolve. This is followed by a discussion of the introduction of the euro which, given what could have gone wrong, has been surprisingly smooth. The recent performance of the EU economy is then briefly reviewed and the heavily publicized fall in the value of the euro is then discussed. EMU, however, cannot sensibly be analyzed just by looking at the short-term macroeconomic indicators or the gyrations of the exchange rate. Instead, it is the viability of the policy system that matters, and the remaining sections of the paper focus on these matters.

THEORY AND EXPECTATION

The move to the single currency was extensively discussed in the academic literature prior to the formal introduction of the euro in January 1999. In addition to the more strident "pro" and "anti" contributions, several key themes emerged and it is instructive to review these in assessing what has actually happened since the euro came into being [Eichengreen, 1996]. The probability of asymmetric shocks and the

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consequences if they should arise has been a major preoccupation. Optimal currency area theory has been pivotal in shaping the debate [Melitz, 1995], although with the paradox that few authors believe that the EU is optimal [De Grauwe, 2000a]. An exposition is provided by Feldstein who claims that the "fundamental economics of evaluating any monetary union is a quite straightforward balancing of potential trade gains against macroeconomic losses" [1997, 32], a clear statement of the optimal currency area approach. His judgement is that this tradeoff will be negative for the EU countries, and he cites the dangers of increased cyclical volatility, a lessening of pressures to undertake structural reforms, and the prospect that monetary union will encourage a protectionist stance by the EU against the rest of the world.

Indeed, Feldstein's article provides an articulate statement of many of the arguments advanced against monetary union and can therefore serve as a template within which the early years of EMU can be evaluated. He argues that EMU lacks the mechanisms normally in place to promote output stability in a monetary union, which include:

- Homogeneity of the economies, which renders them less susceptible to shocks.
- Flexibility in labor markets that might facilitate adjustment.
- Mobility of factors of production to deal with asymmetric shocks.
- Fiscal transfers that can be used to achieve regional stabilization.

However, in an influential paper, Frankel and Rose [1998] made the important point that although countries forming a currency union may not fulfil the optimal currency area criteria in advance, they may endogenously become more optimal. The basis for this conclusion was the empirical finding that countries that trade more intensively with one another tend to have more closely correlated business cycles. Under EMU, the convergence in fiscal and monetary indicators that occurred in stage 2 has, arguably, reinforced the trade-induced trend towards currency area optimality presaged by Frankel and Rose in what they see as a manifestation of the Lucas critique. Indeed, the relevance of the optimal currency area approach has been questioned more generally given the extent of the regime change implied by the move to EMU [Kenen, 2000].

A second strand of literature turns on the credibility and commitment of the monetary authority—typically the central bank—in curbing inflation. Drawing on work on time inconsistency, several authors have come to the view that an independent central bank that has a conservative outlook [Rogoff, 1985] offers the best guarantee of price stability. (For a recent survey, see Berger et al. [2001]). However, some recent contributions to this literature suggest that the outcome will be affected by other factors, such as the stance of trade unions towards inflation and wage negotiators' perceptions of the central bank's approach. Piga [2000], in reviewing the theory and evidence on central bank independence, concludes that the case for independence is not as clear-cut as some believe and he also casts doubt on whether independence solves, rather than simply displaces the time-inconsistency problem. If unions believe that the central bank will restrain inflation whatever happens, they may be less inclined to moderate their demands [Cukierman and Lippi, 1999]. As a result, the relationship between monetary policy and the performance of the real economy is difficult to predict. One inference to draw is that an overly rigid rule-based policy would be inappropriate. Another is that the performance of the monetary authority has to be assessed in the light of parallel developments in, particularly, labor market behavior.

Will the European Central Bank (ECB) achieve credibility? Feldstein is highly skeptical, pointing out that the members of the Governing Council are appointed either by national governments (the national central bank [NCB] governors) or by the European Council (the six executive members, including the President). The implication is that they will lack a common purpose, let alone coherent views on policy. However, Genberg, in comments published as part of Dornbusch et al. [1998], argued that the risk that the votes of the national governors will be conditioned by national inflation preferences is negligible, with the stylized Italian or Spanish member softer on inflation than the German counterpart. In this regard, it is instructive that the ECB has not only operated by consensus rather than majority voting, but also shown no evidence of dissent. Indeed, even the much-publicized Irish contretemps does not seem to have been led to a schism on the Governing Council. This is not a surprising outcome given that central bankers tend to have a common outlook.

The conduct of policy in the euro area also has to be related to the model of the economy with which policymakers either have to, or choose to, work [Issing et al., 2001]. Although the Maastricht Treaty and certain other formal agreements establish ground-rules, it is also the case that the prevailing orthodoxy shapes the aims and strategies of those charged with implementing policy. Arestis et al. [2001], for example, argue that presently in the EU, there are four tenets of policy-making:

- Central bankers with a clear mandate will make better policy choices than politicians concerned with short-term electoral advantage. A related point is that rules are to be preferred to discretion.
- Monetary policy should target inflation, with the interest rate as the primary instrument.
- There is a NAIRU (non-accelerating inflation rate of unemployment) that determines the sustainable level of unemployment, although it is amenable to supply-side policy.
- Fiscal policy cannot have a lasting effect on the real economy and should, therefore, be aimed primarily at reinforcing stability.

Although central banks tend to have in common a preoccupation with price stability, there are differing approaches to targets and rules. Inflation targeting is advocated by many [Clarida et al., 1999] and has become the preferred option in many countries. In principle the two-pillar approach adopted by the ECB is different. It consists, first, of monitoring the growth of the money stock and, second, of taking account of a range of other variables thought to bear on inflation. Thus, although price stability is the mandate given by the Treaty, by setting an upper threshold of 2 percent increase in the harmonized index of consumer prices (HICP), the ECB does not formally engage in inflation targeting [European Central Bank, 1999].

Svensson is critical of the ECB's two pillar strategy and believes that the first pillar is redundant because monetary growth would naturally be one of a number of indicators considered under the second pillar. He therefore observes that "there seems to be no reason for giving a certain set of indicators of future inflation the status of a separate 'pillar' (rather than one of the bricks in the main pillar)" [2000, 97]. Yet it is clear that Svensson believes that the approach of the ECB, in practice, is not far from inflation forecast targeting based on conditional forecasts and he is sanguine about the outlook for European monetary policy. Yet it also has to be recognized that the Treaty does not give the ECB a mandate to adopt a Taylor rule [Taylor, 1992].

There are contrasting views on the desirability of coordination between fiscal and monetary policy in a monetary union. These overlap with concerns about the policy mix, the assignment of instruments to targets, and the underlying role of macroeconomic policy. Thus, Alesina et al. firmly believe coordination of fiscal and monetary policy is not needed. "[I]f the fiscal and monetary authorities 'keep their houses in order' acting on their own, there is no need for explicit coordination" [2001, xii-xiii]. Formal coordination would give national governments incentives to shirk their responsibilities, and may prove to be harmful. Informal meetings at which fiscal and monetary authorities are able to exchange information and understand each others' thinking are considered to be worthwhile. (See also Beetsma and Bovenberg [1998].) Others have, however, stressed that the absence of coordination is likely to make life more difficult [Eichengreen and Wyplosz, 1998; Leith and Wren-Lewis, 2000]

The necessity for some form of restrictions on the fiscal balance of countries participating in EMU has also been extensively discussed. Many economists were critical of the convergence criteria [Buiter et al., 1993] and apprehensive about the *Stability and Growth Pact* (SGP), arguing that it would restrict governments' ability to deal with specific adjustment problems [Eichengreen and Wyplosz, 1998], while others have been more supportive of a pact. Beetsma and Uhlig [1999] construct a model in which they show that although there is no real advantage for countries with independent monetary policy to sign up to a pact, the case is much stronger once there is a monetary union.

Artis and Buti [2000] argue convincingly that for a variety of reasons, it will make sense for EMU member states to aim for a fiscal policy close to balance over the medium term. Because this dovetails with the rules of the SGP, fiscal policy can only play a limited role in economic adjustment. Once the exchange rate is no longer a policy tool, countries need to rethink using other policy instruments to deal with shocks of various kinds. The principal options fall under the loose heading of supply-side policy and encompass labor market reform, regulatory change and, potentially, a recasting of social protection. To some extent, the employment strategy can be seen as creating one such mechanism.

Dornbusch et al. [1998] set out three challenges for the ECB in developing a European monetary policy to supersede the previous German monetary hegemony: to move forward while maintaining continuity with past policy; to conduct policy to achieve European-wide rather than national objectives; and to understand the various aspects of the monetary transmission mechanisms across the euro area. The third is especially problematic because the Lucas principle suggests that the move to a single currency will significantly change wage-price processes and how financial markets respond. Dornbusch et al. observe that "shooting at a moving target in the fog is no easy task" [1998, 52].

The various contributions suggest that the success of the euro so far has to be judged on a range of criteria. On the whole, these can only be assessed qualitatively because the elapsed time is simply too short to permit econometric estimation, especially when Lucas critique considerations are taken into account. It is also important to recognize that success is not just about the short term, and that any seeds of future problems have to be taken into account. Three broad categories of criteria can be identified:

- Whether the transition to the euro has been successfully achieved. This has both institutional and practical elements, including the techniques adopted for monetary management.
- The outcome in terms of relevant macroeconomic variables. These include both target variables such as growth and the inflation rate, and intermediate variables such as the exchange rate.
- Whether the policy system is developing in a way that will allow the euro area to function effectively, bearing in mind that a new system is bound to take time to bed in and will, in any case, evolve.

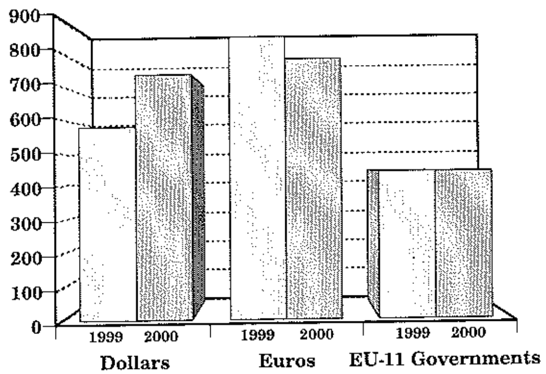
INTRODUCTION OF THE EURO

Bearing in mind that it constitutes a major recasting of governance structures [Kenen, 1995], it is remarkable how little disruption has accompanied the introduction of the euro. Once the list of the first wave of members was decided in May 1998 and the parities set, there were no attacks to speak of on the supposedly vulnerable currencies. Technical aspects of the process, such as the setting up of payments systems or issues surrounding legal contracts in "legacy currencies," have been achieved on schedule. The establishment of the new decision-making machinery for monetary policy has appeared to allow a seamless transition from the previous national arrangements, so that although the presentation of policy has been consistently criticized, there were few complaints about the conduct of monetary policy until the spring of 2001 when the ECB came under pressure to follow the U.S. Federal Reserve Bank (the Fed) in cutting interest rates.

Despite the presentational shortcomings, the implicit dialogue on which monetary policy relies, which consists of the exchange of coded signals and hints between central bankers and market actors seems to have transferred with few hitches. Indeed, the much more transparent approach of the ECB (compared with, say, the more Trappist attitude of the Bundesbank) has not obviously led to confusion in the markets about the ECB's intentions, when confusion could easily have arisen. In short, none of the many worries about what could have gone wrong has proved to be correct.

Although its commercial use has been slow to take off, the euro has enjoyed immediate success in corporate bond markets. According to the OECD [2000], in 1999 issues of euro bonds as a proportion of the world total were 10 percent above legacy

FIGURE 1
Bond Issues 1999-2000



Schroder Salomon Smith Barney

currencies' share the previous year and higher than the dollar as a share of the total at 45 percent compared with 43 percent. Schroder Salomon Smith Barney [2001] produce figures for international bond issues that tell a similar story (Figure 1) for 2000, with euro issues continuing to exceed dollar issues. In reviewing the euro's first year, this success in the bond markets was attributed by the OECD [2000] to four factors:

- Relaxation of currency restrictions
- Improved attractiveness relative to government bonds as yields fell
- Increased supply and a willingness by the market to accept high-yield bonds
- Financing of corporate restructuring

Some of these factors have more to do with the easing of restrictions as the single market for financial services across the EU becomes consolidated, than with the euro. However, the buoyancy of the euro-bond markets is adjudged by market participants to be a signal that the euro has achieved immediate credibility in the corporate finance arena [Trichet, 2001; Schroder Salomon Smith Barney, 2001].

Drawbacks

Despite establishing a sound base, the euro has had difficulties other than the loss of external value. First, as shown by polls by Eurostat and others [Blanchard and Cottrell, 2000] it has had trouble attracting public support, which has been aggravated by the slide in value. The lack of support is in part due to question marks over transparency and accountability in the decision-making process (see the debate between Buiter [1999] and Issing [1999]), although the efforts made by the ECB to explain its thinking and decisions have, arguably, made it more transparent than might have been expected from central bankers brought up in the continental European tradition [de Haan and Eijffinger, 2000]. Winkler [2000] argues that transparency tends to be interpreted too crudely and suggests that the key issue is not how much information is provided or the clarity with which it is presented, but whether the signals are correctly understood.

A second problem is that policymakers have been slow to react to the perils of the one-size-fits-all interest rate. The reprimand issued to Ireland is a case in point. Inflation rates have also diverged: Ireland today would not pass the Maastricht convergence criteria because of its current rate of inflation. Yet it also has to be recognized that in a currency area with different price *levels*, some correction is not unhealthy, which implies differing rates of inflation in the short term, while there is no guarantee that a system will be ideal for a particular country at a particular time [Frankel, 1999]. Moreover, as Carlino and de Fina [2000] show U.S. regions exhibit differences in inflation rates and the incidence of monetary policy. If the argument of Dornbusch et al. [1998] is accepted, though, allowing difficulties in individual countries to influence the monetary policy decision would be a mistake.

The third problematic area is broader economic policy coordination. Although various initiatives have addressed this issue, as explained below, this is still an unsatisfactory area. Ironically, from a euro-sceptic viewpoint, it is more the weakness than the overbearing character of "Brussels" or "Frankfurt" that is at fault. Fiscal policy remains, formally, a competence of the individual EMU member states, although freedom of action is constrained by the SGP, which imposes limits on public deficits, thereby limiting the risks that monetary policy will be subject to unreasonable and conflicting demands. This means that if a country has to deal with more severe economic shocks, it may be unable to do so under the terms of the Pact [Eichengreen and Wyplosz, 1998]. The Pact, moreover, has an built-in asymmetry in that it sets limits to national deficits, but imposes no rules on public surpluses. Thus (as the recent contretemps over Ireland showed) it can do little to influence the conduct of policy in countries that have robust public finances. There is, therefore, a coordination issue to resolve if the aggregate fiscal policy of the euro area is to be consistent with monetary policy [Leith and Wren-Lewis, 2000].

Gradually, the institutional machinery to achieve this has been put in place through measures such as the Broad Economic Policy Guidelines—agreed annually between the European Commission and the Council—and the establishment under the so-called "Cologne Process" of the macroeconomic dialogue. It is open to question, however, whether this goes far enough. For example, Jacquet and Pisani-Ferry [2001] argue strongly for a strengthening of fiscal coordination, advocating a bigger role, in particular, for the Eurogroup—the informal forum of the finance ministers of euro area participants. Equally, robust opposition to more extensive fiscal coordination is expressed by Alesina et al. [2001].

THE PERFORMANCE OF THE EU ECONOMY

While the Clinton-Greenspan boom was in full swing, the relatively pedestrian performance of the EU economy was easy to deride. The recession of the early 1990s cast a long shadow and the recovery was, arguably, inhibited by the demands of phase 2 of EMU under which governments had to consolidate their public finances. Table 1

TABLE 1
The Macroeconomic Performance of the Euro-zone Compared

	1986-90	1991-95	1996-98	1999	2000	2001(e)	2002(f)
GDP growth(%)							
Euro area	3.4	1.6	2.2	2.5	3.4	1.6	1.3
United States	3.2	2.4	3.8	4.1	4.2	0.9	0.5
United Kingdom	3.3	1.6	3.8	2.3	2.9	2.3	1.7
Inflation(annual rate, %)							
Euro area	4.0	4.0	2.0	1.2	2.4	2.8	1.8
United States	4.0	3.1	2.5	2.2	3.3	3.0	1.8
United Kingdom	5.9	3.4	2.7	1.6	2.9	1.8	1.5
Unemployment rate (%)							
Euro area	9.3	10.2	11.1	9.9	8.9	8.3	8.6
United States	5.9	6.6	5.0	4.2	4.0	4.7	5.9
United Kingdom	9.0	9.5	7.1	6.1	5.5	5.1	5.4
Current account balance of payment, (% of GDP)							
Euro area	0.7	−0.2	1.2	0.4	−0.1	0.4	0.4
United States	−2.3	−0.9	−1.8	−3.3	−4.4	−3.7	−3.3
United Kingdom	−3.2	−1.6	−0.3	−2.1	−2.0	−1.9	−2.9

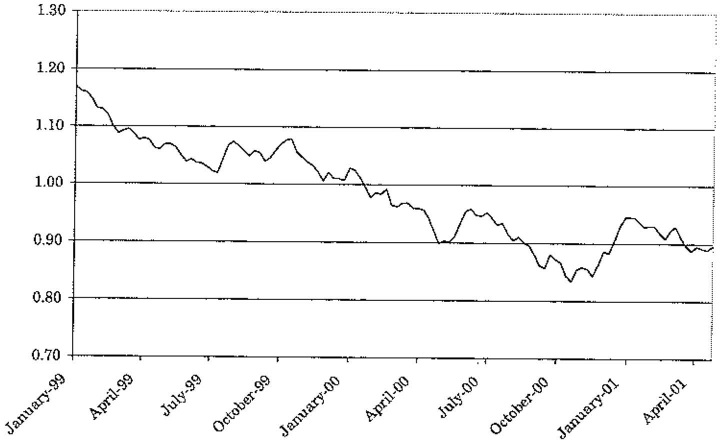
European Commission, 2001.

compares the euro area performance on the main indicators with those of the U.S. and the UK, the latter notoriously ambivalent about EMU. The comparison emphasizes the persistence of high unemployment in the euro area relative to the United States and the relative sluggishness of growth since the mid-1990s. The one area where the euro area has clearly out-performed the United States is the current account of the balance of payments, which has progressively deteriorated in the United States, while remaining favorable in the euro area. There is, however, little to choose between the three areas in inflation.

What is perhaps more significant is that the euro area macroeconomy picked-up in 1999 and 2000, although it is now clear that the EU has not been able to avoid being affected by the U.S. slowdown and is expected to have only low growth in 2002 [European Commission, 2001]. Core country growth was reasonably healthy until the summer of 2001, but the German economy, in particular, has been sluggish and dipped into recession in the second half of 2001 Although countries elswhere were, to a degree, over-heating–for example, Ireland and Finland–the danger signs were, perhaps, over-stated. Indeed, there is a certain irony in the fact that it is the peripheral countries of the EU, about which fears have regularly been expressed, that grew most rapidly in the early years of EMU.

The underlying performance of the EU economy has been a source of worry for some time and there have been repeated calls for reforms on the supply-side of the EU economies [Fagerberg et al., 1999], especially since the publication of the Commission White Paper *Growth, Competitiveness and* Employment [EC, 1993]. Monetary union *per se* does not affect the urgency of securing such change, except in so far as greater flexibility on the supply-side might facilitate the functioning of EMU. In

FIGURE 2
Euro: Dollar Exchange Rate



this regard, it is worth noting that there are significant differences between the members of the euro area and that far-reaching transformations have taken place in some countries such as Ireland or the Netherlands [O'Donnell, 2000; Visser and Hemerijck, 1997].

THE FLUCTUATIONS IN THE EURO

The most visible characteristic of the euro in its first two years was its external value which fell almost continuously from its inception at the beginning of 1999 to the autumn of 2000 (Figure 2). Yet, at the time of its launch, press comment suggested that the euro was expected to be a strong currency and the principal rival to the dollar. Critics of the whole enterprise have had a field day, with the British euro-skeptic press, especially, enjoying an almost daily dose of *schadenfreude*.

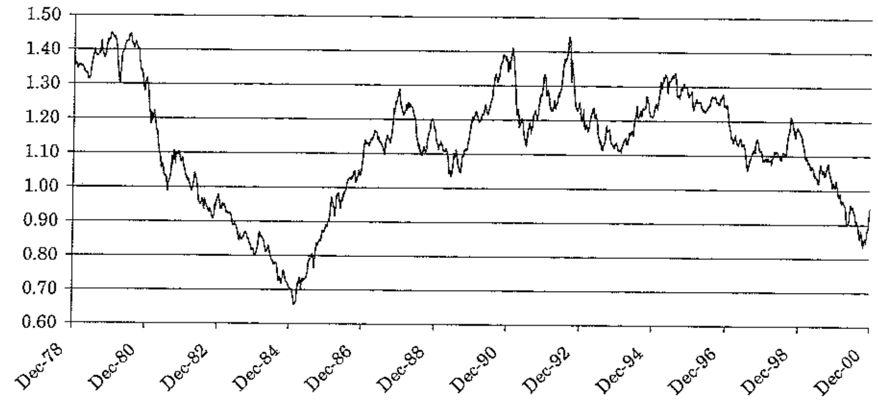
By late summer 2000, there was a growing consensus that the fall in the euro had gone too far, was not warranted by fundamentals and risked destabilizing the international financial system [Trichet, 2001]. A first attempt at concerted intervention by leading central banks, followed by further unilateral interventions by the ECB, began to shift market sentiment, which then turned abruptly in November 2000 as it became more clear that the U.S. economy was hitting the buffers. Can the fluctuations be reasonably explained and, if so, do they shed any light on the long-run viability of the euro as the EU's single currency?

Explanations for the Fall

Many reasons have been put forward to explain the initial fall in the euro, but given the context of a newly-introduced currency in volatile financial markets, it is improbable that the relative contributions of different factors can be convincingly quantified. Work by De Grauwe [2000b], Alesina et al. [2001] and Blanchard and Cottrell [2000] that tries to explore the question analytically has been complemented by a plethora of notes and briefings by market participants. From this welter of information, six main categories of explanation can be discerned:

- The launch rate had been bid up implausibly by the markets. In May 1998, when the parities for the eleven launch members were announced, the equivalent exchange rate was $1.11 to the euro. By the beginning of 1999, the rate had risen by 6 percent, partly fueled by market anticipation of a strong euro, despite the fact that the trend at the time was towards monetary easing in the euro area and tightening across the Atlantic.
- Interest rate differentials in favor of the dollar were positive throughout the euro's first two years and, as just noted, widened in the course of 1999, with the gap only beginning to narrow in mid-2000. Against the backdrop of quiescent inflation in both areas, it can be argued that there were incentives to purchase dollars. Cohen and Loisel [2000] take this argument a step further and present evidence that the policy mix in the euro area (tight fiscal policy relatively loose monetary policy) is the explanation. After the interest rate cuts by the Fed in the first four months of 2001, bringing U.S. rates below euro rates, it would (other things being equal) be reasonable to expect the euro to rise, but although it has edged up, market sentiment has still been negative.
- Market perceptions were also influenced by the apparent stagnation of the EU economy compared with the booming United States, with market sentiment appearing to equate economic growth with currency strength. Why markets should have adopted this view is unclear, although De Grauwe [2000b] argues that the fundamentals of the two economies certainly did not justify it. Instead, he suggests that markets, confronted with an array of often contradictory flows of information, tend to anchor sentiment in a limited number of key variables. In 1999 and 2000, growth happened to be the focus, but De Grauwe goes on to observe that "if the gap between beliefs and facts becomes too large, a turnaround in the exchange rate is imminent" [2000b, 28]. Another possible rationale is that in a booming economy, profits would be expected to rise, fuelling capital inflows attracted by the investment opportunities. On the other hand, rapid growth typically causes a surge in imports that leads to the sort of deterioration in the current account of the balance of payments seen in the United States. Moreover, it is difficult to see how relative growth as an explanation works as well for the fall in the euro against the yen, with the stagnating Japanese economy (see also the article by Salvatore in this issue).
- A fourth explanation is that the relevant financial flows were predominantly portfolio and direct investment lured by booming U.S. equity markets (the NASDAQ factor) and acquisitions in the United States by euro area companies. According to Blanchard and Cottrell [2000] there was net outward investment of some euro 147 billion in 1999, although not all necessarily to purchase dollar assets. Cohen and Loisel [2000], however, argue that the European stock markets performed as well as the U.S. ones in 1999, casting doubt on this argument. With the subsequent fall from grace of U.S. technology stocks, any effect is likely to unwind and there are reasons to expect a wave of corporate restructuring in Europe that would tend to attract external financing.
- Poor and inconsistent presentation by different euro area agents has had an effect on market perceptions of the euro. Most notoriously, the interview given, on the record, by ECB President Wim Duisenberg in October 2000 to *The Times of London* reinforced the sense that there was no coherent policy. In part, this is the result of the assignment of policy competencies within EMU, with the exchange rate policy formally remaining with Finance Ministers, despite their inability to control the key policy instruments affecting it.
- Finally, the fall in the euro is by no means unprecedented. As Figure 3 shows, the movements in the three years from the spring of 1998 are well within the range seen in the mid-1980s when the ECU fell to 64 U.S. cents.[1]

FIGURE 3
Euro (ECU): Dollar Exchange Rate



Taken together, the first five explanations could easily account for the movement in the euro since its inception, while the fact that the recovery at the end of 2000 saw a 10 percent rise in the euro from its low point also has to be borne in mind. A salient point is that neither the euro area nor the United States is an open enough economy (with export or imports at around 12 percent of GDP in both cases) for exchange rate fluctuations to have that great an impact. Indeed, the obsession with the external value of the exchange rate is a puzzle to many economists [Alesina et al., 2001].

The Rise Since the Autumn of 2000 and Prospects

Although the interventions by the ECB and other central banks in September 2000 took the markets by surprise, they did not immediately halt the downward drift of the euro. However, they appeared to set a floor to the fall by gradually convincing the markets that the fall had gone too far [Trichet, 2001]. Moreover, the chorus of voices stating that the parity was too low was swelling, so that once indicators of U.S. economic slowdown became more unambiguous, the long-awaited "correction" of the euro occurred surprisingly quickly.

Several of the factors that lay behind the fall in the euro now look to have reversed themselves. Interest rates have converged, the euro area is now forecast to grow more rapidly than the United States over the next two years [IMF, 2001; European Commission, 2001] and policymakers seem to have learned to be more disciplined in statements that could affect the parity. In addition, there are reasons to believe that the flow of capital will now tend to favor the EU as international investors adjust their portfolios and the status of the euro as an enlarged domestic currency is consolidated [Adjaoute et al., 2001]. Other factors include the auctions of telecom licenses in the EU, the prospect of an upsurge in merger and acquisition activity and catch-up investment. On balance, therefore, the likelihood is that the euro will rise further in the short to medium term. It remains an open question, however, how volatile the euro will be. Ricci and Isard [2001] construct a model in which they show that the outcome will depend on whether any shocks predominantly affect large or small economies.

THE POLICY STRUCTURE

Short-term movements in the exchange rate do not, however, reveal much about the long-term viability of the single currency. Instead, the criterion by which it should be judged is whether it can provide convincing macroeconomic policy. In this respect, the euro area policy framework has been subject to a number of criticisms, particularly in relation to fiscal policy and the problems of assuring coordination both between member states and with monetary policy [Eichengreen and Wyplosz, 1998]. Peter Kenen argues that the two key questions are:

> Does the formation of a monetary union increase the need to constrain or coordinate national fiscal policies? Does it require a centralized, union-wide system of built-in fiscal stabilizers? [2000, 24]

However, it also must be recognized that EMU alters the balance between supply- and demand-side policies in economic management, and that policymakers consequently have to look afresh at the mix of instruments used to steer their economies [Muscatelli and Trecroci, 2000]. Structural reforms may be warranted for other reasons, notably to boost the underlying capacity of the economy, but they can also provide a means of compensating for the loss of the exchange rate as an adjustment mechanism [Begg and Hodson, 2000; Bayoumi and Prasad, 1997].

There are differing views on the character of industrial relations systems [Snower and de la Dehesa, 1997], and thus on how easily countries will adapt their labor markets to EMU. Because monetary union and the curbs on fiscal policy restrict flexibility on the demand side, new approaches on the supply side will be needed. But given the dearth of EU policy instruments, there are clearly major differences between the United States and Europe in the scope for achieving adjustment [Nickell, 1997]. Vinals and Jimeno [1998], while acknowledging that EMU could lead to labor market problems, stress that significant adaptation of, and by, labor market actors is to be expected.

The Conduct of Policy

The architecture of demand-side policies under EMU is clear. Monetary policy is assigned the primary task of assuring price stability, leaving fiscal policy—which remains under the jurisdiction of national governments—to deal with country-specific macroeconomic problems. The *Treaty on European Union* assigns responsibility for monetary policy to the European Central Bank. Unlike the Fed, with its dual mandate to promote price stability and the level of employment, the ECB is given the sole primary task of assuring price stability. The Treaty article then refers to "general economic conditions," but stipulates that any action by the ECB to affect these should be "without prejudice" to the objective of price stability. There is, thus, a hierarchy of objectives. Although the Council of Ministers is responsible for exchange rate policy, its power in practice is confined to institutional arrangements, because the Finance Ministers are not able to vary monetary policy instruments.

The stance of monetary policy in the euro area was looser than might have been expected in the first years of EMU, although it has been judged by most commentators to have been about right for the euro area economy, even though the external value of the currency fell [Alesina et al., 2001]. No doubt, the fact that the French, German and Italian economies were in similar cyclical positions helped, while the more extreme outliers, such as Ireland and Finland, are too small to have much weight in the decision-making. If, in future, the French economy, for example, begins to expand more rapidly than the German economy then monetary policy will be faced with tougher choices. In such circumstances, the maintenance of price stability in the euro area could entail an increasingly asymmetric monetary policy which would calm French inflationary pressures at the cost of inducing stagnation in Germany.

Does the divergence in inflation rates in the euro area signal that there is a latent problem that could pose a severe challenge for monetary policy if nothing is done to correct it? The answer hinges on the degree to which the regime change that the single currency undoubtedly is has induced sufficient behavioral change. Other factors, such as the Balassa-Samuelson effect, also have to be taken into account. This effect arises where countries differ in their price levels for non-traded goods, whereas they face common prices for traded goods. In these conditions, as the country with the low prices for non-traded goods becomes more integrated, it can expect to see relatively higher overall inflation as prices in the non-traded sector adjust upwards. Provided that the change in the price level for non-traded goods does not feed into the traded sector, the catching-up country can remain competitive even though it has a higher headline inflation rate. Clearly, the arithmetic in this regard is important. Alesina et al. [2001] show that claims that the gap between Irish and Spanish inflation and the euro area average are largely attributable to the Balassa-Samuelson effect are exaggerated. Thus, in 1999-2000, they suggest that only about half the excess inflation (averaging 2.5 percentage points above the euro area level) in Ireland can be accounted for by the effect, implying that the rest comes from overheating. In Spain, where productivity growth has been slow, with growth coming mainly from an increase in the employment rate, the Balassa-Samuelson effect, if anything, ought to have dampened inflation.

These calculations could be taken as evidence that the one-size-fit-all monetary policy in the euro area will become unstable, especially if interest rates continue to be set too low to curb inflationary pressures in the Irish and Spanish economies (the Walters critique). Yet it also has to be recognized that the changes in how the Irish and Spanish economies react to high demand (Finland is, arguably, in a similar position) have been profound. There are too few observations so far to conduct a comprehensive econometric test of this proposition. However a simple examination of the output gap and the inflation rate for these countries compared with pre-EMU trends from 1984-98 provides striking evidence of a favorable shift. For Spain and Finland, the tradeoff in the last three years has been much better than in the past while Ireland had an improving trend even in advance of EMU. Whether or not the promise or fact of EMU is the cause of this shift is beside the point. What matters is that these countries appear to have changed.

Broader Economic Policy

Structural reforms are seen by many as the key to improved economic performance in the euro area [Calmfors, 1998]. Nevertheless, the demand side should not be neglected and Arestis et al. [2001] argue for a Full Employment, Growth and Stability Pact based on Keynesian rather than monetarist principles as a means of rebalancing policy in the euro area, with the implication that more active policy intervention should occur. The stance of the ECB is, however, clearly articulated by Issing who states that "fiscal laxity, far from enhancing the flexibility of public finances as macroeconomic shock absorbers, only ties the hands of policymakers in the long run" [2000, 1].

Although examination of output gaps implies that some member states are closer to their structural capacities than others, all are adjudged to be in need of structural reform to improve their respective economic performances. The watchwords here include flexibility, liberalization, corporate governance, and welfare reform. Germany and Italy are regarded as the laggards, whereas the Netherlands and the UK, which, respectively, suffered the Dutch disease and was the sick man of Europe in the 1970s, have been most adept at reform. Some of the smaller economies, notably Denmark, Ireland, and Finland, have made great strides during the 1990s, whereas Greece and Belgium have, arguably, been slower to act. In principle, the Lisbon European Council held in March 2000 provides a setting for the examination of such problems and extends the scope of coordination. Notably, it provides that such matters to be revisited each year.

As Jacquet and Pisani-Ferry note in suggesting that it is not sufficient to look at coordination only in the context of fiscal policy and the policy-mix, "structural policies affect potential output and thereby also the environment in which the ECB has to decide its interest rate policy. If ...structural reforms ... boost potential output, ...the ECB would take this into account and make room for faster growth" [2001, 8]. The trouble is that the traditional EU approach of policy harmonization has acknowledged shortcomings. It is legislatively cumbersome and inflexible, and evokes adverse reactions from member states concerned about ceding power to Brussels. An alternative approach of setting targets, as in the Maastricht convergence process, has the limitations of tending to be one-dimensional and being subject to the risk that once any targets are attained, it is unclear what happens next. Quite apart from any risks that governments will free ride, therefore, it is far from obvious that they will have incentives to cooperate.

Scope for better policy coordination is, however, being afforded by enhancing the role of key committees and by the initiation of the macroeconomic dialogue following an agreement reached at the 1999 Cologne European Council. Although the Treaty only recognizes the Council of Finance Ministers of all fifteen member states (ECOFIN), the informal group of (twelve) single currency finance ministers now known as the Eurogroup (formerly Euro-11) has been set up to deal with issues that only affect the "ins". The work of these two political groupings is complemented by two other committees whose membership is made up of civil servants: the *Economic Policy Committee,* which focuses on long-term economic change and the *Economic and Financial Committee,* which focuses more on macroeconomic issues.

Using data for the EU and OECD countries from 1961 to 1998, Mayes and Viren [1999] find evidence of considerable non-linearities and asymmetries in the Phillips and Okun curves. High unemployment, they find, has a relatively limited effect in pulling inflation down compared with the inflationary consequences of low unemployment. Moreover, they find significant difference between the Phillips and Okun curves in different member states. The impact of disinflationary policy in Spain, for one, was noted to be both slower and milder than in other member states. This means, in effect, that there are clear asymmetries in the relationship between demand pressure and the propensity to wage inflation in the euro area. As a consequence, the GDP weighted aggregate of individual member states could, in this sense, lead to erroneous monetary policy in the euro area, which ignore the specificities of national economies.

LIKELY DEVELOPMENTS IN THE POLICY STRUCTURE

Gradually, the lacunae in the EU policy framework are being dealt with, and it is noteworthy that this is the result of innovations in the policy process, rather than the resolution of problems along conventional lines. Political imperatives rule out supranational fiscal policy and there is little prospect of the EU budget being changed from its current role (largely, funding agricultural policy and regional development) or its level of just over 1 percent of EU GDP [Begg, 2000]. The Euro-group is seen as the most likely forum for reaching political agreement on policy and an enhancement of its role has regularly been canvassed, notably by French commentators [Jacquet and Pisani-Ferry, 2001].

Supply-side coordination is also inhibited by political sensitivities, and in response the EU has come up with a new approach dubbed the open method of coordination (OMC). The essence of this is to agree to common objectives and guidelines to steer policy, but to leave implementation to the member states. This new style of EU economic policy-making has gradually come to the fore. It is one which, arguably, reflects the preferences of the larger member states that are most reluctant to cede powers to Brussels rather than the more *communautaire* of countries. The policy style has a number of characteristics:

- First, while it gives the European Commission an important role in orchestrating policy, implementation is strictly reserved for the member states. In this way common objectives, such as boosting employment, are agreed, yet subsidiary in policy-making is respected.
- Second, there is increased use of sharing of experience, benchmarking and related techniques aimed at securing better policy by comparing approaches in different jurisdictions. This is at its most developed in the "Luxembourg Process," the agreement that governs EU employment policy and its coordination. Member State provide examples of good or innovative practice in their "National Action Plans" for employment and there is scrutiny of each country's approach by both their peers and the European Commission.
- Third, the new approach is one that achieves coordination of the policies that complement monetary union, without the need for constitutional amendment.

This amounts to soft pooling of policy, with differing degrees of formal assignment of competence to the EU level. Fiscal policy has the underpinning of the Stability and Growth Pact and the corresponding Treaty articles on excessive deficits. Employment policy coordination is based on the Employment Title added to the Treaty at Amsterdam, but with much less specific guidance in the form of either prescriptive Treaty articles or directives. Coordination of social policy is softer still, yet is manifestly an area in which there will be a long-run need for concertation of policy from a macroeconomic perspective under EMU.

OMC is not, however, a panacea and is open to a number of criticisms. Equally, as a novel approach to integration it has the potential to be developed in diverse ways. Using it more extensively could help to extend OMC as a policy approach as well as offering a way forward for policy areas, such as social policy, that risk treading on national sensitivities. Its principal advantages are that it provides the means to move toward common solutions to common problems without demanding the sort of harmonization that would be anathema to many governments, and that it can be implemented by governments without recourse to major and potentially contested legislative change. Moreover, by allowing countries to shape national programs within common guidelines, OMC allows governments to weight their policy packages appropriately.

VERDICT

Is the euro a failure? Judged by the evolution of the EU economy since it was introduced, it is doing well. A Center for Economic Policy Research (CEPR) report gives a cautious approval to ECB decision-making on interest rates, but is more doubtful about the Bank's two-pillar approach to monetary policy [Alesina et al., 2001]. Fears that an overly cautious ECB would make decisions that resulted in a stagnating economy or a policy stalemate have, so far, proved to be unfounded, but this could be attributed to the economic cycle as much as to the influence of EMU *per se*. There are, however, good reasons to believe that the ending of the uncertainty about the start of monetary union and of the fiscal retrenchment associated with the convergence process has been instrumental, but it is clearly too early to say that a new era has dawned [Eichengreen and Ghironi, 2001].

What can be stated more robustly is that the ECB has had a good start and that the policy system as a whole is rising to the challenges. As Trichet [2001] points out, the technical side of the introduction of the euro—setting up the institutions and procedures; the development of the TARGET payments system—has passed virtually without a hitch. Monetary policy decisions appear to have been well-judged and the overall stance of policy seems to have been conducive to stable growth. Although inflation is currently a fraction above the ECB's announced target of 2 percent, it would be hard to argue that price stability is in any jeopardy. ECB Chief Economist Otmar Issing, not normally given to hyperbole, summarizes the achievement thus:

> After years of dire warnings it came, I suppose, as a somewhat puzzling surprise to many that the birth of the euro proceeded as smoothly as anyone could have hoped for. Indeed, it was a resounding success. The process of the change-over to the euro was virtually free of technical faults. We created almost overnight a unified money market, which—notwithstanding formidable transaction overload—functioned from the very start almost without frictions. Short interest rate volatility remained well contained, and the main refinancing operations, along with the standing facilities and the reserve requirement system with averaging provisions, have since guaranteed money market developments closely in line with the ECB's intentions. Above all, long-term bond yields in the euro area reflect the confidence that informed investors place on the ECB. Surveys of inflation expectations, which account for the trust and the credit that the general public accords to a currency, are persistently in line with our medium term objective of price stability. [2000, 1]

Will the next stages of development of EMU witness more problems than the first three years? It can be argued that over and above the trade impact foreshadowed by Frankel and Rose [1997], there is an additional respect in which the regime change induced by EMU may have been underestimated. This is that the behavior of economic agents may have changed radically in a way that may be engendering endogenous optimality of the euro currency area. For example, the knowledge that the ECB will act if inflationary pressures surface must be expected to influence the reactions of wage bargainers and it is also clear that governments have been made more conscious of the need for structural reforms. The question of whether the euro gives an impetus to supply-side reform is, consequently, a crucial one in understanding the impact of, and prospects for, the single currency.

At present, only tentative answers can be given. The findings presented above on the tradeoff between the inflation rate and the output gap for the supposedly overheating countries imply that labor market responses are changing, perhaps radically as Vinals and Jimeno [1998] suggested they might. Anecdotal evidence from France suggests that despite an anti-flexibility rhetoric, there has been something of a seachange in the French labor market which created over half a million new jobs in 2000, although it has, lately, started to falter as a result of the economic slowdown. Several countries have embarked on fiscal reforms aimed at enhancing productive potential. Reform of welfare systems, though slow, is happening and countries in the vanguard, such as the Netherlands or Denmark (the latter not in the euro are but shadowing it), seem to have achieved a considerable transformation without forgoing national preferences or having to accept unacceptable curbs. Much, plainly, remains on the agenda, especially in the area of pensions, although as Artis and Buti [2000] show, adherence to "close to balance or in surplus" rule in the SGP should provide sufficient latitude.

CONCLUSIONS

This paper has made the case that, since the start of stage 3 of EMU, there has been little evidence to support the more dramatic predictions of things going wrong. Both the EU and EMU have, nevertheless, reached an interesting point in the process of achieving integration of economic policy. Further consolidation of the economic policy framework is required to improve the coherence of different policy areas and, more generally, the economic governance of the EU [Crouch, 2000], such that the broader economic and social ambitions of the Union are achieved.

Fresh thinking is also likely to be needed on how the ECB and the fiscal authorities carry out their respective mandates. The two pillar approach of the ECB has been criticized, for example by Svensson [2000], but seems to work. Is it a reasonable approach described in the wrong way or is it flawed and in need of reform? It is probably too soon to say, especially when some of the procedures are evolving—for example the degree of transparency. Despite the theoretical disputes on the merits of coordination, some facets are likely to need to be strengthened. Other issues, such as the extent and nature of fiscal stabilization are bound to remain on the agenda [Bayoumi and Masson, 1998; Melitz, 1999].

Whether against the odds or not, the euro so far seems to be more of success than expected.

NOTES

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1. Strictly, the ECU is not the same basket of currencies that now constitute the euro, but for present purposes, the difference is minimal.

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