



The Birth of the Euro

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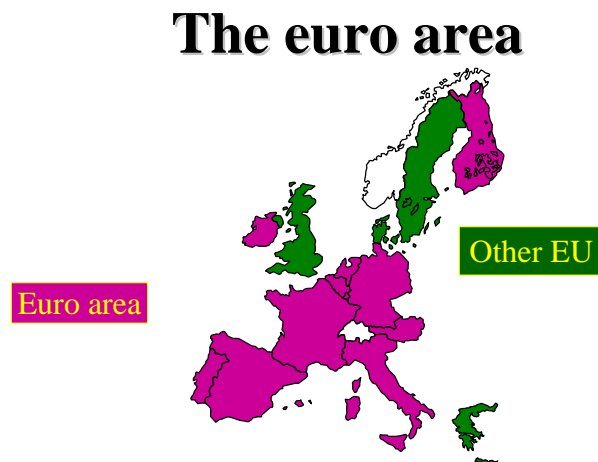
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Last year I gave a presentation to this group on the decision of the leaders of the European Union (EU) to proceed with Economic and Monetary Union (EMU). At that time the final decision about which countries would participate had just been taken after an unusually long summit meeting in Brussels. Many commentators had doubted that the EU would ever get to that point, and some thought that the monetary union would collapse before it was formally launched.

Since then a lot has happened. In my presentation today, I will try to bring you up to date on what has happened in Europe over the past year. After reviewing the main events, I will explain the structure of the new decision-making bodies, assess the performance of the euro in the first few months of its existence, and raise some longer term questions to which I shall return in the future.

Figure 1



The substance of the decision to proceed with EMU is, first, that sovereignty over monetary policy has shifted from the individual national central banks to the new European Central Bank based in Frankfurt, and second, that the national currencies of the participating countries have been replaced by the euro.

The arrival of the euro is important for many reasons. At a minimum, it confirms the strength of the commitment of the leaders of the EU to the process of greater economic and political integration that began shortly after World War II. More importantly, it has fundamentally altered international monetary arrangements, creating a single currency area that matches the US in terms of its size. Should the ECB succeed in fulfilling its mandate of price stability, the euro may one day challenge the primacy of the dollar as the world's most important international currency.

What has happened?

As I noted at the outset, the past year has been an eventful one in European central banking circles. Following the decision to proceed with EMU, the European Council appointed the first Executive Board members of the ECB. The Executive Board, in combination with the governors of the national central banks of those countries that are participating in EMU, makes up the Governing Council of the ECB.

With the formal founding of the European System of Central Banks at the end of June last year, the Council got down to work on various issues that had to be addressed prior to the launch of the euro. One of the most important of these had to do with the choice of a monetary strategy for the euro area. The Council also addressed a myriad of other issues to ensure a complication-free birth, and generally succeeded. The changeover weekend (December 31 to January 3) passed without any major glitches, and at 5.00 a.m. (local time) on the morning of January 4 the first euro trades were carried out on the Sydney market.

However, after a very brief post-launch rally the euro has declined steadily against the dollar, losing almost ten percent of its value in the first four months of its existence. The euro has also declined somewhat against sterling.

The past year has also seen the first major conflict between the ECB and politicians. The change of government in Germany last fall brought to power a number of left-leaning politicians with unusual views about how monetary policy should be conducted. The ECB won this battle, but there are likely to be many more. And finally, on April 8, the ECB took its first policy action, lowering its target interest rate by 0.5 percentage points.

The Executive Board of the ECB

The first order of business once the heads of government had decided to proceed with EMU was to appoint the Executive Board of the ECB. As you may recall from my presentation last year, the members of the ECB's Executive Board play a role very similar to that of the Governors of the Federal Reserve System.

Figure 2



The first President of the ECB is Wim Duisenberg, former Dutch finance minister and central bank head. Duisenberg now speaks for Europe on monetary affairs, taking over the role previously occupied by the president of Germany's Bundesbank, Hans Tietmeyer.

The Vice-President is Christian Noyer of France, who has extensive government experience but is a newcomer to the business of central banking. The other Executive Board members are Eugenio Domingo Solans of Spain, Sirkka Hämäläinen of Finland, Otmar Issing of Germany and Tommaso Padoa-Schioppa of Italy.

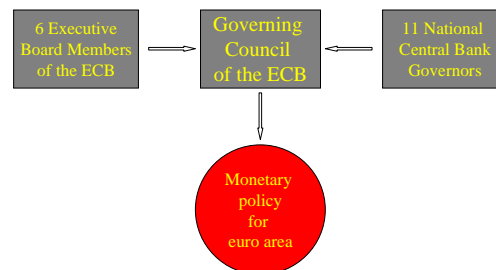
Of these four, Issing and Hämäläinen have the strongest anti inflation credentials. Issing was formerly on the Bundesbank Council, and oversaw the economics department of the Bundesbank. He now occupies a similar position at the ECB, overseeing the Economics and Research Directorates, and is arguably the second most important member of the ECB Board. He is the only board member to have been appointed to a full, unqualified, eight-year term. Ms. Hämäläinen was formerly governor of the central bank of Finland and was at one point considered a compromise candidate for the presidency of the ECB. Tommaso Padoa-Schioppa is one of the architects of EMU, having been a key member of the Delors committee that proposed EMU in its current form. Finally, Eugenio Domingo Solans comes from an academic and central banking background and is probably the least well known of the board members.

The decision making bodies

The Maastricht Treaty stipulates that the Governing Council of the ECB shall be responsible for the formulation of monetary policy for the euro area, while the Executive Board of the ECB shall be responsible for the implementation of monetary policy. Open market operations are carried out by all eleven national central banks, rather than being concentrated in one or two major financial markets.

Figure 3

Policy making institutions



While the Governing Council is the functional equivalent of the FOMC, it differs from the FOMC in some important respects. To begin with, the Executive Board is outnumbered by the governors of the national central banks, while the Board of Governors enjoys a permanent voting majority on the FOMC. Some have argued that this more diffuse power structure may be a potential source of problems in the long run. The diffusion of power is underlined by the fact that the national-central-bank-dominated Governing Council gets to determine the budget of the ECB, which differs from the way things are done in the US.

Monetary strategy

One of the most pressing decisions faced by the newly appointed Board and Council last year was to settle on a strategy for monetary policy for the euro area. As a new institution with no track record it

was crucial that the ECB articulate a strategy that would enable the public to understand and to some extent anticipate its decisions. And they had no shortage of advice about what to do.

The main question was whether the ECB would opt for an inflation targeting strategy (following the practice of the newly independent Bank of England), or whether it would pursue the monetary targeting strategy of the Bundesbank.

In the end the ECB opted for a hybrid strategy. In deference to the inflation targeters, the ECB bases its policy decisions on a broad-based assessment of the outlook for price developments. But it does not attempt to target the inflation rate, nor does it publish its own inflation forecasts. In deference to the money targeters, money plays a key role in the policy deliberations of the ECB. However, instead of a *target* for money growth the ECB has announced a *reference value* that is used to gauge whether money growth is consistent with price stability.

And to enhance its accountability the ECB has provided a quantitative definition of price stability. The Maastricht Treaty mandates the pursuit of price stability as the primary goal of the ECB, but leaves the ECB free to define what constitutes price stability. The ECB has announced that an annual rate of increase of consumer prices in the euro area of less than 2.0% over the medium term is what it is aiming for. This is essentially the definition of price stability used by the Bundesbank.

Euro area inflation

You may recall that one of the criteria used to determine which countries would participate in EMU was an inflation rate of no more than one and a half percentage points in excess of the average of the three best performing economies in terms of inflation. This requirement encouraged a remarkable convergence of inflation rates within the EU, with the result that inflation in the euro area for 1998 was only 1.1%. Inflation has remained around the 1.0% level through the first quarter of this year, and there seems to be little in the way of upside risks in the foreseeable future. The consensus among forecasters polled by *The Economist* newspaper is that prices in the euro area will rise by 1.0% this year and 1.4% next year.

Euro area money growth

The preferred aggregate for assessing monetary developments in the euro area is the broad M3 money aggregate. The choice of this aggregate reflects the practice of the Bundesbank. The exact definition of this aggregate is not quite the same as that used in the US and need not concern us here. Suffice to say that euro area M3 has some properties that are desirable from the perspective of assessing nominal developments.

The reference value for growth of this aggregate is 4.5%. This figure was arrived at by working back from the requirement of price stability that in the medium term prices grow by no more than 2.0% per annum. Assuming that the trend rate of growth of real output is 2.0% to 2.5%, while the trend decline in M3 velocity is about 0.5% to 1.0%, the

Figure 4

Euro area inflation

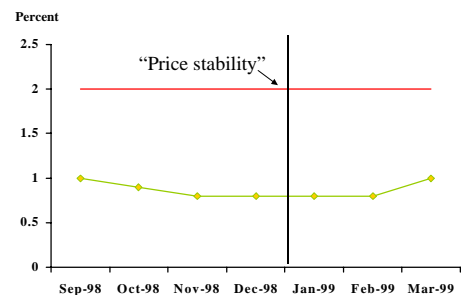
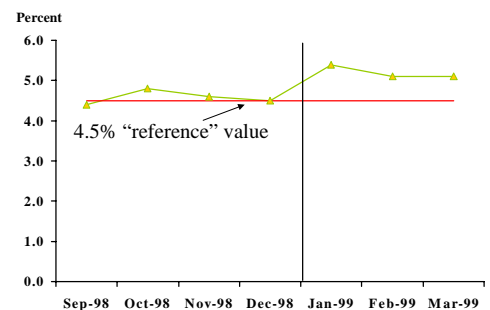


Figure 5

Euro area money (M3) growth



minimum rate of growth of money consistent with price stability is 4.5%. M3 growth remained close to the reference value towards the end of last year, and has exceeded it only modestly since the formal launch of the euro.

First rate cut

Citing the subdued inflationary pressures in the euro area, the Governing Council decided on April 8 to lower its target interest rate. The repo rate (which is their equivalent of our federal funds rate) was reduced by 50 basis points, from 3.0% to 2.5%. The interest rate on the marginal lending facility, which puts a ceiling on overnight interest rates, was reduced from 4.5% to 3.5%, while the rate on the marginal deposit facility, which sets a floor on overnight rates, was reduced from 2.0% to 1.5%.

In the press conference that followed the meeting at which this decision was made, the President of the ECB emphasized that the rate cut was motivated more by the favorable outlook for inflation than by the slowing of euro area economic activity or the stubbornly high rate of unemployment in the euro area. Indeed, in their public pronouncements, the President and other Executive Board members have gone out of their way to drive home the message that the unemployment problem in Europe is structural in nature and cannot be solved by monetary policy.

We might note in passing that the ECB did not reveal how the members of the Council voted when the decision was taken to lower interest rates. The ECB has decided that the minutes of its meetings will not be published for sixteen years, arguing that it is essential to keep the votes of Council members secret so as to protect them from domestic political pressures. There were indications, however, that the vote was not unanimous, which should not be too surprising with growth in the euro zone ranging from near recessionary levels in Germany to pre-crisis Asian-tiger rates in Ireland.

The practice of keeping the votes confidential contrasts with the practice at the Fed, where voting behavior is disclosed in a very timely manner.

Decline of the euro against the dollar

So how has the euro fared in the international arena since its launch? Not too well, by the looks of things. After peaking just above \$1.18 shortly after its launch the euro has steadily declined against the dollar, and this week was trading at \$1.07 (having bottomed out at \$1.0573 on May 4). Prior to the euro's launch there was some expectation that it would strengthen relative to the dollar relatively quickly as central banks sought to diversify their portfolios of reserves. The relative current account positions of the US and EU were also thought to favor early euro strength.

An unwinding of last year's appreciation of the ecu

However, it is far too soon to pronounce on the long-run external value of the euro. In many ways, the decline of the euro over the past four months is simply an unwinding of the appreciation of the euro's predecessor, the European Currency Unit or ecu, towards the end of last year. At that time, after Russia had defaulted in its debt, there was a sense of crisis in the global financial community and a belief that the US economy could end up being adversely affected. By contrast Europe seemed to be little affected by the ongoing turmoil. There was even a belief in some quarters that the imminent arrival of the euro was insulating Europe from the financial crisis, and that the introduction of the euro would be a fillip to growth.

Figure 6

Decline of euro against the dollar since its introduction...

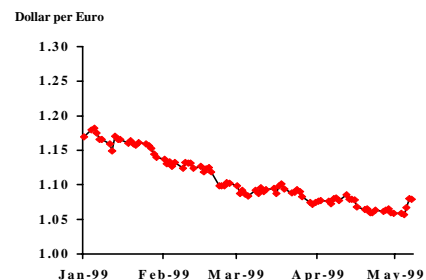
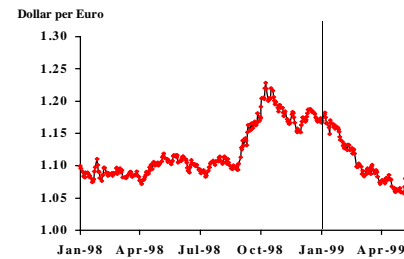


Figure 7

...is mostly an unwinding of last year's appreciation of the ECU



An unwinding of this “europhoria” was inevitable. It is interesting that the recent peak in the dollar-euro exchange rate occurred at about the same time as the change of government in Germany. After sixteen years of rule, the Christian Democratic government of Helmut Kohl was replaced by a coalition government made up of Social Democrats and Greens, headed by Gerhard Schröder. Schröder’s appointee as Finance Minister, Oskar Lafontaine, is not a man known for his liberal views on economic policy. The ensuing conflicts with the Bundesbank and the ECB did not do much to inspire confidence in the nascent currency.

That the euro continued to slide even after the departure of Mr. Lafontaine is not too surprising, given the ambiguous statements of the ECB about its attitude towards the exchange rate. The public pronouncements of Board members have gone from saying that their attitude towards the exchange rate was one of benign neglect, to saying that any further fall would be a matter for concern.

Questions for the future.

That's a very quick review of what has been going on in Europe in the past year. I now want to turn to a number of questions that I believe are important and to which I hope to return at some point in the future.

First among these is whether the UK will join. As I noted at the beginning, only eleven of the fifteen members of the EU are currently participating in the single currency. Of the four non-participants, the most important (from both a European and an American perspective) is the UK.

Second, given the dubious economics of EMU, what is the likelihood that it will survive? Should we expect a crisis comparable to, or worse than, the ERM crisis of 1992-93?

Third, will the ECB be as successful as the Bundesbank in preserving the purchasing power of the currency that is its primary product?

And finally, will the euro some day challenge the dominance of the dollar as the world's premiere international currency?

What about the UK?

The single currency does not yet include the UK or three other members of the EU, Sweden, Denmark and Greece. Both the UK and Denmark negotiated specific opt out clauses in the Maastricht Treaty. In the case of the UK the clause was inserted at the insistence of the then Conservative government which was strongly euro skeptic. With the change of government in the UK in May 1997, the official stance towards Europe changed. The new Labour government is a lot more favorably disposed towards the European project, and would probably have joined EMU from the outset had domestic political circumstances permitted.

Instead the government has worked on shifting public opinion. This began with the announcement that the UK would only join after a referendum on membership, which will probably occur shortly after the next general election. In late 1997, the UK Treasury announced five economic tests that would be used to determine whether EMU membership would be the right thing for the UK. More recently the UK government has ramped up the level of discussion by announcing a national changeover plan.

Assuming that there are no major crises in the next three to four years, we should expect the UK to join the single currency at around the same time that the euro notes and coins are introduced.

Will EMU endure?

EMU is a risky undertaking by any criterion. It has been clear from the outset that the driving factor behind the project was politics rather than economics. But the fact remains that the economics of the undertaking are questionable at best, and at some point in the not too distant future we should not be surprised to see a serious conflict over the conduct of monetary policy in the euro area. EMU needs to be seen in the context of the longer run process whereby Europe has become more integrated over time. The process of integration has often involved taking two steps forward, followed by one step back. But the process has kept moving forward.

The long-term fate of EMU is inextricably tied up with two other issues. First will EMU alleviate or exacerbate Eurosclerosis? Since 1980, net private sector job creation in the euro area has been negligible. More than one worker in ten in the euro area is unemployed, and there is little prospect of that number falling any time soon. The convergence criteria laid down in the Maastricht Treaty did spur some reforms in public finances, but as you may recall from my presentation last year there was widespread use of creative accounting to make sure that the key debt and deficit criteria were met. The introduction of a new currency is unlikely to make much difference *per se* (just as dollarization is not a panacea for those countries currently considering it, a subject to which Bill Gruben will return in his board presentation in July). The unemployment problem in Europe is a real rather than a monetary phenomenon. Only reform of the tax system and the welfare system and repeal of restrictive labor legislation will make a significant difference to Eurosclerosis.

The long-term outlook for EMU will also depend on how successful the Maastricht Treaty and the Growth and Stability Pact are at controlling public expenditure. The Growth and Stability Pact was adopted at German insistence on concerns that the potential members of EMU had not fully embraced the *Stabilitätspolitik* of the Bundesbank.

The Growth and Stability Pact attempts to enforce fiscal discipline in EMU member states by requiring that their deficits never exceed 3% of GDP (except in exceptional circumstances) and that the budget be balanced or in surplus on average over the course of the business cycle. The Pact has teeth in the form of fines that may be levied on member states that breach the limits, and the expectation is that it will help redress the perverse incentives that national governments will face under EMU.

It remains to be seen whether the Pact will achieve its intended objective. In its first Annual Report released in April of this year the ECB warned about slippage in the attempts of some countries to consolidate their fiscal affairs, and already there have been calls by the Italian government for a more "flexible" interpretation of the guidelines.

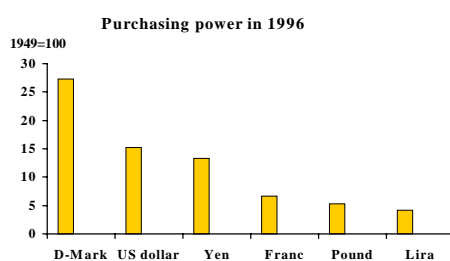
Regardless of how successful European governments are at addressing the problem of chronic unemployment, and regardless of how well the Growth and Stability Pact succeeds in controlling government spending, there is no turning back. The Maastricht Treaty does not include provisions for countries to secede from EMU. Were a country to do so unilaterally it would provoke a constitutional crisis in the EU. A more likely outcome is that should significant tensions arise over the ECB's pursuit of price stability, some aspects of the Treaty would be renegotiated.

Will the ECB prove as successful as the Bundesbank in controlling inflation?

The Bundesbank is still revered as one of the world's most successful central banks. The picture below explains why. In the postwar period, the Bundesbank has done a better job of preserving the purchasing power of the DM than has any other central bank. This success led many European central banks to link their currencies to the DM prior to EMU to obtain some of the Bundesbank's credibility (what Bob McTeer has referred to as the Tietmeyer effect).

Figure 8

The Bundesbank's track record



How well the ECB will succeed in following the Bundesbank's act. The ECB has a lot going for it. As I pointed out last year, the ECB enjoys greater statutory independence than did the Bundesbank. The fact that the legislation governing the existence and mission of the ECB is an international treaty that can only be changed with the unanimous consent of all of its signatories makes it difficult to exert pressure on the ECB. The Treaty also prohibits the ECB from soliciting or taking instructions from national governments or other entities.

And it has a much stronger mandate for price stability than did the Bundesbank. (The Bundesbank is charged with "...safeguarding the currency" which is slightly more ambiguous than "maintaining price stability.")

But the ECB lacks the political legitimacy of the Bundesbank. There is a popular perception that there is a democratic deficit in EU institutions, and the ECB is no exception in this regard. While the President of the ECB has agreed to testify to the European Parliament up to five times a year, it remains to be seen whether this will suffice for meeting the needs of central bank accountability in a democratic society. Until recently the European Parliament lacked any meaningful power, but it did enhance its stature earlier this year by forcing the resignation of the European Commission, and it has acquired additional powers under the Amsterdam Treaty that came into force on May 1 of this year.

There is also the possibility that the diffuse power structure of the ECB may undermine its ability to carry out its tasks. Some commentators have drawn an analogy between the current structure of the ECB and structure of the early Federal Reserve System. In their monumental *Monetary History of the United States*, Milton Friedman and Anna Schwartz argued that one of the reasons that the Great Depression in the US was so severe was the ineptitude of the monetary policy that resulted from the absence of clear leadership in the Federal Reserve System.

Will the euro displace the dollar as the world's most important currency?

There is no doubt that many members of the French establishment would dearly love for the euro to displace the dollar as the world's most important currency. And the euro clearly has some potential in this regard. Its domestic habitat is comparable in size to the US, and the ECB has a much stronger mandate for price stability than does the Fed. The first factor means that the euro is already the world's second most important currency. The second will determine whether it can displace the dollar in the long run. But it will be years, or decades, before we know.

When thinking about this we should keep a couple of things in mind. First, it is very difficult to displace a widely used currency from its pre-eminent position because of what are known as network externalities. This is just a fancy way of saying that I will only find it convenient to switch from using the dollar to using the euro if I expect a lot of other people to switch as well. It took a long time for the dollar to displace sterling as the world's most important currency. During that period, the world experienced two world wars and the Great Depression, and Britain went into serious long-term decline. While it is difficult to predict whether or when there will be another major global conflict, there does not seem to be any prospect of the US slipping into long-term decline any time soon.

And second, it will take a while for the ECB to establish a track record, earn its spurs so to speak, and show that its commitment to price stability is as strong as that of the Bundesbank.

Finally, it is worth asking how this matters for the US. At the aggregate level, the real benefit that the US gains from having the dollar widely used outside the US is the additional seigniorage revenue that we get. By some estimates, this amounts to about \$12 to \$15 billion a year, less than 1 percent of tax revenues, or less than 0.2 percent of GDP. Serious money, yes, but its loss would hardly be noticed in our multi-trillion-dollar economy.

Conclusions.

The past year has been an eventful one in Europe. The euro has been successfully launched, and the ECB has taken over the reigns of monetary policy for the euro area. The arrival of the euro is a major change in international monetary relations, of greater importance arguably than the founding of the Bretton Woods system of fixed exchange rates after World War II. While it is too early to pass judgement on the long term prospects for the new currency, the euro will automatically become the world's second most important currency by virtue of the size of its domestic habitat. What remains to be seen is how far it will succeed in displacing the dollar. The fact that the EU has succeeded in creating a monetary union should lead us to expect that it will increasingly speak with one voice on many issues. However, it still has some way to go, and we should not be surprised to see heated arguments about economic policy in Europe in the coming years.