The EMU: A Groundbreaking Monetary Experiment

ON JANUARY 1, 1999, the European Union (EU) is scheduled to introduce the euro, a first-of-its-kind currency designed to help blend 15 politically divergent countries into a unified economic area. The euro caps off the economic and monetary union (EMU), which requires that each country give up its national monetary policy and abide by the policies of a common central bank.

Never before have politically independent nations with histories of monetary independence and long-standing central banks given up that independence to form a common central bank and adopt a single currency. If successful, the EMU will be the biggest event in the world financial system since the Bretton Woods system of fixed exchange rates broke down in the early 1970s.

Many analysts remain skeptical about the EMU's potential for success. They believe the euro will be unpopular and the central bank will find it difficult to be tough on inflation without the benefit of a unified fiscal policy.

Although this historic union will not occur for nearly two years, preparations for the EMU are already greatly affecting the European economies. The outlook for the new currency's success and stability has also begun to impact financial markets.

Economic and Monetary Union

The euro will essentially link the currencies of participating countries with permanently fixed exchange rates. To increase the likelihood of the EMU's success, each country must meet strict monetary and fiscal criteria before joining. The economic strain on the EMU will be reduced if all the countries converge to roughly the same inflation and interest rates.[1] The countries also have to meet government debt and budget deficit criteria.[2] The hope is that if EMU countries have fairly healthy balance sheets, markets will not expect political pressure to force the central bank to print money to pay down a country's debt.

Of the 15 current members of the European Union, only those that meet the monetary and fiscal criteria will be eligible to join the EMU. The decision of which countries qualify, based on 1997 economic data, will take place in early 1998. Most likely, eight countries will be eligible to join in 1999: Germany, France, Belgium, Luxembourg, the Netherlands, Finland, Austria and Ireland. Italy, Greece and Portugal have begun EMU campaigns and may be able to join as well. Although the United Kingdom and Denmark will likely be eligible to join, it is not clear if those countries will participate in 1999.

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The EMU and the Economy

The euro will effectively merge the Deutsche mark, the strongest European currency, with some weaker ones. For most countries, the newly formed European Central Bank will be much less likely to inflate because of political pressures than their current central banks. With a successful monetary union, these countries can achieve lower overall inflation and interest rates through a single coordinated policy. Already, the move to a single currency has motivated European countries to lower their inflation rates and get their fiscal policies in order.

If the move to a single currency is successful, it is expected to spur economic growth and stimulate export demand in Europe. The euro will make it cheaper and easier to transact business across Europe, reducing transactions costs and exchange rate risk. If the single currency generates more income and stability for Europe, it would also stimulate demand for U.S. goods.

On the downside, a lack of exchange rate flexibility and loss of national monetary policy may prolong regional economic downturns. A country cannot lower interest rates when it goes into a recession unless all the other countries agree that this is a good policy, perhaps prolonging a localized recession. For example, the fact that Texas could not lower interest rates when a collapse in oil prices sent its economy into recession in 1986 may have extended Texas' recession.

Several European countries have struggled with recessions during the push for a single currency, making convergence difficult. Their recessions have been blamed on the single-currency

push because governments have been tightening fiscal policy and companies have cut costs in anticipation of a more competitive single market.

The Euro and U.S. Financial Markets

The euro could prove a strong alternative to the U.S. dollar. Financial markets will conduct transactions in euros, and central banks will want to hold some of their reserves in this currency. Both transactions will reduce the number of dollars held, but it is unclear by how much. How quickly the shift will occur is uncertain.

The EMU will create a broad bond market in which European governments and corporations will issue debt in euros. Roughly the size of the U.S. market, this will be the first alternative widely traded bond market available for issuers of debt. U.S. bond prices and interest rates will likely become more volatile as investors test the new market and then, perhaps, return to the U.S. market.

If the euro takes off as a strong currency, it may affect the dollar's role as a reserve currency for the rest of the world. The European Union represents a big market. It is likely that the world will want to hold more euros and fewer dollars for international transactions. If fewer countries hold dollars, then it will be a loss for the U.S. Treasury because foreign holdings of U.S. dollars are interest-free loans to the United States from the rest of the world. But if the euro is unstable, then the dollar is likely to be seen as a safe haven and international holdings of dollars will grow.

As the birth of the EMU nears, uncertainty about its impact has already sent ripples through financial markets. In recent weeks, France, Germany and Italy have indicated that they may not meet some of the criteria for a single currency. Signs that the introduction of the euro may be delayed have pushed the dollar down against the mark. Many investors would prefer to hold dollars when the union occurs but are choosing to jump back into Deutsche marks on signs of a delay.

Still, the euro may go forward as planned because vagueness in the language of the Maastricht Treaty, which sets forth the parameters for the EMU, suggests that countries failing to meet the criteria can join if they show evidence of "sufficiently diminishing" debt and budget deficits. Essentially, if the EU believes it is advantageous to the EMU for a country to join, it will be allowed in.

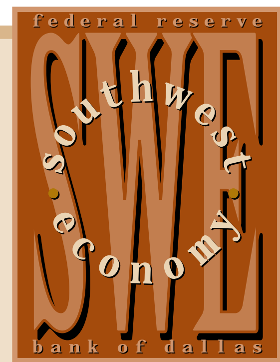
The EMU's impact on the world's financial system could remain uncertain until it becomes clear to investors that the monetary union has either succeeded or failed.

—Fiona Sigalla
David Gould

Notes

[1] To be eligible for convergence, the inflation rate cannot be more than 1.5 percentage points higher than the average of the three lowest-inflation countries, and long-term interest rates cannot be more than 2 percentage points higher than the average interest rate in the three lowest-inflation countries.

[2] The fiscal criteria require government debt to be less than 60 percent of GDP and the budget deficit to be less than 3 percent of GDP.



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