Europe: Risk and Reward Under Monetary Unification

SKEPTICS DOUBTED THAT the politically and culturally diverse nations in the European Union (EU) could ever set aside their differences and unite to form a single currency. However, in the 10-year span since the Delors Report[1] proposed the idea, the economic and monetary union (EMU) has gone from concept to reality for the EU11, as the EMU countries have come to be known.[2] On January 1, 1999, the EU11 will hand over control of their money supplies to the European Central Bank, and in 2002 the euro—the region's new currency—will officially replace the local currencies.

While the coming of the euro is now a certainty, it is yet to be decided how much, if at all, the euro-zone countries will benefit from the single currency, what the risk of failure is and what implications the union has for the United States.

Benefits to Monetary Union

The motivation behind the EMU may be more political than economic, and many see it as merely the next step toward a more integrated Europe. However, adoption of the euro does have some important economic implications and might provide some economic benefit to the participating countries.

One aim of moving to the single currency is to foster trade not only among the EU11, but also between the EU11 and other countries. Currently, for a German company to purchase goods from France, it would first need to convert Deutsche marks into francs. This poses two problems for the German company. Not only will it incur transaction costs in the conversion, but it also faces the risk that the francs will decline in value once they are purchased. The single currency will virtually eliminate these two problems. Similarly, a firm from a country outside the EU11 would only need to convert its domestic currency into euros to do business with any of the 11 countries.

Another potential benefit of the monetary union relates to the business cycles of the member countries. As the euro-zone countries' economies become more integrated and the factors of production become more mobile, business cycle swings may become less pronounced and more correlated between countries.

At the moment in Europe, most of such business cycle smoothing occurs not between countries but within a country, where people insulate themselves from large changes in consumption by saving more in good times and less during bad times.[3] If the EMU succeeds in making capital more mobile through lower transaction costs and less currency risk, then more risk sharing will occur between countries as cross-ownership of assets increases. If, however, capital movement across borders is being restrained not by transaction costs and currency risk but by informational barriers, then capital movement might not increase that much and business cycle smoothing will not occur to as great an extent. This is potentially the biggest risk the union faces.

The Business Cycle and Potential for Failure

Most of the concerns about the long-term viability of the EMU stem from one basic problem: the countries in the union are often at different points in the business cycle, which means that one country might enter into a recession at the same time the other countries are expanding. Under the EMU, that country would not have monetary policy at its disposal to lift its economy out of recession, nor would it be able to devalue its currency to increase demand for its products abroad. In the worst-case scenario, if the other countries are experiencing inflation, they may even vote to increase interest rates at a time when a rate cut is most needed by the stagnating country.

In the United States, when one area of the country goes into recession, such as Texas after the 1986 oil-price shock or California in the early 1990s, the U.S. government can use fiscal policy to redistribute income to the suffering region. Also, labor is very mobile between regions, and workers can move rather easily to a healthier area of the country.

The EMU, however, has no central fiscal authority, and cultural differences and labor market issues make workers far less mobile than in the United States. It appears that the only way to insulate EMU countries from adverse economic shocks is through increased capital mobility. As mentioned earlier, however, it is far from certain that capital flows will increase significantly. A possible solution would be to allow governments to temporarily run large budget deficits during rough economic times. Under the current agreement, however, they would not be allowed to do so.[4]

While unemployment in the region has been declining, the euro-zone unemployment rate still stands at 11.1 percent (*Chart 1*). Pressures could mount on the central bank to use monetary policy to alleviate unemployment at the expense of higher inflation, and the disparity in the rates between countries could cause a political rift between high- and low-unemployment countries.

EU leaders are already pressing for lower interest rates, even ahead of the date the European Central Bank starts setting monetary policy.[5] Many feel that European interest rates should converge to the level of the securities repurchase rate in France and Germany of 3.3 percent—currently the lowest of any of the EU11—or perhaps even lower. Such a convergence would represent a 0.5 percent cut for the region as a whole.

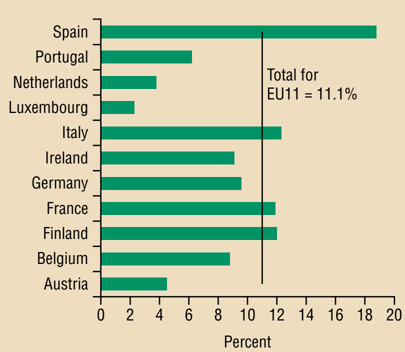
If the European Central Bank fails to cut rates while the U.S. interest rate continues to fall, the dollar could extend its decline against the European countries and the euro might become *too* strong. This could slow growth for the EU11 and create a conflict between those countries that are export dependent and those that are import dependent. Also, the EMU could be seen as not playing its part in alleviating the global financial crisis.

Implications for the United States

Once in place, the EU11 will represent one of the world's largest markets, rivaling the United States in size (*Table 1*). The EMU's success or failure could have significant implications for the United States, and a strong EMU could be very beneficial. If the monetary union strengthens the economies of the EU11, it will create a larger market for U.S. products. Having the single currency will also make it easier for U.S. companies that wish to do business in Europe.

A successful euro won't necessarily benefit everyone, however. U.S. exporters could see some drop-off in demand for their products as the euro-zone countries trade more among themselves. As it stands now, 35.2 percent of EU11 trade is with other EU11 countries. That figure should increase once the monetary union goes into effect.

Chart 1
Disparity of Unemployment Rates in the Euro Zone, July 1998



SOURCE: Eurostat.

Table 1
EU11 Market Compared with United States

	EU11	United States
Population (millions)	290	267
Share of world GDP (percent)	19	20
Share of world trade (percent)	19	17
Unemployment (percent)	11.1	4.6
Stock market value (billions)	$2,248	$6,726

Furthermore, international holdings of dollars will inevitably drop as a result of the union, particularly if the euro is widely held as a reserve currency. First of all, the demand for dollars from the EU11 will decline because they will no longer need to stabilize the value of their own currencies versus those of the other EU11 countries. Moreover, if countries outside the EMU find that euros are cheaper to acquire and easier to use in transactions, then the euro could gain ground on the dollar as the currency of choice in international reserves. However, because the dollar has a strong history as a store of value and is so widely used and accepted, it is unlikely that it will be supplanted as the preferred reserve currency any time soon.

Conclusion

While politics has to this point been the main driving force behind the European monetary unification, political rifts could also be what one day spell the end of the EMU. The political momentum that has carried it this far will likely help it through tough times in the near future; however, a long period of sustained unemployment or low output growth could lead to a weakening of the union. If transaction costs and currency risk under the current system do not restrain trade and capital movement to a great extent and the EMU fails to bring the business cycles of the EU11 in line, then the benefits from the union would be small.

On the other hand, the union could be a boon to trade as transactions become more efficient and the countries of Europe reach a new level of economic and political cooperation. Only time will tell what the actual outcome will be.

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Notes

1 See Jacques Delors et al., *Report on Economic and Monetary Union in the European Community* (Luxembourg: Office for Official Publications of the European Communities, 1989).

2 The EMU consists of Austria, Belgium, Finland, France, Germany, Ireland, Italy, Luxembourg, Netherlands, Portugal and Spain. Greece has not yet met the criteria for membership, but will probably join by the year 2002.

3 See Bent E. Sørensen and Oved Yosha, "International Risk Sharing and European Monetary Unification," *Journal of International Economics* 45, no. 2, August 1998, pp. 211–38. The authors find that among European Community countries, 40 percent of GDP shocks are smoothed at the one-year frequency, with half of that smoothing attributed to corporate saving and the other half to government deficits.

4 The Stability and Growth Pact, signed in 1996, will impose fairly severe fines on EMU countries that have government budget deficits exceeding 3 percent of GDP.

5 At a recent European Union summit, EU leaders joined in calling for lower interest rates among the EU countries. Italian Prime Minister Massimo D'Alema said, "There is no doubt the hope is for a general reduction in interest rates, starting with Germany."