Eight Years of EMU – What are the benefits?

Professor Rolf Eggert
President of the Hamburg Regional Office of the Deutsche Bundesbank
Deutsche Bundesbank
Hamburg Regional Office
Willy-Brandt-Str. 73
20459 Hamburg
Germany
Tel +49 (0)40 3707 - 2000
Fax +49 (0)40 3707 - 2205
rolf.eggert@bundesbank.de

1. What changes has the euro brought about?

"Eight years of EMU" and a little bit more. What can possibly be really be new about this subject? In our fast-moving times, eight years are almost an eternity. The focal points of the political and economic policy debate are shifting ever more quickly. While this gives us the feeling of being up to the minute on important matters, it is not always good for the quality of the analysis.

Let me just put forward a contrasting view: when considering the effects of a sweeping change in economic structures, we cannot take an arbitrarily short time path as the point of reference. This is because we need a sufficiently long time horizon of experience. We have to observe how an economic system reacts to external stimuli. And European monetary union is a classic example in this respect. It has significantly changed the operational parameters for the participating economies. Of course, owing to the EC and EU, economic cooperation was already well advanced across large parts of western Europe even before EMU. But the introduction of a single currency represents a quite special step towards integration. For the participating countries, it meant giving up an autonomous monetary policy. Monetary policy is therefore no longer available as an instrument of national economic policy.

Added to this is the fact that the former national currencies of the euro area no longer have separate exchange rates. This is probably the most significant step on the road to a single European market. It also means that all the euro-area countries have the same exchange rates against the US dollar, the pound sterling, and all other currencies. Quite a few companies may be unhappy about the fiercer competition brought about by the elimination of the different exchange rates. In the European context, this effect was intentional: greater competition offers the potential for greater prosperity in all the participating countries. It is quite possible to see the elimination of exchange rates in a contrasting light. On the one hand, it implies a loss of national flexibility. Misguided economic developments at the national level can no longer be cushioned by exchange rate adjustments. For example, a high national inflation rate can no longer be "neutralised" by a depreciation of the national currency.

On the other hand – and this is something that seems to be far more important – the exchange rates themselves generated considerable negative effects in the past. Generally, excessive exchange rate movements – in other words, exchange rate movements that cannot be explained in terms of the economic fundamentals such as price and interest rate differentials – raise major problems. Excessive appreciations of the national currency mean a loss of competitiveness in the international markets and harbour the risk of lower growth and employment. Conversely, excessive depreciations imply the risk of importing inflation: depreciation means that imported goods become more expensive. If these price increases are passed on by producers and merchants, they then spread to other areas and this may result in a general price surge. The introduction of the euro has eliminated this effect within the euro area. Especially for heavily export-oriented countries like Germany, this represents an appreciable advantage. This is because more than 40% of both German export and import business takes place with other euro-area countries. It is very hard to say precisely how much the euro has boosted intra-European trade. According to the empirical studies that are available, the figure is likely to be between 5% and 15 %.[1]

---

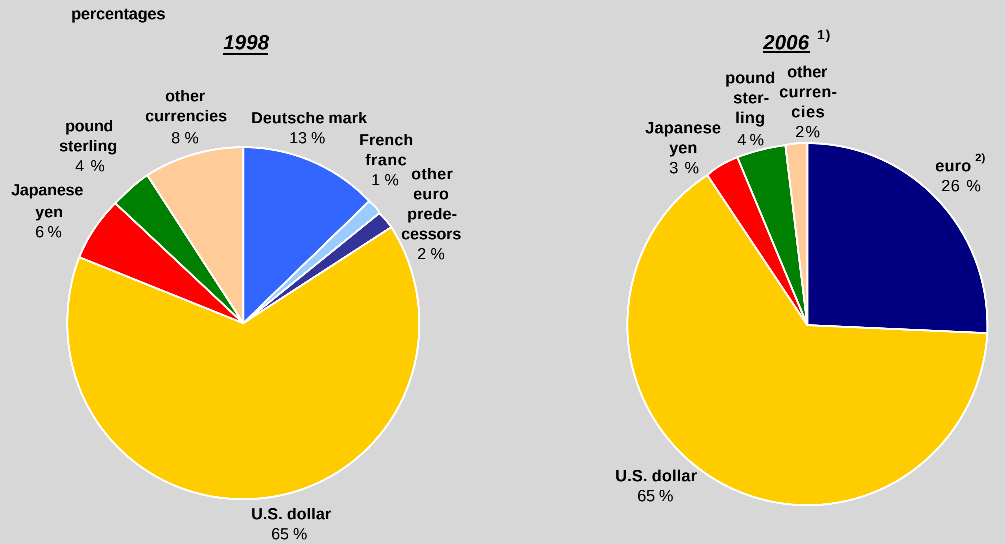
[1] See R Baldwin, In or out: Does it matter? An evidence-based analysis of the euro's trade effects, CEPR, London 2006.

This means that the size of the trade-boosting effect is subject to some uncertainty but it is, in any event, considerable.

Another factor is that the euro's growing importance as an international currency is being reflected more and more in the settlement of foreign trade transactions with countries outside the euro area. Now, 66% of German exports to non-euro-area countries are paid for in euro; as recently as 2002, the figure was 49%. On top of that the euro is a milestone on the road to a European-wide financial market. Without having to worry about an exchange rate risk, both investors and customers can seek out the most favourable counterparty for them internationally. The financial markets are gaining in scope and liquidity. Currently, more than 50% of all bonds issued in the euro area are held by investors from other euro-area countries. As recently as 1997, the figure had been no more than 12%.[2] It can therefore be said that the introduction of the euro has considerably advanced the integration of the European economic area.

Besides there are the various little "bonuses". Thus for consumers, it is easier to compare prices internationally. And anyone who is travelling benefits, of course, from not having to pay currency conversion charges when going on holiday.

Figure 1. Share of important currencies on the worldwide foreign exchange reserves



Differences of total through rounding of the particulars.
1 Data end of December 2006. - **2** The share is not exactly comparable with the share of the euro predecessor currencies, because through introduction of the Euro some foreign exchange reserves were domestic investments. Source: IMF.

Another major point is that the euro now has a 26% share of assignable currency reserves worldwide. Even if this figure is adjusted for exchange rate effects, it exceeds the share of 16% accounted for by the euro legacy currencies. Furthermore, nowadays more than 30% of bonds globally are issued in euro, and this share is likely to rise further.[3] The increase in the size of the currency area has therefore also led to an increase in the international importance of our common currency.

---

[2] Sum of government and corporate bonds.

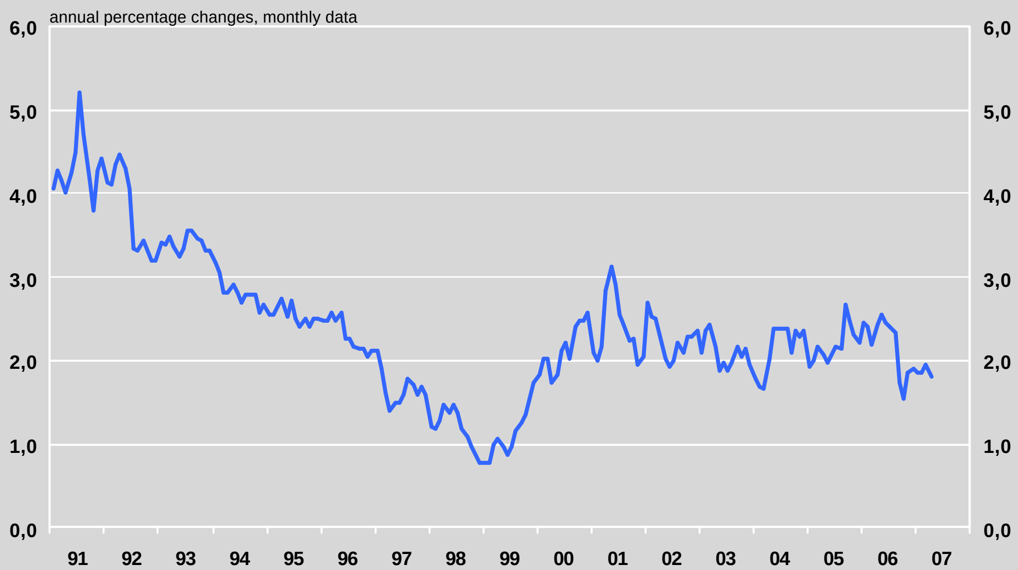
[3] See F-C Zeitler, Acht Jahre Währungsunion – Erfahrungen und aktuelle Aspekte, Rede auf dem Neujahrsempfang der Hauptverwaltung Hamburg on 25 January 2007.

2. Monetary policy

Let us now take a look at the economic policy consequences of monetary union. The key question is, of course, how far the ECB has managed to secure price stability in the euro area. To put it another way: has European monetary policy been successful? Before the launch of monetary union many people feared the euro might pose a risk to price stability in particular. This was especially apparent during the public debate in Germany, in which some critics played on people's unconscious anxieties.

A brief glance at the euro-area inflation rate makes it clear that that, for long periods, price inflation throughout the euro area has been higher than the 2% upper limit aimed at by the ECB. Does this mean that the ECB has done a poor job?

Figure 2. Harmonised Index of Consumer Prices in EMU

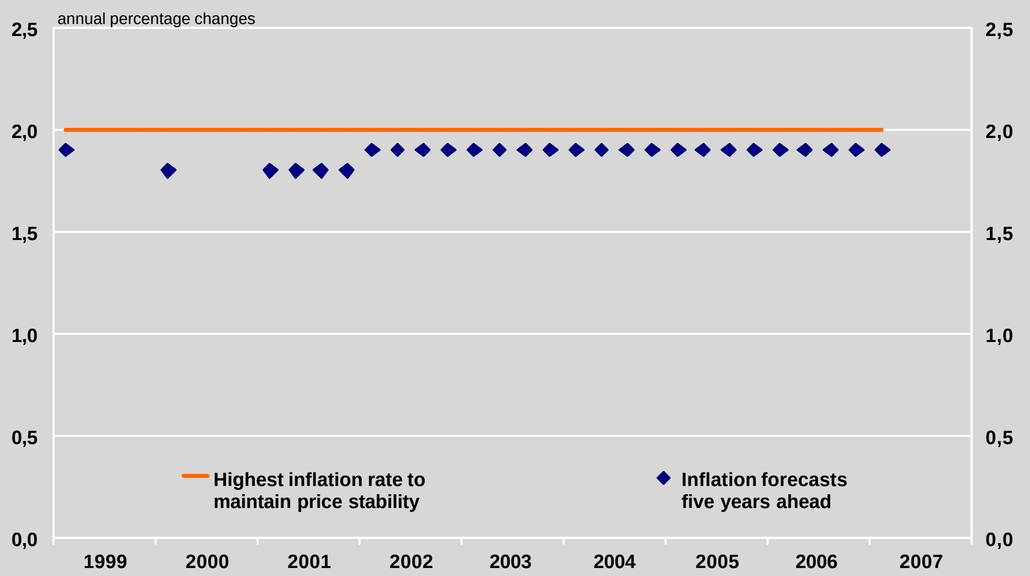


Source: Eurostat.

The answer – even if some people take a different view – is unequivocally "no". In view of the available figures, you might be surprised by such a clear statement but it can be easily justified. The higher inflation in the euro area was mainly the result of a number of exceptional factors – above all, the rocketing rise in the cost of some energy commodities. In the first few years of monetary union especially, temporary increases in food prices – due to BSE and foot and mouth disease – were an additional factor. Such price increases lie outside the sphere of influence of monetary policy. And, as a rule, monetary policymakers should not react to them either, unless there are second-round effects – in other words, price increases spilling over to other areas of the economy. It was precisely the concern about such effects that led the ECB to raise its key interest rate – the rate for its main refinancing operations – in stages since June 2006 by 175 basis points to 3.75%.

Public trust in monetary policy is a crucial requirement for its success. There is one key indicator which supplies us with essential information on the credibility of monetary policy. I mean inflation expectations. These can be defined in different ways. Let us take the expectations of professional analysts for the next five years. Since the start of monetary union, they have remained almost unchanged at just under 2%. This is a major contribution to winning longer-term confidence in European monetary policy – and to ensuring that short-term spikes in the price level do not lead to a longer term hike in inflation.

Figure 3. Longer term inflation forecasts[1)]



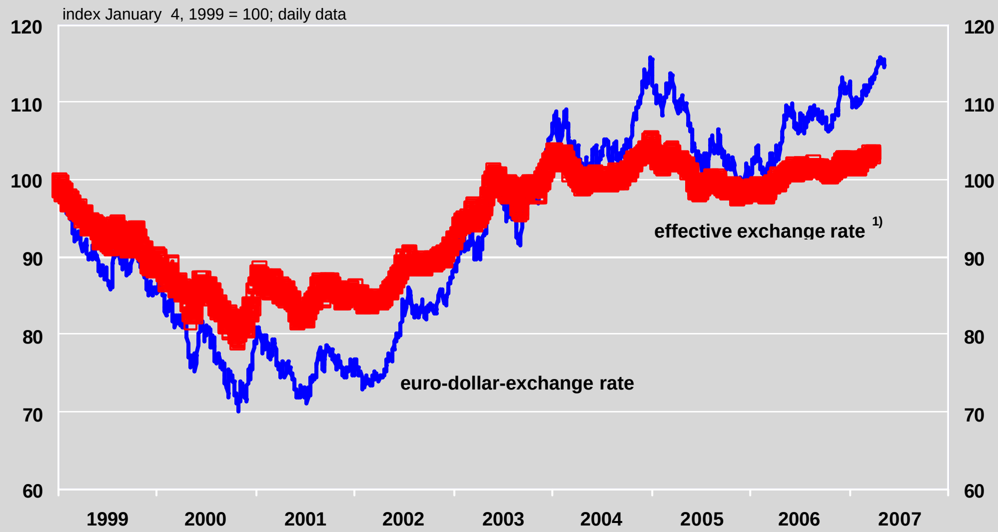
1 Yearly forecasting till 2000, quarterly forecasting from 2001. Source: Survey of Professional Forecasters of the ECB.

In the eight years since the euro was launched, the ECB has, on balance, established a successful track record. This deserves all the more recognition since the task of monetary policy has been handicapped at times – and not just by the special factors I mentioned earlier. It was only natural that the ECB, as a brand-new central bank, could not possibly start off with the same high reputation and standing that the Bundesbank had built up over 50 years. Accordingly, the commentaries on ECB policy were often distinctly more critical – especially in the first few years – than they would have been about the Bundesbank in a similar situation. Having mentioned that, it has to be admitted that the ECB's external communication has not always been perfectly optimal. But the ECB has responded to this, not least by clarifying its monetary policy strategy in 2003. This clarification essentially concerned two points. First it provided a clearer definition of price stability and, therefore, its target with the term "below but close to 2%". Up to then, it had defined an upper but not a lower limit for its inflation target.

Second, the ECB gave a more precise definition of the relationship between the two pillars of its strategy. The economic analysis, which comprises numerous economic variables, is used for assessing price risks in the short to medium term. With regard to concrete interest rate decisions, it is therefore in actual fact more important than the monetary analysis – in other words, the analysis of monetary aggregates. This is likewise used for studying the risks to price stability, but in a longer-term perspective.

Let us turn to exchange rates now. Put rather bluntly, this was the topic that people moaning and groaning in the first three years of EMU. The reason was that, for a time, the euro's value against the US dollar dropped by one-third during that period. It was often inferred from this that the euro was a weak or even unstable currency – in any event, weaker than the D-Mark had been. Well, even at the time, the logical gaps in this argument were obvious. When assessing a currency's stability, what matters most is internal price stability – and that is something that has very been very much safeguarded in the euro area. It also has to be added that the exchange rate against the US dollar is not the sole criterion even for assessing the euro's external value. A more informative number is the euro’s effective exchange rate, which models its weighted average against the currencies of our major trading partners. And, in this respect, the fluctuations have been much smaller. In other words, the euro's widely perceived weakness was also an expression of the dollar's strength against other currencies.

Figure 4. Euro-dollar-exchange rate and effective exchange rate



1 Effective exchange rate of the euro against 23 currencies (weighted by trade in manufactured goods). Source: ECB.

In the meantime, the trend of the first few years has gone into reverse. The euro has appreciated strongly over the past few years. It is now trading at just under US$1.37, compared with US$1.18 Dollar at the start of monetary union. Exchange rate swings of this kind are nothing new. Nor do they have anything to do with the introduction of the euro. They are caused by the fact that, nowadays, the vast majority of foreign exchange deals are conducted for the purpose of capital transactions, which, in turn, are frequently driven by a search for short-term profits. The well-known phenomenon of “herding” likewise plays a major role in this connection. This means that an exchange rate movement can be greatly amplified once it has been spotted. You will be familiar with this effect from the stock markets. The outcome is that the market rates or prices sometimes deviate substantially from what is felt to be economically reasonable. The euro’s crucial advantage is precisely that such exchange rate volatility has been eliminated vis-à-vis our most important European partners.

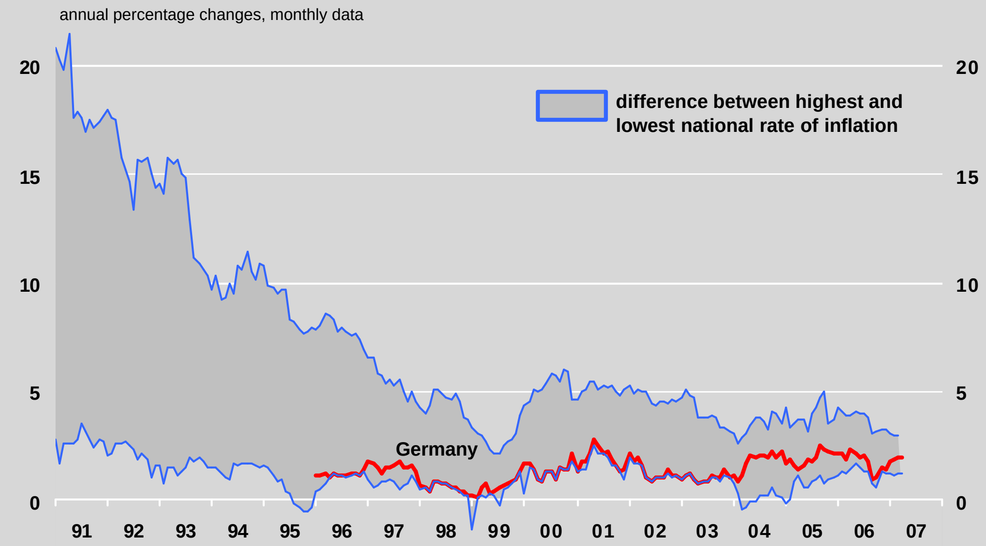
The second topic that got people moaning and groaning was connected with the introduction of euro banknotes and coins at the start of 2002. That was when we all learnt a new expression: “perceived” inflation”. Of course, there were some sectors, which used the currency changeover to make hidden price increases. That rightly annoyed many people and, in many cases, the response was a change in purchasing behaviour. Quite a few “black sheep” suffered painful losses in turnover. In macroeconomic terms there was a measurable but not a dramatic effect. To that extent, the psychological impact was considerably greater than the real one.

3. The significance of inflation differentials

Let me highlight a further point. Even long before it actually started, monetary union had led to considerable changes in behaviour in the subsequent member countries. Inflation rates were clearly on the decline in the 1990s, for example. In line with this, there was a convergence of national interest rates ahead of the euro's introduction towards to the low level prevailing in Germany and some other countries. This greatly enlarged the "price stability zone". This was a considerable advantage, first of all, for the previous high-inflation countries. But Germany, too, benefits from a stable economic setting. After all, we have close economic links with our partner countries.

Yet the spread between the highest and lowest national interest rates has widened again during the first years of monetary union. Differing cyclical situations and growth rates have played a part in this. There are also structural aspects. Individual countries react with varying intensity to oil price increases, for example.

Figure 5. Inflation differentials in EMU [1)]



1 Harmonised Index of Consumer Prices. Source: Eurostat.

This leads to two questions. "What do persistent inflation differentials mean for the individual countries of the euro area?" And "What do inflation differentials mean for the single monetary policy?"

The real interest rate argument is often heard in connection with the impact of inflation differentials on the individual member countries. In a nutshell, the argument is that, in a monetary union, nominal interest rates have almost entirely converged. Accordingly, countries with a comparatively low inflation rate have a higher-than-average real interest rate and, therefore, tougher financing conditions. Typically, countries with weak growth tend to have a low interest rate. Therefore, it is claimed, monetary union poses a further strain on them.

What are we to make of this argument? First of all, it ignores the fact that real interest rates are determined more by long-term inflation expectations than by the current inflation rate. And long-term inflation expectations, both for Germany and the euro area as a whole, are at just under 2%. More important, however, is the fact that the real interest rate argument disregards the positive effects of price stability. Comparatively small price rises imply a corresponding improvement in competitiveness with regard to one's trading partners because, in a monetary union, inflation differentials can no longer be "neutralised" by exchange rate adjustments. To be specific, since 1999 the German economy has, overall, gained roughly 12% in terms of competitiveness against the other countries of the euro area. On the whole, there is therefore much to suggest that the below-average development of prices has benefited rather than harmed the German economy. Not least, this has boosted the dynamic growth of our exports.

Now for the second question: the relevance of inflation differentials to monetary policy. Even through the ECB has no influence on such inflation differentials, they do pose a potential risk to the public acceptability of monetary policy. The ECB has to and can only gear its interest rate policy to the average development of the euro area. For that reason, it cannot take account of particular national circumstances. Nevertheless, this aspect should not be overdramatised. By historical standards, the inflation differentials are small. Furthermore, such differences can also be seen in other large currency areas, such as the USA.

4. Assessment of fiscal policy

Besides monetary policy, fiscal policy, too, has been attracting particular attention over the past few years. In contrast to monetary policy, fiscal policy has largely remained a national responsibility.

Even so, in a single currency area, the national fiscal policies cannot operate entirely independently of each other. One country's borrowing behaviour influences the interest rate level not just in that country but across the monetary union as a whole. Added to this is the fact that the effectiveness of monetary policy and the effectiveness of fiscal policy are interlinked. For example, a fiscal policy that is persistently over-expansionary makes it more difficult to maintain price stability. The performance of fiscal policy over the eight years of EMU so far has been far less impressive than that of monetary policy. Some very large economies, such as France, Germany and Italy, failed to meet the criteria of the Stability and Growth Pact for several years running. This applies, not least, to the budget deficit ceiling of 3% of GDP.

The situation looks better at present. This can also be seen precisely from developments in Germany. The German deficit ratio in 2006 amounted to 1.7% and was thus well below the ceiling. Last year, only Portugal and Italy were still above the 3% limit. However, this positive development is due, not least, to cyclical factors. Besides what is currently already quite a high level of debt – for Germany it is 68% of GDP – the expected burdens resulting from demographic change, in particular, underscore the need for further consolidation.

Certainly the reform of the Stability and Growth Pact adopted in 2005 was not helpful in this respect. In particular, the binding nature of the rules was weakened by exceptions and special arrangements. Nevertheless, there's no point in shedding tears over the loss of the old set of rules either. We can only look ahead, and that means constantly urging policymakers to make more determined efforts to improve the state of public finances. We must pursue a sustainable fiscal policy. Higher indebtedness poses a strain on future generations.

5. Looking ahead

Taking a somewhat further look ahead, we come to the future perspectives for European monetary union. The key question at present is when and under what conditions the new EU member states will introduce the euro. For Slovenia, this question has already been answered. At the beginning of the year, we were able to welcome Slovenia as a new member of the euro area. The participation of other countries will further cement the existing close relationships. The adoption of the single currency is the last and probably most important step towards the European single market. As things stand at present, Cyprus, Malta and Estonia wish to introduce the euro on 1 January 2008, Slovakia will do so one year later. There is still no official target date for the other countries.

These different roadmaps for accession are in themselves a reflection of the varying circumstances of the euro candidates. First of all, this concerns the fulfilment of the Maastricht convergence criteria, which naturally still have to be met before the euro is introduced. At present, only the Czech Republic meets all the criteria simultaneously. Seven countries have an inflation rate that is above – in some cases, well above – the reference value, which means there is a considerable, matching need for action.

Figure 6. The new EU-Member countries and the EMU convergence criterias [1)]

✓ yes X no

	fiscal defizit	Gross debt	price stability	long-term interests
Bulgaria	✓	✓	X	✓
Estonia	✓	✓	X	X
Latvia	✓	✓	X	✓
Lithuania	✓	✓	X	✓
Malta	✓	X	✓	✓
Poland	X	✓	✓	✓
Romania	✓	✓	X	X
Slovakia	X	✓	X	✓
Czech Republic	✓	✓	✓	✓
Hungary	X	X	X	X
Cyprus	✓	X	✓	✓

1 Data: 2006. Sources: European Commission, Eurostat.

Cyprus, Malta and Hungary are failing to meet the quantitative gross debt target. At all events, debt ratio of Cyprus and Malta has clearly been on the decline over the past few years, however.

It also has to be remembered that the risks of joining the euro area too soon would lie mainly with the new member states. This is because their economic output is less than one-tenth of that of the existing euro area. The new countries' economic structures have to be far enough developed to withstand the competitive pressure in the singe currency area. As has been said many times, real convergence has to be sufficiently far advanced. This can be determined, not least, by the level of per capita income. Several accession candidates, especially Romania and Bulgaria, but also Poland, for example, have a per capita income of less than half the euro-area average. Ultimately, the introduction of the euro is a perfect example of integration: It offers us major advantages and opportunities. Nevertheless, the past few years have also shown that it is crucial to have the right underlying conditions in place.