The Euro Debate

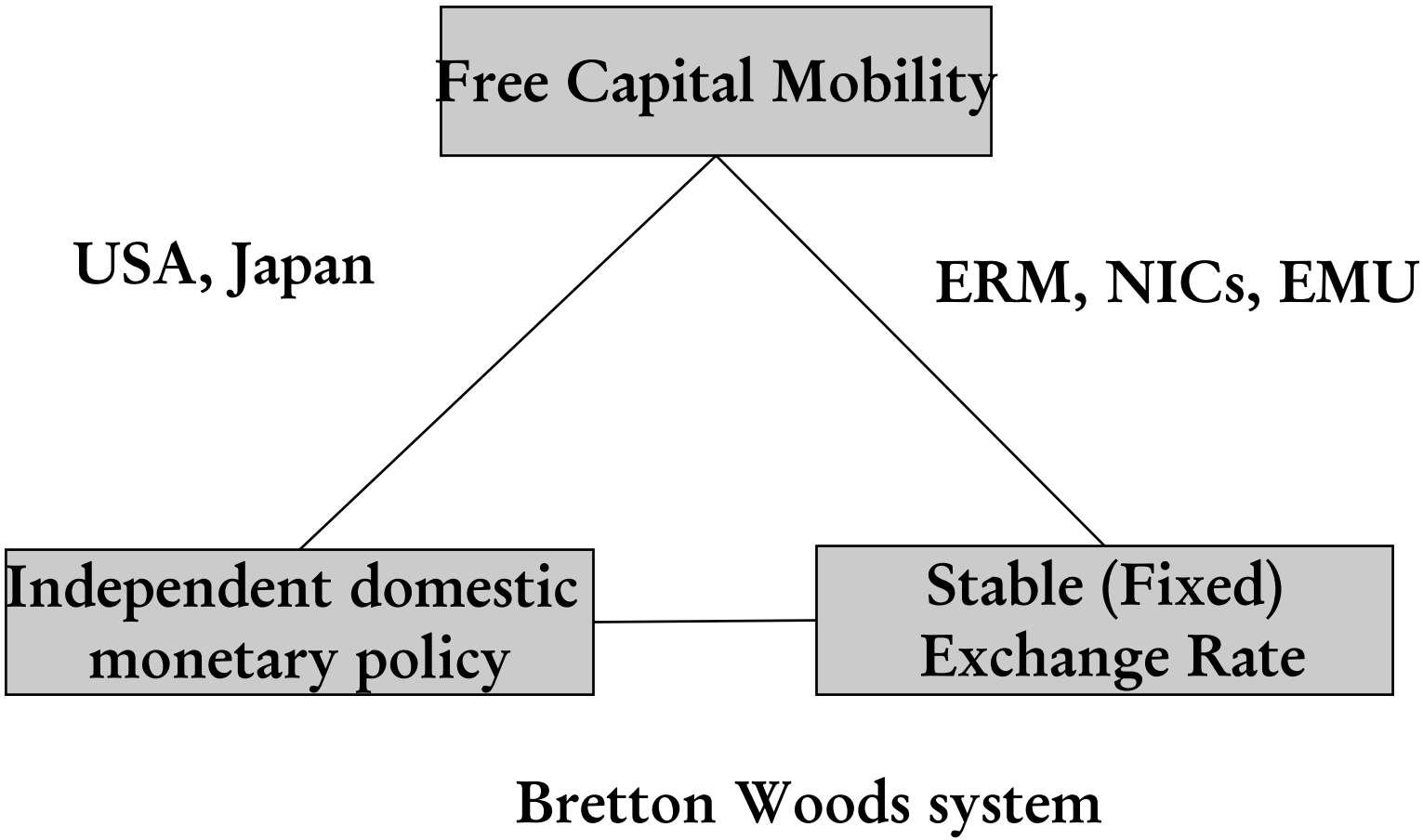
Gavin Cameron

Wednesday 17 July 2002

Oxford University

Business Economics Programme

the Trinity


Free Capital Mobility
USA, Japan
ERM, NICs, EMU
Independent domestic monetary policy
Stable (Fixed) Exchange Rate
Bretton Woods system

the development of EMU

- April 1972: The Snake.
  - 6 EC founders plus UK, Ireland, Denmark, Norway agreed to keep within ±2¼% bands. Sterling left in June 1972, Italy in February 1973.
- March 1979: EMS.
  - Core countries used ±2¼% bands while Italy, Ireland, Spain, Portugal, UK had 6%.
  - No realignments after January 1987; phased reduction of FX controls;
- September 1992: Crisis.
  - Stress caused by misalignments of Italy, UK and Germany.
- August 1993: Wide bands.
  - All EMS bands widened to ±15% except DM: Guilder.
- January 1999: EMU.
- January 2002: Euro notes and coins began to circulate.

floating exchange rates

- Under pure/clean floating, foreign exchange markets are in continuous equilibrium.
- The exchange rate adjusts to maintain competitiveness in the long-run such that Purchasing Power Parity holds.
- But in the short-run, the level of the floating exchange rate is determined by speculation: differences in interest rates must be offset by expected movements in exchange rates and/or risk premia.

effect of a speculative inflow

- Under floating, the nominal (and real) exchange rate rises and competitiveness is lost.
- With a fixed rate, the central bank has to sell domestic currency, which causes inflation and raises the real exchange rate.
- This might destroy the peg (Malaysia, Thailand, Mexico).
- No difference in effect in the long-run but may take longer under a fixed system.

effect of monetary relaxation

- With floating rates, a cut in interest rates causes the exchange rate to fall, competitiveness rises, aggregate demand rises.
- This causes inflation which restores competitiveness back to original level.
- With fixed rates, a cut in interest rates isn't possible if there is high capital mobility (i.e. interest rates must be equal across the world).
- More monetary discipline under fixed rates.

fixed vs floating exchange rates

- Robustness and flexibility
  - Bretton Woods was abandoned when it couldn't cope with real and nominal strains;
  - A flexible system is more robust and flexible.
- Volatility
  - Fixed rate offers fundamental stability;
  - Flexible system is potentially volatile:
    - US and UK have had twice as much (nominal and real) exchange rate volatility as Germany and France since 1980. Japan has had three times as much.
- Financial discipline
  - Fixed rate system imposes discipline and policy harmonization.

exchange rate overshooting

- Two ingredients:
  - Slowly adjusting prices;
  - Interest parity.
- If interest rates rise, for the asset market to be in equilibrium, the currency must be expected to *depreciate*. But higher interest rates will tend to reduce inflation and therefore lead to currency *appreciation*.
- The exchange rate 'overshoots' if, in response to a shock, it initially jumps above its long-run equilibrium and then adjusts back slowly.

exchange rate variability against ERM

	1974-78	1979-85
France	1.68	0.76
Germany	1.47	0.70
Italy	1.93	0.88
ERM	1.48	0.73
Japan	2.11	2.17
UK	1.68	2.09
USA	1.88	2.74
non-ERM	1.72	1.79

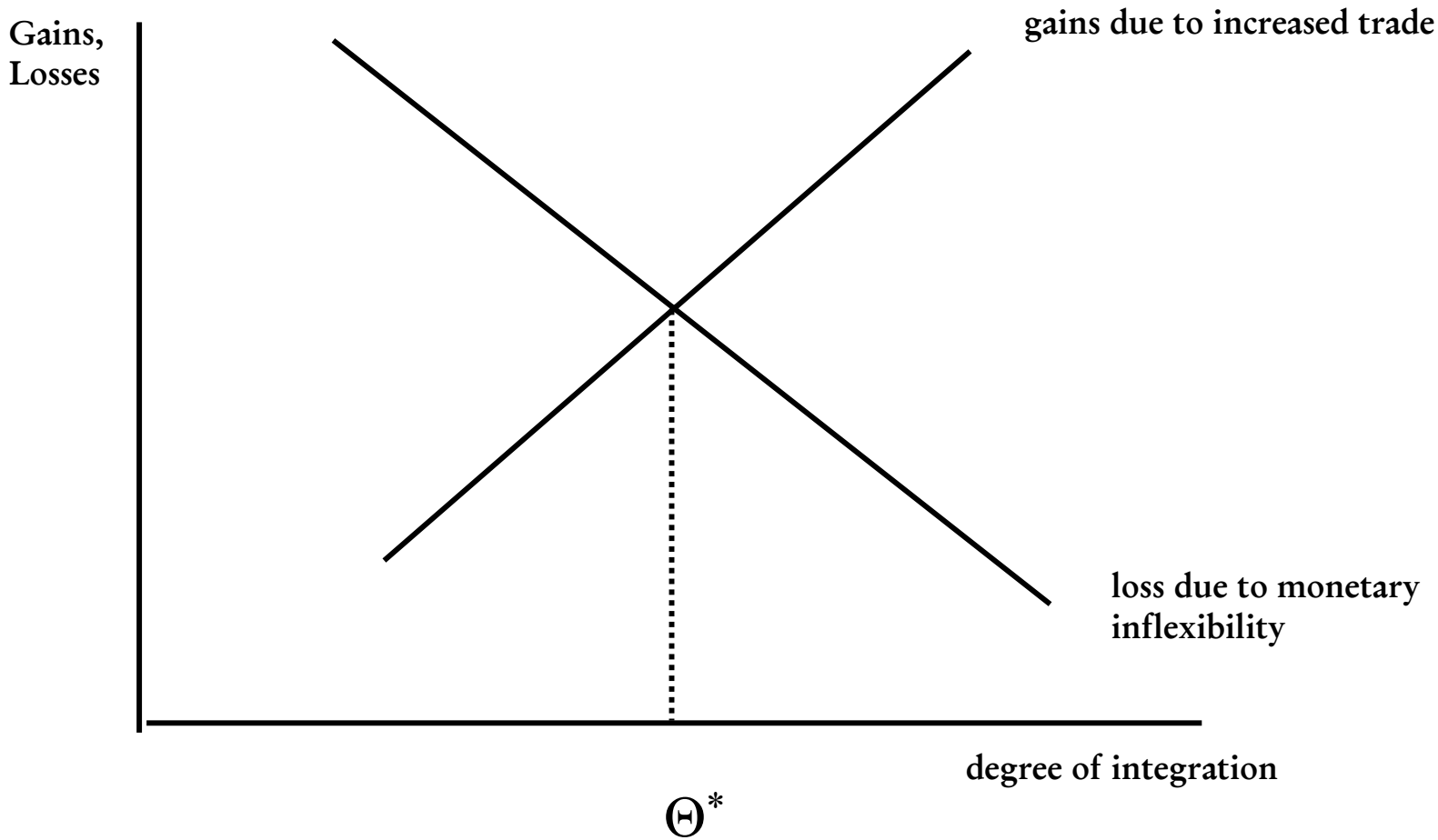
Note: *Variability is the standard deviation of monthly log changes (x100)*
Non-ERM is UK, USA, Austria, Canada, Norway, Sweden, Switzerland and Japan.

Source: *El-Agraa (2001) table 17.3.*

optimal currency areas

- An optimal currency area (OCA) should have the following characteristics:
- Lots of trade within the area;
- Similar industrial structures, housing and financial markets;
- Shocks are symmetric;
- Flexible labour markets (when wages change, labour moves);
- Fiscal federalism (i.e. fiscal transfers to depressed regions);
- Similar transmission mechanisms.

gains and losses from EMU



benefits of EMU

- No overshooting;
- Commitment to Euroland inflation rate;
- Lower transactions costs, so more trade.
- More open pricing, so more competition;
- Less uncertainty;
- Higher economic growth?

costs of EMU

- Loss of monetary independence;
- ECB anti-inflationary credentials unknown (asymmetric target, no transparency of decision making, Stability Pact);
- Cannot use exchange rate to offset region-specific shocks;
- 'One size fits all' monetary policy inappropriate for different industrial structures and financial systems;
- Countries may differ in their preferences to inflation and unemployment.

intra-Union exports and imports (% GDP)

	Exports	Imports
Ireland	45.7	27.8
Belgium and Lux.	41.9	40.8
Netherlands	32.1	24.9
Portugal	19.4	25.5
Sweden	18.4	17.0
Finland	16.9	14.3
Denmark	16.3	16.6
EU-15	14.7	14.0
Austria	14.3	21.6
UK	12.8	13.3
Germany	12.7	10.9
Spain	12.2	13.7
France	11.7	11.1
Italy	11.0	10.0
Greece	5.7	16.1

Source: *De Grauwe (2000) table 4.1.*

GDP growth correlations with Euroland

	1977-1986	1987-92H1	1992H2-96
Germany	0.89	0.28	0.93
France	0.72	0.85	0.99
Italy	0.93	0.65	0.92
Austria	0.65	0.71	0.85
Belgium	0.51	0.92	0.97
Finland	0.17	0.68	0.88
Ireland	0.30	0.65	0.76
Netherlands	0.76	0.60	0.89
Portugal	0.48	0.43	0.41
Spain	0.21	0.62	0.94
UK	0.48	0.53	0.57
Denmark	0.33	-0.07	0.54
Greece	0.65	0.36	0.83
Sweden	0.27	0.61	0.90

Note: *Correlation with EMU11 area on a semi-annual basis*
Source: *Huhne (2001) table 4.1.*

sacrifice ratios

	1980-4	1980-6	1980-8	1980-92	1980-95
USA	0.64	0.51	0.36	0.05	-0.20
Germany	4.43	3.82	6.73	117.33	14.70
France	1.40	1.55	2.29	3.41	4.64
UK	1.51	2.00	2.69	2.99	3.58
Italy	0.42	0.63	1.01	1.76	2.47

Note: *Ratio of cumulative increase in unemployment to difference in inflation.*
Source: *El-Agraa (2001) table 17.4.*

the housing market

	Owner-Occupation Rate	Mortgage share of GDP	Fixed Rate share
Austria	54	30-33	n/a
Belgium	67	22	25
Denmark	50	65	90
Finland	62	30	n/a
France	54	21	80
Germany	38	51	20
Greece	76	6	30
Ireland	79	27	43
Italy	68	7	60
Netherlands	48	60	25
Portugal	67	26	0
Spain	78	22	20
Sweden	39	51	n/a
UK	67	57	n/a
EU15	56	36	n/a

Source: *Maclennan, Muellbauer and Stephens (1998).*

stability pact

- Nations can default on their debt in two ways: outright default and through surprise inflation and devaluation.
- Within EMU countries cannot use the latter option, but does that make an outright default more likely?
  - No evidence of increased risk of outright default from EU bond differentials with Germany. Post-EMU differentials smaller than between US states.
- The Stability Pact:
  - Countries must aim to achieve budget balances;
  - Deficits of more than 3% of GDP will receive fines of up to ½% of GDP.
  - Fines will not be applied in exceptional circumstances (i.e. natural disasters or a 2% fall in GDP in one year).
  - The Pact is neither flexible nor symmetric, but will it ever be applied?

Gordon Brown's five tests

- Are business cycles and economic structures compatible so that we and others could live comfortably with euro interest rates on a permanent basis?
- If problems emerge, is there sufficient flexibility to deal with them?
- Would joining EMU create better conditions for firms making long-term decisions to invest in Britain?
- What impact would entry have on the competitive position of the UK's financial services industry, particularly the City's wholesale markets?
- In summary, will joining EMU promote higher growth, stability and a lasting increase in jobs?

summary

- Move towards the two extremes (single currency in EU, floating in developing world).
- Rapid liberalization of capital movements provides threats as well as opportunities.
- No system is universally best. Generally, as long as a country is running a responsible domestic policy the choice of regime is unlikely to be important, but when it has large foreign debts or is acting irresponsibly, any exchange rate regime can become unstable.
- Benefits of EMU likely to be small and spread over a long-period of time.
- Upfront cost of entry might be huge if at too high a rate or at wrong point in business cycle (q.v. Britain in 1925, 1946 & 1990).