The Euro Area and the World Economy

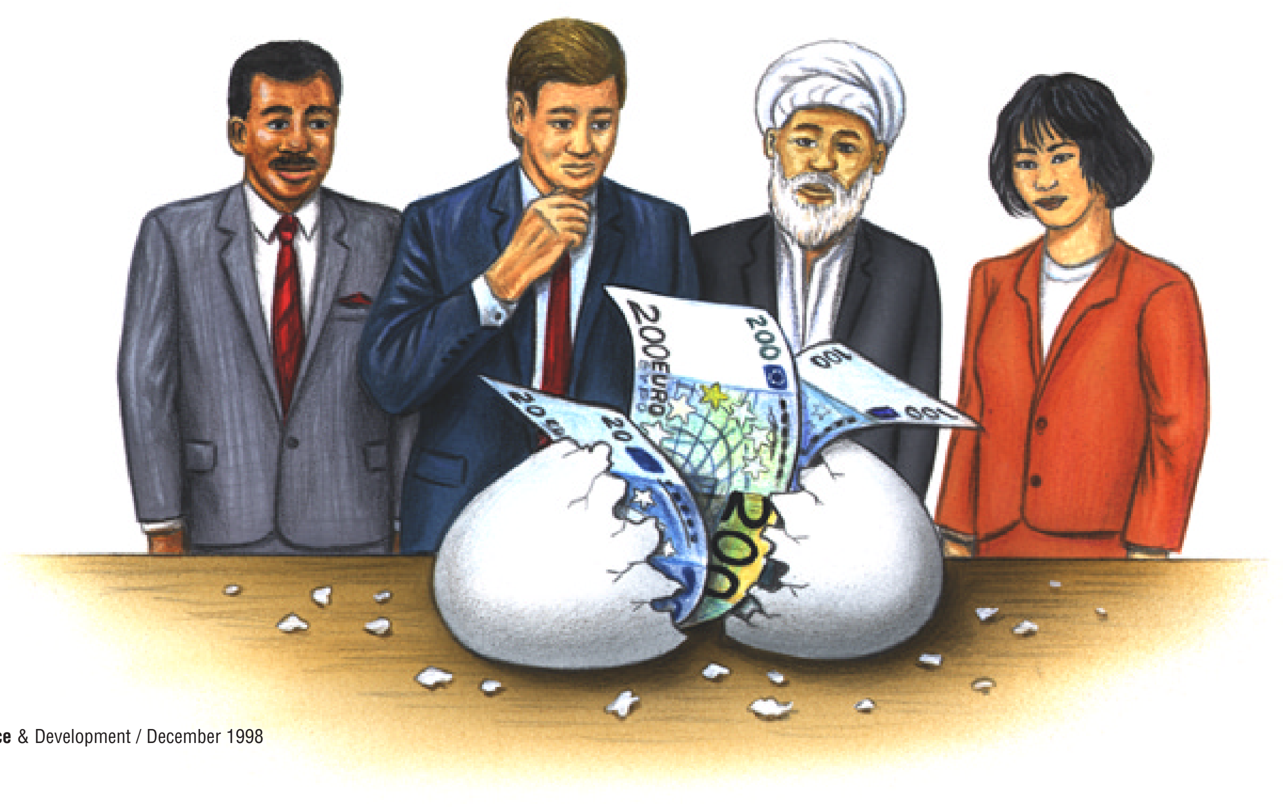
European monetary union will bring both new opportunities and fresh challenges for economic policies in countries outside the euro area.

John Green and Phillip L. Swagel

THE advent of European Economic and Monetary Union (EMU) and the development of a single, more powerful economic market will have an impact both on the other economies of Western Europe and on other countries with established trade and financial links to Europe, including countries that will link their own currencies to the euro. The transition economies of Central and Eastern Europe and the Baltics, the developing countries of the Mediterranean basin, and countries in Africa are most likely to be affected by EMU. Countries in Asia and the Western Hemisphere and advanced economies outside Europe will also be affected, though to a lesser extent.

Global environment

The global environment has been supportive, until now, of the transition to a single currency for 11 members of the European Union and the achievement of their economic objectives. Strong demand by advanced countries for exports from the euro area, coupled with the depreciation of the currencies of euro area countries over the past three years, has stimulated recovery in the euro area and helped to offset the effects of the Asian crisis (see chart). As the growth in



demand from these areas is likely to slow, however, it will become more important for demand within Europe to become self-sustaining.

There are also challenges for EMU in the global economic environment.

- The crisis in Asia and other emerging market economies could produce adverse spillover effects on the euro area and make monetary policy more difficult to carry out.
- If the crisis deepens further, external demand could weaken and dampen the current recovery in Europe, which, in turn, could dampen confidence and domestic demand.
- In addition to the portfolio shifts expected as investors become accustomed to holding the euro, financial market volatility could add to uncertainty in assessing the economic indicators that the European Central Bank (ECB) will be monitoring.
- The weakness of the yen over the past several years and the recent volatility in the yen-dollar exchange rate demonstrate how rapidly market exchange rates can deviate from those indicated by medium-term fundamentals; such deviations could adversely influence financial conditions and monetary policy deliberations in the euro area.
- The Asian crisis, coupled with the possibility of a broader crisis in emerging markets, could influence the transmission of policy to the real economy if, for example, commercial banks in the euro area have to make substantial provisions for nonperforming loans.

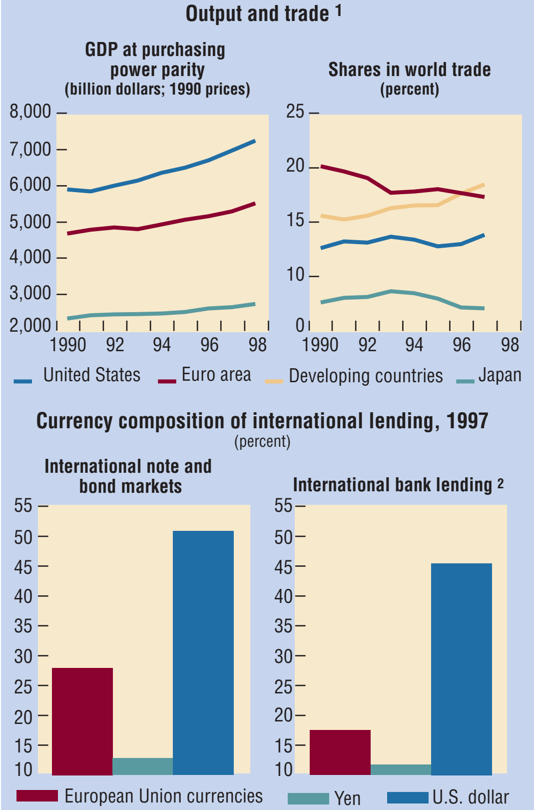
The euro

While the future behavior of the euro cannot be readily predicted, it is likely to appreciate against the dollar and the pound sterling over the next few years, but to depreciate against the yen. Exchange rate movements along these lines may have already begun. Cyclical factors—the United Kingdom and the United States are at more advanced stages of recovery than the euro area, but the euro area is well ahead of Japan—are one element of this reasoning.

Measures of fundamental equilibrium exchange rates further support this assessment. For example, in evaluating exchange rate levels, the IMF uses a macroeconomic balance approach that considers medium-term national savings and investment, which, in turn, determine the medium-term current account balance. For the euro area, demographic factors—such as the proportion of the population approaching retirement age—can be expected to raise national savings in relation to investment, which would lead to a current account surplus in the medium term. At the same time, countries in the euro area recorded a medium-term surplus in 1997 that was larger than a reasonable medium-term equilibrium. This would suggest that the euro is likely to appreciate, relative to exchange rate levels of euro area members in the first half of 1998, toward a level consistent with a smaller surplus.

Also important will be the extent to which investors see the euro as a stable store of value, which will depend on the credibility of the ECB. Such credibility is likely to be strong

Euro area and United States: Indicators of relative economic size



Sources: International Monetary Fund, *World Economic Outlook* (Washington, October 1998); and Bank for International Settlements, *68th Annual Report* (Basle, June 1998).

[1] For 1998, IMF staff projections. Trade shares are calculated through 1997 only.

[2] Cross-border claims and local claims in foreign currency of banks located in industrial reporting countries. European Union currencies comprise the deutsche mark and the French franc only.

because the new central bank has been given the independence to pursue price stability as a primary objective, and its governing body is composed mostly of central bankers who are known "inflation hawks" dedicated to maintaining price stability.

It is also likely that, once the single currency takes effect, the national central banks of the euro area will reduce their international reserve holdings. Trade within the euro area will be denominated in a single currency and will no longer need to be backed by international reserves. Estimates of the EMU countries' resulting "surplus" of international reserves range from $50 billion to $230 billion. Given that these amounts are small in relation to the total stocks of the international assets and liabilities of the United States, any downward pressure on the exchange rate between the euro and the dollar resulting from the sale of U.S. dollars is likely to be small. Rebalancing of official reserves will, in any event, be swamped by shifts in private sector supply and demand for euro-denominated assets.

Advanced economies outside the euro area

Developments in the euro area will have important implications for those countries of the European Union that will not take part in the first round of monetary union.

Euro area and selected countries: trade linkages

(exports to and imports from trading partners in 1996; percent of total trade and output)

	Partner countries						
	Trade [1]			Output [2]			
	Euro area	Other advanced	Developing and transition	Euro area	Other advanced	Developing and transition	Total
Euro area	51.0	30.8	18.2	11.7	7.1	4.2	22.9
Denmark	47.1	40.2	12.7	11.1	9.5	3.0	23.6
Greece	57.5	21.4	21.1	8.4	3.1	3.1	14.6
Sweden	44.5	43.1	12.3	13.0	12.6	3.6	29.1
United Kingdom	49.4	34.9	15.7	11.0	7.8	3.5	22.3
Japan	11.3	54.7	34.1	0.9	4.5	2.8	8.2
United States	13.8	53.6	32.6	1.3	5.0	3.1	9.4
Asia	12.5	67.7	19.8	2.5	13.3	3.9	19.7
Africa	39.8	34.4	25.8	7.7	6.7	5.0	19.5
of which							
CFA franc zone	48.1	23.7	28.2	12.3	6.1	7.2	25.5
Middle East and Europe	26.9	42.8	30.2	6.9	11.0	7.8	25.6
of which							
Central and Eastern Europe	51.0	16.1	32.8	16.8	5.3	10.8	32.9
Western Hemisphere	13.3	61.4	25.3	2.0	9.1	3.7	14.8

Source: International Monetary Fund, *World Economic Outlook* (Washington, October 1998).

[1] Imports plus exports of goods from and to partner countries as percent of total imports plus exports.

[2] The average of imports plus exports of goods from and to the partner countries as a percent of GDP.

• Greece has continued to make significant progress toward macroeconomic convergence with the EMU countries and has indicated its objective of entering EMU in 2001. In the period ahead, Greece will follow tight fiscal and monetary policies to ensure that it meets the Maastricht Treaty's criteria and to maintain broad exchange rate stability between the drachma and the euro.

• In 1997, Denmark, Sweden, and the United Kingdom all met the Maastricht criteria for inflation and interest rate convergence, and none had excessive deficits. They have indicated, however, that they do not intend to participate at present. Any decision on membership would require approval by a public referendum in each country, and public support does not appear strong at this time.

• In the United Kingdom, the authorities have set five benchmarks—various macroeconomic and structural convergence indicators—to ensure that U.K. entry into monetary union is consistent with its central economic objective of high and stable growth and employment.

• All three countries face the challenge of adjusting their existing economic policy frameworks and stances to be compatible with EMU membership. This is unlikely to be a problem for Denmark, because the krone has been linked to the deutsche mark within the exchange rate mechanism (ERM) of the European Monetary System. The Swedish krona and the pound sterling have floated and not participated in the ERM since the crisis of 1992, but it is unclear whether this would constitute an obstacle to future participation in the euro area.

• Norway and Switzerland, although they are not members of the European Union and are therefore not eligible to participate, will be directly affected by monetary union owing to both geographic proximity and their strong trade and financial links with the euro area.

• The advent of the single currency and economic development in the euro area are likely to have a smaller direct impact on the non-European advanced economies. For Canada, the United States, and the advanced economies of Asia, trade with the euro area represents a relatively small share of each country's total trade or GDP, and the direct impact of developments in the euro area is likely to be limited (see table). Indirect influences could be more important, however, especially for the United States. A redirection of demand for international reserves from dollars to euros would tend to reduce the U.S. current account deficit as a counterpart to the negative impact on the U.S. capital account. A shift from international reserves held in dollars to euros would also redistribute some international seigniorage revenue from the U.S. Federal Reserve to the ECB. Overall, EMU and European integration can be expected to have a positive effect on the United States and other countries, as the single currency and the integrated market will facilitate financial and business transactions.

Developing and transition countries

For developing and transition countries, the main impact of the unified European market is likely to come through trade and financial linkages. More robust activity and high import demand in the euro area will lead to increased exports from, and output in, developing and transition countries. Similarly, exchange rate arrangements, financial market developments, and capital flows will have implications for developing and transition countries and their policies.

• An increase in the cyclical strength of the euro area will lead directly to increased exports for Europe's trading partners. In addition, the launch of the single currency is likely to lead to further progress in reforming labor markets and addressing other structural problems and, consequently, to medium-term output gains. Trade with the euro area makes up between 40 and 50 percent of total goods trade for Africa as a whole, with countries in North Africa and the CFA franc zone at the higher end of this range.

• A number of emerging market countries with close ties to Europe currently link their currencies to the deutsche mark or the French franc. These links are expected to be shifted to the euro. Changing values between the euro and the dollar or yen could affect these countries' external competitiveness when the currency or currency basket of the exchange rate target deviates from the trade-based effective exchange rate. At the same time, countries with dollar- or yen-denominated debt would be affected: an increase in the value of the euro would benefit those countries that peg their currencies to the euro, because it would decrease the domestic currency cost of servicing their dollar-denominated debt. Conversely, any depreciation of the euro would increase the cost of such debt service.

• To offset these effects, countries may decide to adjust their exchange rate regimes to reflect better the composition of their trade and financial links or to change their debt-management policies. Adjustments to debt management will be facilitated as the euro becomes widely used in trade and financial markets and accounts for a larger share of debt securities. Countries that peg to the euro will be able to lower their dollar exposure and reduce the fluctuations in their dollar-denominated debt payments.

EMU may also lower borrowing costs:

• Deeper and more liquid capital markets in Europe will lower borrowing costs, both for countries in the euro area and for other countries that raise euro-denominated funds.

• EMU will allow private institutions, such as insurance companies and pension funds, in the euro area to shift some of their portfolios into emerging market investments. Because investments outside their home countries but within the euro area will be reclassified as domestic currency investments, investors will find that EMU effectively eases constraints imposed by currency exposure requirements.

• Emerging market economies could benefit from direct and portfolio capital inflows if converging asset returns in Europe lead global investors to increase their emerging market holdings in order to diversify across countries.

EMU may also create some financial risks for emerging market countries:

• A successful EMU that raises productivity and growth could make Europe more attractive to investors and increase the cost of capital for emerging market economies.

• Increased competitiveness of European financial institutions and the greater depth of financial markets in the euro area could lead firms in developing and transition countries to raise capital in euros rather than in their domestic currencies, thus challenging local capital markets. This could, however, provide an incentive for developing and transition countries to strengthen their financial intermediation and build sound banking systems.

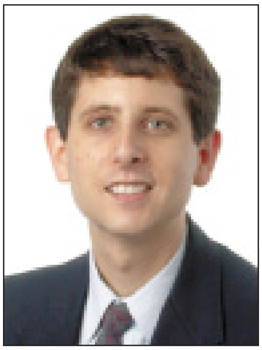
Challenges of EU enlargement

The European Union is currently being enlarged to include the transition countries of the Baltics and Eastern Europe, together with selected European countries in the Mediterranean region. Countries that intend to join the European Union will need to show progress toward meeting the Maastricht criteria, although this is not required for accession, nor are new members expected automatically to join EMU. Potential EU members must overcome a number of challenges. They need to progress with privatization and to continue to reduce government involvement in the economy while dismantling monopolies, removing trade restraints, and developing flexible labor markets.

Six countries—Cyprus, the Czech Republic, Estonia, Hungary, Poland, and Slovenia—have received favorable opinions from the European Commission on their membership applications, and accession negotiations are under way. These six countries have already made good progress toward meeting the fiscal guidelines of the Maastricht Treaty, but inflation rates in the five transition countries in this group are still above those in the euro area. Although progress on this front is important, it would seem more relevant to define economic convergence in terms of a broader set of structural and institutional requirements. Full capital account liberalization is among these and will itself require development of robust financial sectors and stronger regulatory and oversight capacities to help ensure stability. F&D

This article draws from material contained in International Monetary Fund, World Economic Outlook *(Washington, October 1998).*

John Green is a Deputy Division Chief in the World Economic Studies Division of the IMF's Research Department.



Phillip L. Swagel is an Economist in the World Economic Studies Division of the IMF's Research Department.