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THE STABILITY OF CURRENCY AREAS AND THE EMU EXPERIENCE [1]

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Dino Martellato

Dipartimento di Scienze Economiche, Università Ca' Foscari di Venezia, Canaregio 873 Venezia

Abstract. *Recurrent crises of the 1990s have rekindled the debate over the virtues of different exchange rate regimes, by focusing more closely on the stability of different regimes. Opinions continue to differ. The experience of European Monetary Union, being an extreme case of exchange rates fixity in a currency area, is an interesting case in point. The aim of this paper is to consider EMU, its companion ERM II and the original ERM as examples of exchange rate regimes. Integration of markets inside EMU is to be reached only gradually after the full integration of the money market. There is one conviction that the increased integration between member countries is not only able to deliver macroeconomic stability and convergence, but also to sustain average real growth. It is, however, debatable whether in a large monetary union such as EMU convergence in real growth and stability could really be achieved in all member countries. It can be argued, indeed, that if independent monetary policies are not able to deliver stability and growth in all countries before the start of Phase Two of the euro, the common monetary policy cannot automatically be assumed to be a guarantee for achieving the same goals.*

Key Words: *exchange rate crisis, exchange rate regimes, European Monetary Union.*

The number of countries open to international capital flows and with a pegged exchange rate that, at some stage, have been obliged to devaluate is very high. Indeed, when a country faces a severe shock or when it has been slow in taking the necessary policy actions, the resulting gap between the official rate and the equilibrium nominal rate becomes large and the central bank is unable to face speculation fuelled by free-moving capital. Notable examples of exchange rate crises were met by the European Exchange Mechanism in 1992 (Italy, England, Spain and Sweden), Mexico in 1994, South-East

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Asia in 1997, Russia in 1998, Brazil in 1999, Turkey in 2006. As the consequences of such crises have often been severe, the countries that were hit resolved to alter their exchange regimes. Some of those countries (e.g. England, Russia, Brazil, Mexico, Indonesia, Korea, and Thailand) shifted from their peg or band to some form of managed float; while others hardened their previously softer peg, participating in a currency area, or by adopting a currency board or plain dollarization.

It can be said that the recurrent crises of the 1990s have rekindled the debate over the virtues of different exchange rate regimes, by focusing more closely the stability of different regimes. Opinions continue to differ. Frenkel (1999) purports the relativistic idea according to which there is no optimal currency in general. In his view, the optimal exchange rate regime varies across countries and over time; others advocate the so-called bipolar view. Fisher (2001), for instance, argued that soft pegs must be avoided as something intrinsically unstable, and found a free float or some form of hard peg preferable. Dornbush (2001) took the extreme view when he famously suggested that in many cases it would be preferable to reduce the number of currencies altogether. He remarked that, notwithstanding the superiority of floating exchange rates over fixed ones, flexibility in exchange rates is actually not exploited even in those countries that have refused to fix the exchange rates of their currency.

As currency areas are considered a typical example of the hard way of pegging exchange rates, the experience of European Monetary Union, being an extreme case of exchange rates fixity in a currency area[2], is an interesting case in point. We suggest considering EMU, its companion ERM II and the original ERM as examples of exchange rate regimes[3]. Our perspective, admittedly, is quite narrow for assessing EMU, given the broad range of goals pursued by the countries adhering to the single currency. Nevertheless, it is legitimate to consider EMU in this way, as it is actually a recipe for getting absolute rigidity in nominal exchange rates inside the area and substantial, if not absolute, flexibility of the euro via-à-vis such key currencies as the US dollar and the yen[4]. EMU is loosely inspired by the economic doctrine of currency areas as the required degree of openness and integration that is expected to be met in any optimal currency area did not exist in 1999 i.e. when the single monetary policy came into being. Although there are some specific policies aiming at integrating capital markets, in particular, and some goods and services markets in the EU which are being implemented, integration is still relatively weak after eight years of EMU. Integration of markets inside EMU is to be reached only gradually after the full integration of the money market. Economic rhetoric purports the idea that the increased integration between member countries is not only able to deliver macroeconomic stability and convergence, but also to sustain average real growth. It is, however, debatable whether in a large monetary union such as EMU convergence in real growth and stability could really be achieved in all member countries. It can be argued, indeed, that if independent monetary policies are not able to deliver stability and growth in all countries before the start of Phase Two of the euro, the common monetary policy cannot automatically be assumed to be a guarantee for achieving the same goals.

[2] As is well known, in a currency area the member countries keep their currencies and central banks, while in a monetary or currency union the member countries share a common currency.
[3] Collins and Giavazzi (1993) explored the viability of fixed exchange rates of Bretton Woods and EMS in relation to inflation disparities.
[4] As well as relative stability towards the currencies of EU members that are out of EMU.

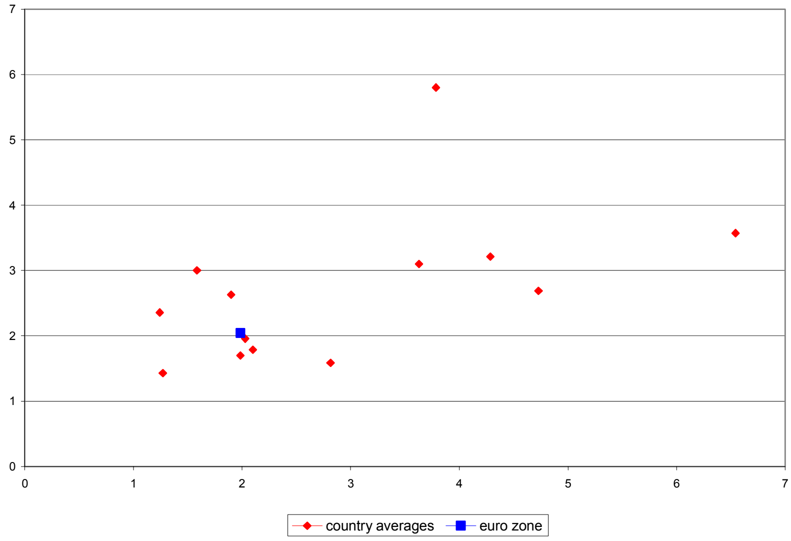

Fig. 1. Inflation and growth in the euro zone, country averages 1999 – 2005

Figure 1 shows average inflation and growth rates in the single member countries[5] and carries clear evidence of disparities in both inflation and growth from 1999 to 2005, i.e. in the first seven years of the common monetary policy. The basic finding in Figure 1 is that, irrespective of the fact that area-wide inflation in almost on target and growth not very far from the potential, differences in inflation and growth rates still remain across countries. As inflation differences could widen growth disparities through their effects on real variables[6], the long run viability of EMU could be undermined and the credibility of the common monetary policy diminished by the lack of convergence to a stable and low inflation rate. From the point of view of the choice of the exchange rate regime, EMU is therefore the manifestation of the economic force that has forced some countries to abandon their soft, and sometimes unstable, exchange rate peg in favour either of a managed float (Sweden, UK, Denmark) and some others (the members of euro-zone) to the hardest peg of all, i.e. the single currency. EMU, in other words, can be seen as an example of the search process which is at the heart of the bipolar view (Fisher, 2001). The successful launch of the euro is considered an example to be imitated[7], but the effective power of the monetary union to lead to inflation convergence and to be sustainable has not yet been proved.

In general, it can also be said that hard pegs such as currency areas, currency boards, monetary unions and dollarization, have been adopted either by countries trying to avoid competitive devaluations or by countries searching for an anchor in order to curb internal inflation and stabilize public finance. In reality, hard pegs have not yet proved to be more

[5] Slovenia, which will be admitted in the euro in January 2007, has been added.
[6] We allude to real exchange rates, real interest rates and real wages rates.
[7] Some Asian countries have planned to create the Asian currency unit – or acu – loosely inspired by the ecu, the European currency unit which paved the way for the euro.

sustainable than soft pegs, and EMU cannot be considered a proof that monetary unions are a stable exchange rate regime.

Although optimal currency areas are held to confer well-known and tangible benefits to member countries, participation in a currency area which is not optimal implies net benefits that could be much lower than otherwise. In principle, costs and benefits should be weighted case by case, but when costs are high and must be borne earlier than benefits, they may appear excessive and it could be difficult for member countries to meet them fully. A long time ago (e.g. Krugman, 1993) it was argued that by increasing their integration, members of EMU could become more specialized and thus find themselves more exposed to asymmetric shocks. High or increasing integration could then hamper the possibility of policy coordination just because the different countries integrate and specialize[8]. But even in the case of a currency area where business cycles are increasingly synchronous and asymmetric shocks rare, there are difficulties that were merely conjectured before the actual start of the euro but which are now increasingly apparent.

When the common currency implies high costs, there is no certainty that all countries are really able or willing to bear them. Indeed, just as there are many examples of countries unable to adopt the difficult policy actions they were expected to take in order to make soft pegs viable, there are also countries, such as Italy and Portugal, which are struggling in the monetary union. The impossibility of depreciation when the competitiveness gap in key sectors has widened to an unsustainable degree exposes the country to the risk of losing jobs forever and thus becomes a real hurdle. The countries that failed to implement economic policies of sufficiently good quality while in the ERM-EMS, suffered a gradual real appreciation, lost competitiveness and eventually faced an exchange rate crisis. This is what happened when the German mark, the anchor of their peg, appreciated heavily against the US dollar. This was the case of Italy and Spain in 1992, but also that of England and Sweden[9]. The countries in the euro-zone that are now experiencing the mix of economic policy ineffectiveness and loss of competitiveness, very similar to what they knew while in the ERM, will eventually face even greater troubles as the global economy is now more competitive than before and the appreciation of the euro could be marked at least against the US dollar. Those countries will, in particular, be caught in a trap by permanently low growth and weak public finances and thus find it difficult to meet expectations about the increase in per capita income[10]. The euro-zone experience shows that the transition from a soft peg (such as the ERM-EMS to the hard peg in EMU with its combination of fixed internal rates and flexible external exchange rates) may imply neither the transit from an unstable to a stable exchange rate regime[11] nor good economic performance.

The case of the euro-zone is particularly interesting for understanding the implications of discontinuing monetary independence in a monetary union. In the euro-zone, fiscal policies are left to national governments, but a pact has been struck in order to limit their discretion in the budget. The pact was aimed at forcing governments to accomplish fiscal

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[8] Member countries would not face the problem if they were able to integrate by diversifying their economies.
[9] Staying afloat, Sweden was able to recover and gain strong competitiveness.
[10] The ageing population makes the problem particularly worrying.
[11] The Treaty of Maastricht does not even consider the possibility of exiting from the euro zone

consolidation, at increasing flexibility in the budget and efficiency in the common monetary policy[12]. The monetary union, indeed, sought to be an anchor for macroeconomic stability more effective than softer pegging arrangements. As redistribution policies face obvious limits, particularly if growth stays low, the main task left to national governments is to act in order to make governance more effective and to increase competition in the markets, as it is believed that increased competition could push domestic companies to innovate, raise productivity and thus deliver real growth. Laggard countries will be in trouble as they are without independent monetary policy, and unable to increase their competitiveness enough. They could adjust through flexible real wages and labour mobility only, but this hardly protects existing jobs. In a monetary union, furthermore, the fixity of exchange rates and the attainment of low inflation reduce the room for flexing real wages, which is supposed to be key in the adjustment process.

Attaining fiscal discipline is not easy as political costs could be high in the short run while the benefits largely accrue in the long run. This makes it difficult for national governments to be steadfast in their effort, as benefits appear more distant and uncertain than costs, particularly in the countries where coalitions are weak. As shocks need not be symmetrical and countries are not equally successful in implementing the required economic policies, it is likely that the monetary union delivers unequal benefits and costs to member countries. The existence of gainers and losers is a great risk for any union as it is likely that the losers, being forced to bear the increasing costs of union as time passes, will end up contesting the common policies and the desirability of the union itself. The exit of a country is not a remote possibility and the breakdown of the union itself may be the outcome of economic and political tensions with their reverberations in financial markets. The termination of a monetary union is not even mentioned in the Maastricht Treaty. The ECB representatives deny any possibility of leaving or breaking EMU, which is understandable, but the international press does not exclude it and the Sapir Report (Sapir et al., 2003) explicitly considers the problem of long term sustainability of EU. The termination cannot be judged as impossible as the European countries have strong identities and parliaments. The 20th century offered many examples of soft pegs crises, but it also brought equally prominent examples of hard pegs that failed to absorb the shock of World War I[13].

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[12] Efficiency means that stabilization is obtained with a lower average interest rate.
[13] The Latin Monetary Union and the Scandinavian Monetary Union are such examples.

6. Sapir, A. P. Aghion, G. Bertola el al. (2003) "An agenda for a growing Europe: Making the EU economic system deliver. Report of an independent study group established on the initiative of the President of the European Commission. July,
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STABILNOST VALUTNIH PODRUČJA I EMU ISKUSTVO

Dino Martellato

Periodične krize 90-ih godina ponovo su pokrenule debatu o prednostima različitih režima deviznih kurseva, fokusirajući se više na stabilnost različitih režima. Mišljenja su bila podeljena. Iskustvo Evropske Monetarne Unije, postojećeg ekstremnog slučaja fiksnih devizih kurseva u valutnom području, predstavlja interesantan slučaj u tom pogledu. Cilj ovog rada je da se razmotre EMU, njen pratilac ERM II i originalni ERM kao primeri režima deviznih kurseva.

Integracija tržišta unutar EMU biće ostvarena postepeno nakon pune integracije tržišta novca. Postoji uverenje da povećana integracija između zemalja članica ne samo da može da podrži makroekonomsku stabilnost i konvergenciju, već i da održi prosečnu stopu rasta. Međutim, sporno je pitanje da li u velikoj monetarnoj uniji, kao što je EMU, konvergencija realnih stopa rasta i stabilnosti može zaista biti ostvarena u svim zemljama članicama. Naime, pretpostavlja se da ukoliko nezavisne monetarne politike nisu sposobne da doprinesu stabilnosti i rastu u svim zemljama članicama nakon početka Druge faze eura, ne može se očekivati da će zajednička monetarna politika garantovati ostvarivanje istih ciljeva.

Ključne reči: *krize deviznih kurseva, režimi deviznih kurseva, Evropska Monetarna Unija.*