

The (past and) future of European currencies*

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Abstract

The paper casts the analysis of recent monetary developments in Europe and the future prospects for Economic and Monetary Union in historical perspective. The first part (the ‘past’) reconstructs the long march toward monetary union. The second part (the ‘present’) briefly introduces the monetary framework of the Eurosystem, arguing that at the very core of the current policy debate are the costs and benefits of ‘continuity’ between current and past policy strategies in Europe. The third part (the ‘future’) discusses whether the Economic and Monetary Union will be able to act as a catalyst for future financial and economic integration in Europe, notwithstanding the many asymmetries that characterize the current outlook.

JEL: E4, E5, F3, G2.

1 Introduction

The currency and financial turmoil of Southeast Asia — in the aftermath of other regional crises in Western Europe and Latin America over the 1990s — has rekindled long-standing controversies on costs and benefits of limiting currency flexibility. The new consensus holds that the only fixed exchange rate regimes likely to survive large-scale waves of speculative frenzy and financial panic require extreme institutional arrangements, possibly involving the adoption of a foreign currency as legal tender or full-fledged monetary unification. On the other hand, the take-off of the European Economic and Monetary Union (EMU) in 1999 has provided unequivocal evidence that successful currency unification *is* indeed feasible in the economic and financial reality of the new century.

Can the experience of European currencies provide a benchmark to evaluate the likely future evolution of world currencies? In other words, is EMU ‘exportable’? Some of the papers in this issue of *Cuadernos de Economía* present useful elements toward an answer to this question. In this paper we focus on the more modest task of casting the recent European developments in historical perspective and against the main emerging policy issues. The future (and the present) of European currencies cannot be appropriately assessed without understanding the deep roots of the twin process toward economic integration and monetary unification.

Throughout the entire economic history of Europe, both the political and the intellectual leaders of the movement towards European integration have shared a pronounced aversion to exchange rate fluctuations. One after the other, the political initiatives undertaken to strengthen the process of European integration have led to attempts to lock European currencies into systems and mechanisms limiting the flexibility of their conversion rates. EMU has been heralded as the endpoint of the long-lasting quest for financial stability and the catalyst for further economic integration in Europe. Its success or failure will be decided on the basis of whether EMU is able to deliver on such promises.

The paper is divided in three parts. Section 2 (the ‘past’) reconstructs the long march toward EMU. Section 3 (the ‘present’) briefly introduces the monetary framework of the Eurosystem, arguing that at the very core of the current policy debate are the costs and benefits of ‘continuity’ between current and past policy strategies in Europe. Section 4 (the ‘future’) discusses whether EMU will be able to act as a catalyst for future financial and eco-

conomic integration in Europe, notwithstanding the many asymmetries that characterize the current outlook. Section 5 concludes.¹

2 The idea of European monetary unification: birth and early developments

2.1 The quest for exchange rate stability

After World War II, the institutional framework for exchange rate stability, in Europe and elsewhere, was provided by the Bretton Woods system. When, in 1958, the Treaty of Rome created the European Economic Community (EEC), the aim was to develop a common market for goods, services, labor and capital. The Treaty of Rome did not go beyond referring to exchange rates as a matter of common concern. Individual countries were authorized to take appropriate actions whenever exchange rates appeared to be inconsistent with the common goals of external equilibrium, full employment, price stability and confidence in members' currencies. No mention was made of the desirability, let alone the possibility, of a European monetary union, as, within the framework of an Atlantic strategic alliance, no form of monetary cooperation independent of the US dollar was considered feasible at the time.

In the mid-1960s, the EEC initiated the Common Agricultural Policy (CAP). Its purpose was the Community-wide stabilization of food prices and the support of agricultural producer prices at levels generally above their world market values. Over time, the CAP may have provided an independent reason for aversion against intra-European exchange rate flexibility, as the requirement that the effects of exchange rate fluctuations on domestic agricultural prices be neutralized through a complicated system of subsidies and import levies, the so-called Monetary Compensatory Amounts, became generalized. But the importance of the CAP in motivating the choice for limiting intra-European exchange rate flexibility should not be exaggerated.

Within the Bretton Woods system, intra-EEC exchange rates were indeed stable throughout the 1960s, with very few episodes of realignments of

¹The historical reconstruction and analysis in this paper builds on our previous work on the subject, especially Buiter, Corsetti and Pesenti (1998, ch.2) and Corsetti and Pesenti (1999). A vast collection of policy, theoretical, and historical papers on the euro is available on the Euro Homepage maintained by Giancarlo Corsetti at www.econ.yale.edu/~corsetti/euro.

the central parities. Nonetheless, by the end of the decade the system was under unsustainable strain. In response to the threatening disruption of the international monetary system, the Summit of EEC Heads of State, held in The Hague in December 1969, solemnly declared that a monetary union did belong among the long-term goals of the Community.

Following a procedure which would again be adopted twenty years later, the 1969 Summit resolved to appoint a special Committee, with the task of designing a blueprint for the transition to such a Union. Such blueprint, the so-called *Werner Report*, proposed a three-stage approach to monetary unification: the first stage would foster policy coordination; in the second stage, realignments of exchange rates would require agreement among the countries participating in the plan; finally, a unique central bank, similar to the Federal Reserve System in the US, would take control over European monetary policy. At the Summit in The Hague, the program to speed up European integration was actively sponsored by the German Chancellor Willy Brandt, whose proposals were strongly endorsed by the French government.

Notwithstanding this strong political support, the process toward monetary unification was brought to a swift halt by the international economic turmoil of the early 1970s. As the world monetary order was disrupted by heavy speculative attacks, Germany and the Netherlands let their currencies float against the dollar in May 1971, while the other European countries introduced severe capital controls in an attempt to fight speculation. After President Nixon officially suspended the gold convertibility of the US dollar in August, few doubted that some specifically European contribution was required to maintain currency and financial stability in the EEC.

The Smithsonian Agreements in 1971 enlarged the Bretton Woods bands of fluctuation *vis-à-vis* the dollar from 2.0 to 4.5 percent. The width of the implied band for non-dollar currencies — which was as high as 9.0 percent under the new regime — was deemed too large by European standards. The creation of the ‘Snake’ in 1972 was the first Community-wide response to the difficulties encountered in setting up a new stable and sustainable global system of fixed exchange rates. Each EEC member country committed itself to limit to 2.25 percent the fluctuation of its own currency around the dollar parity (implicitly defining a system of 4.5 percent intra-EEC currency bands). This European currency Snake was therefore placed well inside the tunnel represented by the floor and ceiling rates *vis-à-vis* the US currency, as established in Washington.

An asymmetry in the operating characteristics of the facility, the same

one that had also plagued the Bretton Woods system, was a key feature in the system. In practice, once a weak currency was at the bottom of the bilateral band *vis-à-vis* some other currency, it was the central bank issuing the weak currency which was held responsible for the defense of the band. Thus when a currency was under pressure, rather than the strong-currency central bank engaging in international reserve accumulation, the central bank issuing the weak currency incurred international reserve losses. Since the amount of credit that could be obtained to bolster international reserves was — *de-facto*, if not *de-jure* — strictly limited, the credibility of the Snake suffered from the limitations of the financing mechanism among central banks.

Soon after the implementation of the Snake by the six EEC countries in April 1972, the system was joined by the UK, Ireland, Denmark and Norway. However, the fragility of the Snake was apparent: UK membership in the system only lasted eight weeks, during which the pound was hit by heavy speculative attacks, while a large capital outflow forced the Italian lira out in February 1973. In March 1973, European central banks stopped defending the dollar parities of their currencies. Freed from the ‘tunnel’ and reduced to a D-mark zone of monetary stability, a trimmed ‘floating Snake’ represented an element of continuity, even if only in a formal sense, between the European monetary agreement of the 1960s and the birth of the EMS in 1979.

It was again the political arena where the next thrust toward monetary union originated. On April 7 1978, at the European Council of Copenhagen, the German Chancellor Helmut Schmidt and the French President Valéry Giscard d’Estaing engineered a vigorous revival of the European project, by launching the idea of a European Monetary System (EMS) for all members of the EEC. It took three months to reach a Community-wide consensus on the project and six months to elaborate the system in detail.

Although superficially similar to the Snake — as the width of the bilateral bands was maintained at 4.5 percent with the exception of a 12 percent target zone for the lira — the Exchange Rate Mechanism (ERM) of the EMS could count on stronger political support as well as on more ample financial means. The newly created European Currency Unit (ECU) was intended not just as a unit of account, but also as a means of settlement among EEC central banks.

The EMS labored on, in an atmosphere of widespread pessimism about its chances of success. Skepticism prevailed as to the feasibility of a system of fixed exchange rates where a low-inflation country such as Germany coexisted

with Italy and France, which at the end of the 1970s showed very few signs of inflationary rectitude. Indeed, between 1979 and 1985, the cumulative devaluation of the Lira and the French Franc against the ECU turned out to be 20.25 percent and 9.25 percent respectively. Over the same time interval, the cumulative revaluation of the D-Mark in terms of the ECU reached 22.25 percent. In these years, the GDP deflator increased by 85 percent in Italy, 55 percent in France, and 21 percent in Germany.

Between 1979 and 1983, the ERM had little influence on domestic policies. Periodic realignments largely accommodated inflation differentials, with the aim of keeping domestic competitiveness approximately constant. This strategy being understood by the private sector, financial markets could anticipate the timing and size of such realignments, making room for potentially destabilizing speculative behavior. This is the main reason why high inflation countries kept severe capital controls in place during the first few years of the EMS.

A major change occurred in 1983, as soon as the French socialist government signalled the abandonment of its former policy strategies — aimed at pursuing growth through the expansion of domestic demand — by giving high priority to disinflation within the framework of further European integration. Italy soon followed the French lead. Instead, the British government under Mrs. Thatcher reinforced the anti-European stand of the UK, which did not join the ERM until 1990. Inflation differentials narrowed but persisted, despite the increasing stability of the exchange rate system.

While the birth of the EMS was marked by a strong conflict between Germany, determined to maintain full control over its domestic price level in the European system, and France, concerned with the deflationary bias implied by a Germany-dominated EMS, the early years of the system witnessed the progressive emergence of German monetary leadership. In the early 1980s, the D-mark was increasingly perceived as the key currency in the EMS.

2.2 The decision to unify

In the second half of the decade — in parallel with the new ambitious phase of European integration signaled by the Single European Act (SEA) of 1986² — not only was the reality of German monetary leadership universally recognized, but a new vision of the European process was changing both the

²The SEA was the first revision of the Community's founding Treaty of Rome.

political and the intellectual evaluation of the desirability of this leadership. An asymmetric system where the low-inflation country sets the pace of system-wide monetary policy was suddenly seen as an opportunity for monetary and fiscal authorities in inflation-prone countries to make an explicit and publicly verifiable commitment to contain domestic inflation and loss of international competitiveness.

Participating in the ERM of the EMS was a way of ‘borrowing credibility from the Bundesbank’ when undertaking a change in the domestic policy regime.³ This proposition undoubtedly dominated the European political and economic debate in the second half of the 1980s and in the early 1990s, right up to the collapse of the ERM that started in the second half of 1992. The encouraging performance of inflation rates in the 1983-86 period boosted the confidence of European decision-makers in the ability of the EMS members to achieve complete convergence by the end of the decade. By 1986, the annual inflation differential against Germany was not larger than 3 percent for most European countries, and even for Italy was down to 5 percent. A political commitment to disinflation was widely viewed as synonymous with the acceptance of the D-mark as nominal anchor.

This so-called *New EMS* was set for a relatively long period of European exchange rate stability. No realignment took place between January 1987 and September 1992 (with the exception of a technical realignment of the Lira when it joined the narrow band of the ERM in January 1990). Meanwhile, as the idea of complementarity between a single market and a single money received widespread political support, proposals for a European monetary union were back on the European agenda.

At the Madrid Summit in June 1989, the Council endorsed the Delors Report as the official blueprint for monetary unification in Europe. Echoing the Werner Report, the Committee of representatives from European central banks chaired by Jacques Delors again proposed a *three-stage* approach to monetary union. Further progress on the road to monetary union required a modification of the Treaty of Rome: this happened with the Treaty of Maastricht, signed in December 1991.

When the Treaty was signed, Stage I had already begun with the removal of capital controls in 1990. Stage II, started on January 1, 1994, was char-

³‘Borrowing credibility from the Bundesbank’ was obviously not the exclusive prerogative of the EC countries. Although outside the ERM, a few Scandinavian and Eastern European countries started a policy of unilaterally pegging their currencies against the ECU.

acterized by a set of institutional initiatives preparing the way for monetary union. In this stage, as domestic laws were modified appropriately to conform to the Treaty, national central banks were given formal independence according to the standards agreed upon in Maastricht. While a European Central Bank was not to be established before Stage III, the Treaty prescribed the creation of a European Monetary Institute (EMI) as early as January 1994, with the goals of strengthening monetary policy coordination, monitoring the functioning of the EMS and organizing the preparation of the final stage.

2.3 The 1992-93 crisis and the process toward monetary integration

While these institutional developments were taking place, Germany was witnessing the unprecedented economic and political event of reunification: the integration of two economies which had undergone post-war reconstruction under two very different systems, ending up with a substantial gap in productive capacities as well as standards of living. The idea that reunifying Germany would generate the need for an appreciation of the D-mark in real terms (at least in the short and medium term) motivated much of the debate around and after German unification. From the date of reunification until the signing of the Maastricht Treaty in December 1991, German key rates were gradually raised in four steps, and the target range for growth of the M3 measure of the money supply was lowered once without changing the intervention rates. At the end of 1991, it became quite clear that, in the absence of a realignment in the ERM, the Bundesbank would pursue the goal of monetary stability by using the interest rate instruments regardless of the consequences for the domestic real economy and the international implications of its policies.

In retrospect, the 1992-93 EMS crisis was rooted in the unresolved policy conflict between Germany and the rest of the system on how to deal with growing price and output asymmetries — both related to the shock of German unification and the cumulative effect of persistent inflation differentials on intra-European cost-competitiveness. In the rest of Europe, in fact, erosion of competitiveness as measured by the standard set of price and cost indicators — namely real exchange rates based on labor costs and relative prices — was quite apparent in the case of Spain and Portugal, and, to a lesser extent, the UK and Italy. It also characterized Sweden and Finland,

which, although not formally members of the EMS, had pegged unilaterally to the D-mark. A devaluation was considered counterproductive by several European central banks, as it would undermine hard-earned anti-inflationary gains, would represent a relaxation of the external constraint on domestic fiscal policy, and would generally destroy the credibility borrowed so painfully from the Bundesbank over a number of years.

The beginning of a new chapter in the history of the EMS was written on June 2 1992. In a national referendum, Denmark's voters unexpectedly rejected the Maastricht Treaty by a narrow margin, 50.7 percent against to 49.3 percent in favor. The confidence of the market in a smooth, fast, and irreversible transition to monetary union had been weakened irreparably. As acknowledged ex post by the European central banks, "*the outcome of the Danish referendum in June was only a catalyst for the subsequent events, which culminated in September 1992 in the most serious crisis of the EMS since its inception*".⁴

The crisis shattered all remaining enthusiasm for the fixed exchange rate policies that had supported the concerted European disinflation efforts in the 1980s, and were supposed to provide the monetary framework up to the introduction of a common currency. Once, in the summer of 1993, the ERM bands around central exchange rate parities were widened up to 15 percent in either direction, monetary stability and credibility — as was observed at the time — had to be built at home with other means than exchange rate targeting.

For some countries, building stability and credibility at home meant, in addition to fiscal rectitude, a reform of monetary policy signaling some radical break with the past. For instance, the Bank of England and the Bank of Sweden adopted inflation targeting as a new comprehensive strategy to stabilize prices. For other countries, the credibility-building strategy was a stronger domestic political consensus to participate in EMU, and therefore to fulfill all the formal prerequisites established in the Maastricht Treaty. These prerequisites included complying with the convergence criteria of the Treaty in terms of inflation, fiscal stance, and interest rates, as well as appropriate reforms to prepare central banks to be integrated into the new European system.

Macroeconomic stability was indeed reached in Europe well before the formal launch of the euro. National inflation rates were already rather low

⁴Committee of Governors of the Central Banks of the EEC (1993), p.2.

in 1997. Notably, the Asian and Russian crises in 1997-98 did not induce any significant speculative wave in European financial and currency markets. A common monetary policy *de-facto* preceded the birth of the common currency, as the European Central Bank (ECB), established in June of 1998, engineered a coordinated cut of interest rates in December 1998 by all national central banks to the common level of 3 percent (with the only exception of Italy, which cut its rate to 3.5 percent).

The Eurosystem was structured to guarantee as much continuity as possible with respect to the objectives and policy framework of those national central banks (NCBs) that had been most successful in the past, notably the German Bundesbank. Perhaps, continuity with the Bundesbank was seen as key to endow the newly created ECB with an anti-inflationary reputation: at the birth of the euro European countries were, more than ever before, ‘borrowing credibility from the Bundesbank’.

3 Continuity in monetary strategy

Objections to continuity are at the core of the current debate on the ECB. The critics emphasize that European policy makers are missing an opportunity to build a monetary policy framework suitable for Europe on its own merits, rather than on the merits of the institutions (such as the Bundesbank or any other NCB) that have adopted it in the past. Given the political dimension of European integration, most critics focus on the standards of transparency and accountability of the ECB. In some cases, the ECB is urged to change its strategy by moving towards explicit inflation targeting — a move that would reduce the distance with the European Union (EU) countries so far outside of EMU. Yet, considerable uncertainty remains about the monetary architecture that will actually emerge in Europe as a result of the regime shift associated with a switch to a common currency.

3.1 The goal of price stability

Since the beginning of the 1990s, the Treaty of Maastricht stated that ‘price stability’ is the primary objective of the European System of Central Banks (ESCB). The definition of price stability is a year-on-year increase in the Harmonized Index of Consumer Prices (HICP, essentially a CPI without interest costs) for the euro area as a whole of below 2 percent, which is to

be maintained over the medium run. The focus on the euro area as a whole implies that sector- or region-specific shocks will be considered only insofar as they provide information on the development of the aggregate HICP.

The word ‘increase’ in the definition suggests that the ECB is concerned with a downward risk for price stability. Thus, any inflation rate in the range 0-2 percent seems to be compatible with price stability, although a precise lower bound has not been officially announced. Incidentally, the choice of 2 percent as the upper boundary of the range can be justified mainly on grounds of continuity, being the value that has been used in the past by the Bundesbank. Perhaps to rule out expectations that any development of prices outside the range 0-2 percent would automatically entail a policy response, the ECB has stressed that its quantitative definition of price stability is not an inflation range target.

Over the short history of EMU, some observers and market participants have criticized the ECB — especially after the April 1999 interest rate cut — for allowing too much latitude for discretion in its monetary strategy and acting as if the commitment to price stability in practice coexisted with cyclical concerns. Such criticism, however, is hard to justify in light of the monetary constitution of Europe as established by Art.105(1) of the Treaty of Maastricht. Provided that it does not see its actions as putting price stability at risk in the medium run — and so far the inflation rate has been inside the reference range — the Eurosystem is *expected* to support counter-cyclical policies. Also, a strict focus on price stability need not imply that the output gap and unemployment are ignored in policy decisions, but rather that they are treated exclusively as indicators of future inflation or deflation.

3.2 A monetary aggregate as first pillar — not as target

In addition to the quantitative definition of price stability, the monetary strategy of the ECB consists of two ‘pillars’: a reference value for the growth rate of M3, and a broad assessment of the outlook for future price developments and the risks to price stability. The reference value for the annual growth rate of M3, according to the ECB, is not to be considered a target. Under normal circumstances, deviations of current monetary growth from the reference value are interpreted as signaling risks to price stability, prompting further analysis to identify and interpret the economic distur-

bances that caused the deviations. However, no automatic policy reaction should be expected when the actual monetary aggregate deviates from its reference value.

The ECB has chosen to announce a single reference value for M3 growth (4.5 percent both in 1999 and 2000), rather than a range as in the tradition of the Bundesbank. Perfectly consistent with the German experience, instead, is the derivation of the 4.5 percent reference value within a quantity-equation framework. The basic formula for the derivation of the Bundesbank's monetary targets was: growth of (real) production potential + medium-term price assumption + addition/deduction for the longer-term change in the velocity of circulation of money = growth of the money stock which is consistent with production potential.⁵ In the ECB case, starting from estimates of the medium-run rate of change in velocity (in the range of -.5 to -1 percent) and trend output growth (in the range of 2 to 2.5 percent), the annual increase in the HICP associated with a 4.5 percent growth rate of M3 is in the range of 1 to 2 percent.

The role of monetary aggregates in the monetary strategy of the Eurosystem has been object of controversy and debate. The often mentioned experience of the Bundesbank shows that, between 1975 and 1995, the German annual money target was achieved only in about fifty percent of the cases, and that most of the misses were intentional.⁶ In other words, the reliability of the M3 growth rate as a leading indicator of inflation was dubious, even in the country with the strongest proclaimed reliance on monetary targeting. In fact, since the launch of EMU, the annual rate of growth of M3 in the euro area has exceeded the reference value of 4.5 percent. Demand for liquidity has been buoyant throughout the period, and the rate of growth of credit to the private sector has remained very strong during 1999.

There are three possible arguments to explain the role played by the first pillar in the ECB strategy. The first argument is that monetary aggregates may provide a more dependable guide for monetary policy in the euro area as a whole than has been the case in single member states. Econometric studies show in fact that money demand appears to be more stable in a larger European context than in any national environment, both in the short and the medium run. A key problem with these studies is that, to obtain sufficiently

⁵See Deutsche Bundesbank (1995, p.81).

⁶See Deutsche Bundesbank (1995, p.79), Issing (1997, p.71), and Von Hagen (1998, pp.692-694).

long series for European money, prices, output, and interest rates, they must necessarily rely on pre-EMU country-specific information. This procedure is an easy target for the Lucas critique, since there is no presumption that the time-series properties of the variables considered are invariant to the EMU regime shift.

A second interpretation sees the choice of mixing (weak) elements from both inflation and monetary targeting in the Eurosystem framework as an implicit declaration that the ECB is unwilling, in the present circumstances, to commit to a specific strategy/model/vision of monetary policy. The ECB is well aware that, after the launch of EMU, it will take time to develop some understanding of the new economic environment and the transmission mechanism of monetary policy in Europe. Even the availability and quality of data, while rapidly improving, is still far from adequate. A monetary policy strategy based on direct inflation targeting is deemed — for better or worse — infeasible due to the difficulties of forecasting price developments in current circumstances. In view of these unique conditions and the circumstances of particular uncertainty associated with the start of EMU, the Eurosystem attributes high option value to flexibility in choosing among alternative policy strategies.

A third argument, already mentioned above, is that the first pillar provides a public sign of adherence to the tradition of the Bundesbank, under the presumption that continuity in itself would enhance the ECB's credibility. At the launch of EMU — precisely when the need for flexibility and discretion is stronger — the Eurosystem starts off without a track record on which to base its credibility. At the same time, however, EMU does not start off in a historical vacuum: one of the NCBs absorbed by the new system is the unchallenged depository of anti-inflationary reputation in Europe. The larger the extent to which the Eurosystem is able to signal continuity of strategy and behavior between its experience and the Bundesbank's, the richer the perceived bequest of credibility accruing to the new institution.

A problem with this argument is that, as discussed above, the Bundesbank's adherence to monetary targeting was more formal than effective. From this vantage point, it is not obvious that continuity with the Bundesbank is the best possible course of action for the ECB. Critics stress that credibility will actually be hampered by adopting the first pillar. Decisions taken while paying limited attention to the growth rate of M3 will have to be explained to the public while pretending that monetary developments are nonetheless essential leading indicators of inflation.

A cosmetic token to continuity with the Bundesbank could be harmless, provided that in its communication strategy the ECB is able to provide a convincing account of the true decision process. The risk emphasized by ECB critics is that the first pillar may become a smokescreen hiding the true motivations of monetary decisions. In that case, it is argued that lack of openness and transparency cannot but induce the impression of a very high degree of discretion — eroding, rather than increasing, any initial capital of credibility that the ECB has managed to inherit from the past.

3.3 The second pillar *vs.* inflation targeting

The second pillar of the Eurosystem strategy amounts to an analysis of a rather large list of indicators of unequal status and nature. The vagueness in the definition of the second pillar raises the critical question as to which analytical framework — *i.e.* which economic and econometric model — the ECB will use to filter the available information from such a diverse set of variables. What is stated in this respect is that the Eurosystem “*will evaluate the full range of inflation forecasts produced by international organizations, other authorities, market participants, etc., and will also produce its own assessment of the future inflation outlook.*”⁷ But, at least so far, the ECB has not been willing to publish its forecasts.

This attitude towards inflation forecasts exhibits a striking resemblance to the Bundesbank’s, whose monthly and annual reports neither publish forecasts of economic variables, nor discuss private sector forecasts. The ECB has explained its decision not to publish its inflation forecasts by arguing that giving prominence to a single official forecast would not adequately reflect the actual decision-making process of the Council, and would ultimately confuse and mislead the public. It is plausible that, especially in the initial phase of EMU, the ECB does not want to be evaluated as a forecaster and held responsible for forecast errors, given the considerable uncertainty about the time series properties of the relevant real and financial variables, nor to be tied to any particular econometric model. It may be possible that, in the future, the ECB will consider some form of public discussion of inflation forecasts, without necessarily implying a formal change in its strategy.

⁷ECB Monthly Bulletin, January 1999.

3.4 The exchange rate of the euro

The Eurosystem deliberately does not specify any target for the exchange rate of the euro. The argument is that price stability would be compromised if an exchange rate target were to be pursued. Moreover, quoting the ECB Vice President Christian Noyer, “*the Eurosystem adopts a neutral stance, neither fostering nor hindering the international use of its currency*”.⁸ It has been argued that such ‘neutral stance’ represents an element of discontinuity in European monetary policy from its EMS days. But an important consideration helps understand this apparent departure.

Before EMU, fluctuations in cross-Atlantic exchange rates had an impact on intra-European exchange rates, and were a major source of destabilizing pressures. Such empirical regularity was referred to as the dollar/D-mark polarization: when the dollar strengthened against the D-mark, currencies such as the French franc or the Italian lira tended to appreciate against the D-mark as well.

Downward swings of the dollar were particularly problematic: almost all realignments in the EMS were preceded by a fall in the effective dollar index and were followed by a recovery of the dollar. Other episodes of strain in the EMS were associated with swings of the dollar exchange rate, and the crisis of September 1992 that led to the exit of the lira and the pound from the EMS was preceded in the summer by a dollar crisis.

Today, the risk that cross-Atlantic exchange rate fluctuations have any impact on intra-European exchange rates has disappeared — with the notable exception of the exchange rate between pound and the euro. Other things being equal, a more detached attitude by the ECB toward exchange rate fluctuations is more understandable than was the case in the past.

While the ECB does not appear to have espoused the case for explicit support of a strong euro, consistent with the ‘second pillar’ of the monetary strategy exchange rate developments are monitored with regard to their impact on prospective price developments. Quoting an early pronouncement by ECB’s Chief Economist Otmar Issing: “*if a prolonged depreciation were to lead to significant inflationary risks in the euro area, all other things being equal, we would clearly know how to respond.*”⁹ The vagueness of the ECB pronouncements — clearly, no estimate of the elasticity of the HICP to a depreciation is provided — potentially leaves open all courses of action short

⁸Noyer (2000).

⁹Issing (1999), p.22.

of explicit exchange rate targeting.

The actual experience of the euro over its short history has shown that the risk of prolonged depreciations is by no means hypothetical. At the onset of EMU in January 1999 one euro was worth one dollar and 18 cents. At the beginning of the year 2000, the euro fell below parity with the dollar. The weak performance of the euro has been cited by euroskeptics of all stripes to question whether Europe was, after all, ready for a common currency.

Commentators have cited a host of factors to ‘explain’ the behavior of the euro, ranging from the delayed effects of the Asian crisis to concerns over fiscal profligacy by some EMU members. But in retrospect — and to the extent that a short-term macroeconomic analysis of exchange rate fluctuations makes any sense at all — the most convincing interpretation identifies the root cause of the euro’s slide with cyclical divergence between the European and the world economies.

To illustrate our point, Figure 1 plots the revision over time in expectations for the 1999 growth differential between euro area and US (measured by Consensus forecasts) and provides preliminary but compelling evidence that the timing and magnitude of the shifts in relative growth expectations have so far been consistent with the behavior of the euro. Even the short-lived upswing of the euro in July 1999 was related to an improvement in the expected relative growth performance of the euro area. Among the key elements coinciding with the sudden rebound of the euro was the July release of better-than-expected business surveys from Germany, France and Italy pointing to a recovery in European industrial production.

In sum, the euro’s slide can be thought of as a clear reflection of the ratcheting down of expected growth differentials during 1999. But the prolonged weakness of the euro may heavily affect the communication between the ECB and the public. For instance, after the interest rate increase on February 3, 2000, the ECB president had to make clear that the decision was not a ‘panic reaction’ to keep the euro from falling.¹⁰ However, he conceded the currency’s decline was pushing up the cost of imports, potentially threatening price sta-

¹⁰Duisenberg (2000). At the time, the *Financial Times* remarked: “*The ECB decision to raise interest rates by a quarter point, to 3.25 percent, was premature. A case can be made that the euro-zone needs a tighter monetary policy, though it is a far from compelling one. But the ECB has not made that case. Unfortunately, the move looks like a knee-jerk reaction to the euro falling below parity with the dollar.*” (“Confused Signals from the ECB”, *Financial Times*, February 4, 2000, p.12.)

bility.¹¹ In the February Monthly Report, the ECB explicitly acknowledged that the euro's fall had become a cause for concern. Reportedly, market participants started to weigh more heavily exchange rate movements in forecasting ECB decisions, most likely adding to the short-term volatility of the currency.

4 Monetary unification as a catalyst for integration in an asymmetric environment

EMU was born in the context of long-term regional integration among economies characterized by very high degrees of trade openness. From this vantage point, EMU is expected to act as the catalyst of further economic and financial integration. But EMU was also born in a context of substantial market segmentation, regional diversity, let alone cultural, legal and institutional diversity. Traces of national segmentation appear even in the most integrated market for overnight liquidity, and the extent of home bias becomes increasingly predominant as one moves from the bond and equity market to the banking system. The elimination of currency risk and a common monetary stance may well contribute to diminishing the asymmetries in the euro area over time. But all available evidence suggests that, in the foreseeable future, market segmentation and national divergences are likely to provide the context of economic policy.

4.1 Synchronization of business cycles

To start with, notable differences in growth performances have recently emerged after a two-year recovery phase common to almost all EMU member states. The ECB has recently presented some estimates according to which the increase in growth dispersion reflects to a large extent differences in trend growth rates.¹² At the root of recent divergences in trend growth is the remarkable performance of countries such as Ireland, Finland and the Netherlands, as well as the decline of Italy: against an average trend growth rate

¹¹Apropos of this comment, the aforementioned *Financial Times* article noted: “*this rather contradicted the previous line that what matters is internal price stability and that, since euro-zone trade is largely internal, the ECB can afford be relaxed about short-term fluctuations in the exchange rate.*”

¹²ECB Monthly Bulletin, August 1999.

of 2.3 percent between 1994 and 1998 for the euro area as a whole, Ireland's trend growth rate was a staggering 9.2 percent, Finland and the Netherlands were above 3 percent, while Italy's trend growth rate was as low as 1.3 percent. Similar patterns emerge for employment and industrial production growth.

The ECB study also provides evidence of synchronization of short-term developments, as measured by the correlation of cyclical components of GDP growth in individual countries with those in the euro area as a whole. A part from the usual reservations about trend/cycle decomposition, two observations are appropriate. First, the kind of analyses presented by the ECB cannot detect the nature of shocks underlying cyclical movements. The theory of optimal currency areas, however, suggest that giving up exchange rate flexibility is costly in terms of output stabilization, only in the presence of asymmetric *real* shocks. The overall degree of synchronization is not necessarily informative about the frequency and magnitude of these shocks, relative to financial ones. Second, the evidence shows that synchronization diminishes dramatically in the presence of easily identifiable, large asymmetric shocks, such as the process of German unification. As suggested in Section 2, the 1992-93 EMS crisis serves as a sober reminder of the destabilizing potential of policy conflicts that may arise in those (luckily rare) circumstances.

Independent of the nature of shocks, an increase over time in the degree of cyclical synchronization cannot but represent good news for the ECB, by reducing the scope for political dissonance on its policy stance. Will regional divergences in the euro zone become less pronounced over time? One thesis is that a higher synchronization will necessarily follow the adoption of the common currency. The argument is that the elimination of exchange rate risk and the development of an integrated market for securities will provide growing opportunities to diversify portfolios, stimulate trade, and enhance integration. An extreme version of this view holds that, ultimately, EMU will endogenously become an optimum currency area, even it is not currently so.

Yet, it has been recently observed that the significantly higher degree of business cycle synchronization across US regions relative to Europe can hardly be ascribed to the stricter degree of monetary (and fiscal) coordination in US — structural economic features play a much bigger role. In light of this observation, European cyclical synchronization would not stem from monetary reform per se. In the absence of structural reforms, or if

these reforms are implemented slowly, the presence of unemployment and income differentials across countries and regions may well generate powerful incentives for intra-Eurozone migration, and raise delicate political issues regarding EU-wide redistributive transfers.

At the start of the euro, the policy mix in the area has recorded a combination of tight fiscal policies and loose money. This has helped the region to reach positive growth levels, that in some cases have been quite high. Problems, however, may lie ahead. In particular, in light of adverse demographic trends, a few countries need further fiscal consolidation to put their social security systems in order. By the same token, the need for reforms in the labor and product markets may require fiscal resources. These factors may reduce the scope for resorting to fiscal policies if and when the cycle turns negative.

4.2 Monetary transmission

Around the launch of the euro, EMU watchers have focused on a different dimension of economic asymmetry in Europe. Because of relevant differences in the way banking and financial intermediaries operate in the euro area countries, there could be some heterogeneity in the national mechanisms of transmission of ECB monetary policy, so that a centralized policy impulse can have asymmetric repercussions on the economies of the member states. This issue has potentially far-reaching implications for the conduct of ECB policy, especially when the UK and the other ‘out’ countries in the EU join EMU.

Consider for instance the ‘textbook’ interest rate channel of monetary transmission, according to which monetary policy modifies the cost of capital and borrowing conditions, thus affecting demand for durables consumption and investment. Three possible factors generate asymmetries in this mechanism across countries.

The first consists of differences in the diffusion of consumer borrowing — borrowing that increases the sensitivity of consumption to interest rates, and therefore magnifies the impact of monetary policy on aggregate demand. In light of this consideration, we should expect interest rate movements to have a stronger impact in the Nordic countries and the UK than in Italy, France and Belgium. In the former group of countries, the use of consumer credit is widespread and the ratio of financial liabilities to disposable income is around 100 percent (for comparison, the corresponding ratio in the US is 90 percent).

The opposite pattern characterizes the second group of countries, where the ratio of households' financial liabilities to disposable income is much lower, between 30 and 50 percent.

The second asymmetry reflects differences in the level of public debt, a key determinant of net interest incomes as a share of disposable income. By increasing interest income of households, an interest hike in high-debt countries may actually raise — not reduce — spending. The third asymmetry arises from the percentage of short-term (or floating-rate) debt in private sector financial liabilities. For instance, households' borrowing in the UK and Italy is largely short-term or indexed to short-term rates, while short-term firms' borrowing is sizable in the UK, Italy, Belgium and France, relative to other European countries. Combining the three factors, monetary policy (through the interest rate channel) could be expected to be particularly effective in UK, and relatively ineffective in France. Italy is a mixed case, as the above effects may compensate for each other.

A rather different picture emerges if we allow for a credit channel in the transmission of monetary policy, according to which a liquidity squeeze that reduces the supply of bank loans is more effective, the lower the substitutability of bank credit with bond issuance. The focus is on the development of markets for loans as an alternative to bank credit. On these grounds, there is an apparent divergence between continental Europe, with a high share of bank loans in total debt liabilities, and the UK, where this share is only 50 percent (compared with 30 per cent in the US). Credit channel theories also suggest that monetary policy is more effective, the higher the proportion of small firms and small banks. This is because smaller firms are more likely to be liquidity constrained and depend on banks for their financing, while smaller banks are less likely to use bond holdings as a buffer to insulate their loans' portfolio.

Finally, there are striking national differences in the timing of the response of bank lending rates to changes in key interest rates. This response is rather fast in the UK, due to the presence of competitive securities markets, but slow in countries where banks appreciate long-term relationship with customers, as banks may be less prone to transfer interest rate shocks onto borrowers. In Germany, for instance, it takes one quarter for bank rates to adjust by 36 basis point in response to a one percentage permanent change in key interest rates, and the adjustment is incomplete even after one year. The adjustment is even slower in France, where interest rates adjust by only 60 basis points after one year. The credit channel is also to be considered particularly important

in Italy (where nonbank finance is virtually unavailable, and the small-firm sector is large), but unimportant in the UK (for the opposite reasons). France is somewhat similar to Italy, the Netherlands and Belgium similar to the UK, while Germany is somewhere in between.

At this stage, it is difficult to assess the practical relevance of the above considerations. On the basis of the evidence on the features of national financial markets, one could expect monetary policy to have a somewhat homogeneous impact in France, Germany and Spain. In Italy a strong credit channel is compensated by a weak interest rate channel, while the opposite is true for the UK. The econometric evidence is mixed, and the issue is left to further research.

4.3 Financial market integration

It has been argued that national asymmetries will tend to disappear with the development of deeper pan-European financial markets, and that a necessary condition for this to happen is to dismantle regulatory and political barriers to cross-border mergers (particularly among banks). However, even if this necessary condition is satisfied, national asymmetries may not disappear quickly, to the extent that they are related to structural differences among national financial markets, such as discrepancies in legal structures or bankruptcy law.

The introduction of the euro has brought to an almost immediate convergence of national money market interest rates, despite some problems in liquidity management. The emergence of an integrated and well functioning money market in the area has been fostered by the creation of secure and flexible set of payment systems — especially the real-time gross-settlement system (TARGET) operated by the ESCB. Two interest rate indexes, EONIA and EURIBOR, are widely used reference indexes for overnight transactions and transactions at longer maturities, respectively. Yet, the integration of the repo market remains hampered by the lack of common platforms for the clearing and delivery-settlement of the securities used as collateral in the transaction.

Striking progress has also been recorded in the development and integration of the euro-denominated bond market. In 1999, the international bond market has effectively been a ‘dual’ market, with dollar- and euro-denominated bonds accounting for 80 percent of new issues. According to the Bank for International Settlements (BIS), in the third quarter of the

year euro-denominated bond issuance has even exceeded dollar-denominated issuance, 41 percent against 39 percent. By contrast, the combined share of issuance in former euro-area national currencies plus ECU in the first three quarters of 1998 was only 28 percent. We should note here that, in 1999, euro bonds were to a large extent issued by firms operating in the euro area (68 percent), while dollar bonds were not dominated by home-currency issuers.¹³

4.3.1 Corporate bonds market

By creating a large and liquid bond market, the introduction of the euro is expected to foster the growth of a large market for corporate bonds, and significantly affect the process of disintermediation leading to a significant reduction in the role of banks in European corporate finance. Currently, the proportion of loans to bond financing in Europe is estimated to be almost 3 to 1, roughly the reverse of the US pattern.

The European bond market, especially the corporate segment, is growing quickly. Evidence on the bond market is provided by Capital Data Bondware. Looking at the total of underwritten non-government bonds denominated in euros, issuance in the first three quarters of 1999 reached 638 billion euros, a 42 percent increase over the same period in 1998. Most strikingly, issuance by private non-private corporations increased by 294 percent. The BIS also points out at a record volume of activity by corporate borrowers, ascribing the bulk of the growth to European companies.

If the current growth rates are sustained, the bond market in Europe would bridge the gap with the US in a matter of years. But the specific conditions prevailing at the start of the euro suggest a cautious interpretation of the data. In 1999, a key factor driving new issuance has been an unprecedented wave of mergers and acquisitions occurring throughout Europe, magnifying the financing needs of the corporate sector. The ECB reports that, excluding the banking sectors, transactions related to mergers and acquisitions involving companies located in the euro area increased by 153 percent between 1998 and 1999.¹⁴ The corresponding figure for the banking sector

¹³Interestingly, BIS (1999) notes that the expansion of the euro-denominated bond market has not been matched by an comparable improvement in the position of European underwriters. Leading European underwriters seem to have lost ground in currencies other than the euro.

¹⁴According to estimates included in BIS (1999), the volume of cross-border merger and acquisition transactions arranged by European acquirers rose by 107% in the first three

was 35 percent.¹⁵ With the birth of the euro, it may well be that mergers and acquisitions become more frequent than in the past. Yet their quantitative relevance in bond issuance is not easy to predict, and may not be constant over time.

Also, part of the upsurge in the euro area bond market in the first months of 1999 can be attributed to the fact that some corporations (as well as governments) had delayed and bunched issues in anticipation of the birth of the euro. Reportedly, the rationale for such behavior was the desire to establish a presence in the new market with large and liquid issues. This consideration may explain the sharp increase in the average size of issuance between 1998 and the beginning of 1999. Nonetheless, we should note that the growth of issuance has been sustained throughout the third quarter of 1999.

To some extent, corporations may have been encouraged to resort to the euro bond market by the sharp drop in yield spreads across countries at the birth of the euro. The drop occurred in a context of generalized low yields, which were expected to reduce the traditional resistance of European investors to low-rated bonds as a way to seek better returns (indeed, the available evidence records an increase in the issuance of low-rate bonds).¹⁶ Nonetheless, a close look at the data reveals that most of the growth has so far come from European companies that have already issued bonds in the past, and foreign (i.e. non-euro area) issuers (in particular, the presence of US firms in the European bond market has significantly increased). A larger base of issuers will be a key element in the development of the market.

It is worth stressing that, relative to non-financial corporations, the weight of issuance by banks, although falling, remains very large, dominating the market with more than one half of total issuance. According to the BIS, the first quarter of 1999 has also recorded a large increase in bank lending. After a contraction of USD 126 billion in 1998, for instance, international

quarters of 1999. Approximately 40% of euro denominated issues were related to mergers and acquisitions.

¹⁵ECB Monthly Bulletin, January 2000.

¹⁶Low yields at the beginning of the year may also explain the boom in the issuance of *Pfandbriefe*, the fully collateralized bonds issued by specially authorized German banks to fund housing, shipbuilding and public loans. With an outstanding stock of EUR 930 billion at the end of 1998, *Pfandbriefe* are the largest non-government asset class in Europe, far larger than the stock of any European national government debt. New issues in the first quarter of 1999 exceeded EUR 99 billion; they have since dropped to EUR 33 billion in the second quarter, possibly reflecting the upward adjustment in long-term interest rates.

bank lending in euros has climbed to USD 337 billion in the first quarter of 1999. Not only have European banks added to their portfolio of European debt securities (largely reflecting government issues, as discussed in the next section), they have also been major players in financing mergers and acquisition.

In light of these considerations, while the past few months have recorded significant steps towards a large pan-European corporate bond market, it is still difficult to predict the timing, direction and modalities of changes in the pattern of European corporate finance. Many legal and fiscal issues are still hampering development and integration.

4.3.2 Government debt

With an outstanding stock of about EUR 3 trillion, euro-denominated government bonds account for the largest market for government bonds, larger than the US market. Following the birth of the euro, government debt previously denominated in national currency has been converted into the new common currency. However, European bonds are issued by 11 independent sovereign states, with different financial needs, fiscal policies, and regulations. The birth of the euro has therefore raised interesting and unprecedented issues in public debt management.

By eliminating currency risk, the euro has eliminated an important differentiating feature in the supply of debt instruments, thus forcing European government to rethink their financial policies. By speeding up the process of market integration, a common currency has increased the potential demand for national bonds, but has also intensified competition among sovereign issuers, providing strong incentives to reform markets and pursue efficiency and transparency standards. The euro has also raised the issue as of whether, and to what extent, public debt management is a matter of common concern, requiring coordination and cooperation among European governments.

Despite marked differences in the fiscal stance across Europe, yield spreads have markedly fallen with the adoption of the euro, rarely exceeding 30 basis points during 1999. A significant cross-border diversification of government bond holdings has not (yet) occurred. Although hard evidence on diversification is scarce, the general perception is that very few investors have appreciably modified their holdings of domestic debt. Many market participants, however, anticipate a change in portfolio patterns as soon as European money managers come to be evaluated on the basis of European performance

benchmarks rather than domestic benchmarks.

Underlying these general features of the government bond market are different objectives and strategies pursued by national Treasuries. In the two largest countries in the union, Germany and France, debt management is largely seen as part of a general strategy to promote the national market as European financial centers. The immediate goal is to establish domestic government bonds as benchmark for the euro area as a whole. France can count on the fruits of a decade-long effort to modernize its bond market: French bonds are quite standardized, sufficiently liquid over a large spectrum of maturities, and supported by a well-organized and transparent market for repurchase agreements. The main drawback is perhaps the low liquidity of the French bond futures contracts, compared to the liquidity of the Eurex bund future contracts. To reduce the gap with French standards, Germany has also been reforming its markets. In particular, breaking with its traditional preference for issuing debt through syndication, Germany has recently adopted an auction system, accessible to an ‘auction group’ of domestic and international investors.

In the eyes of market participants, neither government is likely to become the sole provider of benchmark bonds across the whole spectrum of maturities. In part because of the importance of the bund future contracts, German bunds are expected to be the European benchmark for the 10-year sector, while French issues should dominate shorter maturities. However, the specific bond to be included in the set of euro benchmarks may well vary over time, depending on circumstances.

Because of their low credit rating, Italian bonds cannot compete for the status of the European benchmark. Yet the large stock of its public liabilities assigns to Italy a comparative advantage in terms of liquidity, an advantage that has been exploited by resorting to ‘jumbo’ issues of euro denominated, fixed-income conventional bonds. A goal actively pursued by both Italy and Spain in recent years has been an improvement in debt maturity and duration.¹⁷

Issuing a few standard bonds in large amounts is also the dominant strategy in other countries of the euro area, mainly because of concern with the liquidity of their new issues, as well as with the related goal of marketing

¹⁷Between July 1998 and June 1999, for instance, the average maturity of the Italian public debt rose from 4.9 to 5.5 years — a level consistent with the average maturity of the French and German debt.

domestic debt to non-domestic investors. As a general pattern, debt managers have increased the size of each bond, while reducing diversification of their supply. There are however differences across countries in regards to the choice of auctions as opposed to syndication.

Will the euro necessarily encourage more coordination and cooperation among public debt managers? According to some, the euro area should create a single European debt agency, issuing European debt instruments on behalf of national governments. Supporters of this idea — such as the former monetary affairs commissioner of the European Union — stress three motivations: the belief that both lack of coordination among national issuers and market fragmentation is a main factor hampering the euro’s status as reserve currency; the need to avoid congestion in European financial markets because of uncoordinated bunching of issues; and the presumption that a unique agency would reduce the cost of borrowing. Note that the creation of a supranational debt agency as a new European institution would require a costly process of revision and amendment of European treaties.

These arguments in favor of the agency are however unconvincing. Consider first the presumption that a supranational agency would reduce the cost of borrowing. As national issues will be lumped together, there is some scope for increasing the liquidity of European debt instruments. Yet, it is unlikely that the existing differences in rating among sovereign debtors be overlooked by financial markets. At best, the debt issued by the European debt agency would be rated at some average of the underlying rating of member states, so that the creation of a common agency could translate into a net gain for issuers with low rating and a liquidity problem. All other countries, however, would possibly experience a net loss. Moreover, to the extent that the issue of undifferentiated European bonds is perceived to reduce transparency with respect to the creditworthiness of the borrower, the overall cost of debt may well increase, rather than decline.

A supranational agency could reduce competition among national treasuries, which is now perceived as an important factor at the root of innovations and efficiency standards in European financial markets. Also, current practices in the euro area already minimize the risk of congestion. For instance, some countries publish annual or quarterly calendars of issues.¹⁸

On the positive side, the existence of a supranational agency would be

¹⁸Pressured by the scale of debt redemption in 1999, Italy ‘strategically’ presented its 1999 calendar well before France, trying to exploit a first-mover advantage.

likely to promote product standardization — but a market-driven trend in this direction is already detectable. If anything, some market participants have expressed concerns about ‘excessive’ product standardization, as new issues have been largely consisting of standard fixed-income bonds. The supply of indexed bonds, for instance, has markedly fallen. Finally, a European debt agency could reduce the market power of primary dealers, that according to some observers has increased due to competition among debt managers.

As the proposal of a single debt agency has been met with widespread skepticism and criticisms, it is unlikely that such an institution will be created in the near future. Some form of coordination may nonetheless emerge, especially if debt management ends up creating liquidity management problems for the ECB as mentioned above. Notably, an example of an institution coordinating debt issues is provided by the German Committee for Public Sector Credit Issue, which assures full cooperation among the Ministry of Finance, the Lander governments, the Bundesbank as well as public and local institutions.

4.3.3 Equity market

In light of the scant evidence, the impact of the euro on equity markets is harder to assess than on the bond markets. In addition to the elimination of currency risk within the euro area, the common currency is expected to produce important discontinuities in the time-series behavior of national variables (such as inflation), with potential consequences for risk premia. The considerable uncertainty about the new economic environment has encouraged a thorough review of equity portfolio strategies and risk exposure by both individuals and institutional investors.

Bank of England (1999) for instance reports the result of a survey of continental European fund managers carried out in April 1999 by Merrill Lynch and Gallup. In this survey, one out of four managers had already carried out the portfolio adjustment they considered necessary by April 1999, while 62 percent of them were confident to have it completed by the end of the year. The marketing and investment strategies pursued by investment institutions reveal interesting trends. Many of these now emphasize cross-border, sector by sector allocations of portfolios. Such a strategy is supported by the creation of several pan-European stock market indexes, including also sectoral indexes.

The problem with this approach is that, while currency risk has disap-

peared in the euro area, country risk has clearly not. Not only fiscal and regulatory policies, but also labor markets and financial systems differ across member states. As we have discussed below, there is no presumption that the effects of the common monetary policy will be symmetric. Country-specific factors are not likely to disappear from the portfolio strategies pursued by investment managers.

The eventual scope and size of the ongoing portfolio revision are unclear. The first issue is the extent to which the euro will lead to a portfolio reshuffling towards pan-European, rather than national, asset holding. It has been observed that eliminating currency risk could alter the perception and definition of 'domestic' assets, as to include all assets denominated in the common currency. Thus, for a given home bias in portfolio formation, we should expect more cross-border equity holdings. According to recent estimates of equity holdings in Italy, France, Germany, Portugal and Spain, the percentage of domestic assets in resident portfolios is above 90 percent. While evidence at the state level in the United States does not reach these peaks, it is noteworthy that a significant home bias also persists in federal states such as the United States, with the longest tradition of currency union. The US experience could provide a benchmark to assess what could be a realistic end-point for the process of cross-border investment diversification in the euro area.

In spite of the changes in the investment industries mentioned above, major diversification is unlikely to occur rapidly. Other things equal, domestic and local portfolio managers may need time to redirect their operations towards markets where they do not have a comparative analytical advantage. In Europe, there still exist considerable national differences in the fiscal, regulatory and political systems, let alone in corporate behavior. Moreover, the presence of capital gain taxes may discourage portfolio diversification through reallocation of existing holdings, while favoring the more gradual approach consisting of investing abroad new flows of funds. By the same token, the portfolio composition of existing mutual funds may be constrained by their official mandate. Diversification may occur through the creation of new mutual funds with broader mandates, rather than the redirection of existing ones.

By October 1999, the total stock market capitalization of the euro area equity market was as high as 71 percent of GDP, approximately 4,346 billion euros, up from 3,624 euros in 1998. These figures partly reflect an increase in the number of firms listed on stock exchange over the period. The ECB

stresses that the creation of the euro has fostered the development of stock markets for growth companies, as reflected in the expansion of the EURO.NM market. This is an alliance of five European equity markets (Paris, Frankfurt, Amsterdam, Brussel and Milan) aiming at attracting growth companies.

This alliance exemplifies the important changes that are occurring in the organization and technical capabilities of European markets. Other initiatives include the creation of a European platform for initial public offering (Nasdaq Europe), or the creation of an international exchange. But progress in this area crucially depends on the removal of impediments arising from differences in law, regulation, and tax regimes. Although the number of markets in the euro area is considered excessive by many, it is unlikely that domestic markets will disappear. Rather, they are likely to specialize in medium- or low-capitalization domestic stocks, leaving large stocks to a deeper pan-European market.

4.3.4 Banking

It is an easy prediction that the sector at the very center of the European financial system will also be the sector most affected by the transformations brought forward by EMU. But the direction in which continental European banking is heading is by no means clear. A first issue is the extent to which existing differences will persist over time. A second issue is which particular model of banking will become the prevailing model for Europe, and how fast the transformation of European banking will take place.

The sizable difference in the weight of bank loans in corporate finance between continental Europe and the US or, to a lesser extent, the UK, corresponds to a dichotomy between models of financial intermediation. The ‘Anglo’ model, based on the greater reliance on impersonal markets, differs from the traditional European model, based on the greater reliance on relationship banking. In recent years, several factors have already induced changes in these models, independently of EMU. A leading example is provided by the developments in computing and telecommunications technology, which have undermined the very core of the European traditional model by encouraging price competition across a wide range of products and by reducing the relevance of historical bank-customer relationships.

The key issue then is whether, and to what extent, such a dichotomy will persist in the EMU era. Within the context of the ongoing technological and legal transformation, EMU is expected to enhance competitive

pressures in the European banking system. To the extent that the disappearance of currency risk facilitates development of pan-European financial markets, corporations will find it increasingly advantageous to issue securities rather than seek bank loans. The availability of a wider variety of investment opportunities will provide an incentive for European bank customers to shift from safe, but ultimately low-return deposits, to higher-yielding mutual funds, employer-sponsored thrift plans and the like. A significant increase in households' demand for securities will also stem from the development of fully-funded pension plans, that demographic trends and changing political postures are fostering throughout Europe.

The transformation of the European banking system in response to stiffer competition presents several similarities with US financial developments in the past two decades. At the root of both cases is the combination of technological developments, deregulation, and a growing securities industry. In both cases the number of banks has decreased, small banks have been hit more severely than large institutions, and the wave of consolidation has tended to increase market concentration. In both cases, also, the bulk of the adjustment has occurred through mergers and acquisitions, and bankruptcies have played only a marginal role.

What distinguishes the consolidation processes in Europe and the United States is the fact that in the United States indicators of concentration at the local level have slightly decreased, while in Europe the concentration of banking activity in the largest institutions at both the national and local level has significantly increased, especially in smaller countries.

So far, the consolidation of the EU banking industries has mostly taken place within national boundaries. Out of 488 mergers and acquisitions from 1995 to the first quarter of 1998 in the EU, cross-border activity accounts for only 17.6 percent, and the additional wave of mergers from 1998 through 1999 has strongly reinforced the pattern. In other words, the process of European banking consolidation has not yet eroded the segmentation between national markets, nor enhanced the degree of internationalization of the European banking system. With the exceptions of Ireland and Luxembourg, countries in the euro area still report a domestic share of branches and subsidiaries from foreign countries below 11 percent.

Consolidation confined to the national level raises at least two kinds of problems. At the microeconomic level, to the extent that it reinforces the local monopoly power of the banks, it may increase inefficiencies faced by borrowers, and worsens the conditions of those customers, in particular small

firms, that are less likely to have access to international capital markets. At the macroeconomic level, as considered above, it can affect the monetary policy transmission mechanism. But, despite these concerns, for the time being there is no sign that the bias against cross-border bank mergers in the euro area is bound to disappear. While diverse factors can contribute to explain such a bias, a key role is played by national law, regulation and tax regimes, which de facto keep national markets segmented. For instance, there exists no uniform European corporate law providing a framework for the birth of European (transnational) firms. This is a key problem hampering cross-national mergers of both financial and non-financial corporations. Moreover, as the structure of bank supervision in the euro area is decentralized, the incentives faced by nationally-based supervisors may work against cross-border mergers.

Supervision in the euro area remains organized at the national level. Those NCBs having domestic supervisory and regulatory functions in the pre-EMU era (6 out of 11) have retained them. In other countries — such as France and Germany — supervision and regulation resides with independent agencies in close cooperation with the respective NCBs. It is often argued that, as long as bank activity remains essentially confined to the national level, supervisory tasks are not impaired by informational problems. Difficulties in monitoring a bank's activity and balance sheet can however emerge in the case of international banks. The desire to avoid these difficulties may give national supervisors an incentive to discourage cross-border mergers — up to blocking them in countries where bank mergers requires supervisory approval. Interestingly, a few national supervisors have recently expressed their aversion to hostile takeovers in the process of within-border consolidation, perhaps in fear of setting a risky precedent for future successful bids by foreign competitors.

Ultimately, decentralized regulation can itself hamper the process of integration of European capital markets, and impart a bias toward 'national champions', with uncertain implications. To the extent that the process of EMU banking market integration can be slowed down but not halted, 'national champions' may become embarrassing liabilities for national authorities. In an integrated market, these champions will be focused too broadly at national level to benefit from the knowledge of local markets, but at the same too small to compete effectively with large international institutions.

There is another reason why several critics of the current regime of decentralized supervision are concerned with its effectiveness once the European

banking market will become more integrated. In crisis situations, a national supervisor may not fully internalize the euro-wide implications of its decision when facing the option of rescuing a bank located in its own country but also operating abroad. Crisis-management considerations thus make it likely that the emergence of European transnational banks will lead to some centralization in supervision. Currently, national supervisors cooperate with each other on a bilateral basis, according to a memorandum of understanding between EU countries that regulates exchange of information and provides for periodic meetings, without, however, being legally binding. There are also two multilateral forums: the Banking Supervision Committee of the ECB, and the lower-level Groupe de Contact.

Early on, critics questioned the ability of the new EMU institutions to cope with financial crises in a timely and effective manner. After the launch of the euro, however, the ECB has replied to these criticisms by clarifying the Eurosystem procedures for crisis management. Provision of emergency liquidity is a national responsibility, and its costs are to be born at national level. Cooperation and exchange of information are required for the ECB to manage the impact of emergency interventions on the monetary stance of the euro as a whole. An issue that remains open is what role market segmentation will play in a potential EMU crisis scenario. On the one hand the segmentation currently characterizing the euro area could effectively contain the risk of cross-border contagion of a financial crisis erupting in one member country. On the other hand, there may be severe problems associated with lack of information at a central level, as well as with constraints on the flow of liquidity from one market to another.

5 Conclusion

For most critics of European monetary integration, the main argument against a common currency hinged on the view that European countries were too heterogeneous — significantly more so than the United States — and therefore too vulnerable to country-specific shocks, which could be best dealt with by letting exchange rates change. The creation of EMU has of course settled the policy debate on whether Europe could afford to give up exchange rate flexibility, without necessarily implying, however, that the issues and concerns raised during the debate have been answered.

If there is a lesson that can be drawn from the EMU experience is that

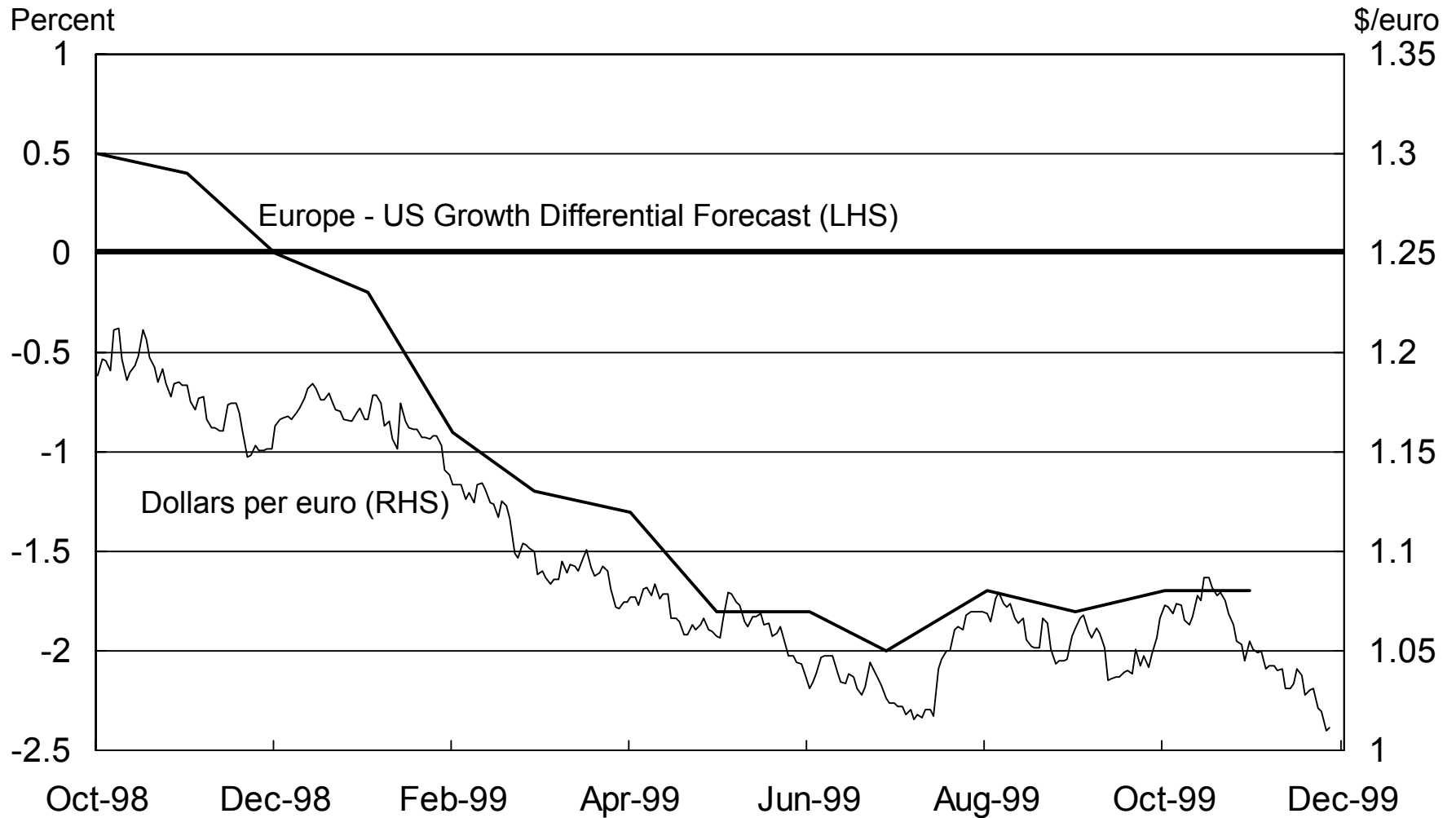
heterogeneity and asymmetries represent obstacles and constraints to the process of monetary unification, but need not be emphasized as *criteria* upon which to base the strategic decision whether or not to undertake the process of monetary unification. This is not to say that heterogeneity and asymmetries do not matter — our paper shows that quite the opposite is true. The point is that an extreme and long-lived form of limited exchange rate flexibility can only be viable in the context of long-term regional economic integration, unambiguously supported by a strong political drive. The legacy of EMU to the countries debating the future of their currencies and contemplating a potential move towards monetary unification is to show that such strategy can be successful, to the extent that it is fully consistent with the medium and long-term prospects for enhancing regional integration.

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Figure 1. Revisions to 1999 GDP Growth Forecasts and the \$/Euro Exchange Rate



Source: Consensus Economics, European Central Bank