Economic Risks of EMU

Michael Frenkel\textsuperscript{1} and Paul McCracken\textsuperscript{2*}

\textsuperscript{1}WHU Koblenz, Otto Beisheim Graduate School of Management
\textsuperscript{2}University of Michigan Business School

Abstract: This paper reviews recent research and the first five years of EMU experience with a view to examine the risks that EMU entails for governments, firms, and workers. It also looks at the long-term stability of the euro. Although it has often been emphasized that exchange rate risk is eliminated by EMU, risks can occur for a variety of reasons which are discussed in this paper. More specifically, we consider fiscal policy, rigidity of labor markets, and EMU enlargement as potential sources of risk in the EMU and look at shifts of the importance of different risk components in financial markets resulting from EMU.

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\textsuperscript{*} This paper was originated by discussions I had with Michael Frenkel on European monetary policy issues. On this basis and since I have followed the career of Professor Gunter Dufey, in honor of whom this volume is written, from its beginning to his current internationally distinguished position, Michael Frenkel felt strongly that I should be associated with this project. He therefore has suggested that this paper be a joint authorship, though his has been the primary responsibility for its preparation.
1. Introduction

EMU has been reality since the beginning of 1999, when the first eleven EU member countries transferred sovereignty for monetary policy from their central banks to the European Central Bank (ECB). Since then, the ECB together with the central banks of the member countries forms the European System of Central Banks (ESCB). The number of countries of the euro area increased to 12 in 2001, when also Greece adopted the euro as its currency.¹

Before EMU was established, an intensive debate took place over the costs and benefits of a monetary union in Europe. The academic discussion was based on the optimum currency area theory (OCA) which develops criteria for assessing whether a monetary union is superior to a system of independent national currencies. The creation of EMU is based on the assumption that it will be a lasting arrangement and that it will grow in size as more and more EU member countries join the euro area.

This paper reviews the recent research on EMU and the first five years of EMU experience with a view to examine the risks that EMU entails for governments, firms, and workers. It also looks at the long-term stability of the euro. The discussion concentrates on economic risks of EMU and, thereby, excludes political considerations (foreign policy, national identity etc.). The paper recognizes that EMU is a fact and it does not aim at weighing costs against benefits of this arrangement. By focusing on the risks of EMU in a volume on risk management, it examines the macroeconomic environment firms and individuals have to take into account for various types of decisions. Although it has often been emphasized that exchange rate risk is eliminated by EMU, risks can occur for a variety of reasons which are discussed below.

For reasons of space, this paper limits the discussion to four different sources or aspects of risk within the euro area. First, although EMU is based on certain fiscal rules which are included in the Pact for Stability and Growth and which aim at supporting the efforts of the ECB to achieve and maintain price stability, the risk remains that relatively high fiscal deficits in member countries will ultimately not be penalized. If this is the case pressures may be exerted on the ECB to be more expansionary than otherwise so that the effects of excessive borrowing on interest rates are mitigated. As this would ultimately undermine the objective of price stability, the question is whether, over the medium and long term, the Pact for Stability and Growth will be adhered to or not. If not this would certainly have important implications for the stability of the system and the euro. Second, since Mun-

¹ The term “euro area” is used in this paper to define the area of EU countries that have already adopted the euro as their national currency. In many publications, these countries are referred to as EMU countries. However, this is not precise, as, from a legal point of view, all EU countries are automatically EMU countries and the proper distinction is between EMU countries that have adopted the euro and those that have not.