Facing the Euro: Prospects for Growth or Stagnation?

The introduction of the euro has been overshadowed by the controversy over the appointment of the president of the European central bank and the possible implications for the bank’s policies. The effects of the launching of the single currency on growth and employment depend on a multitude of factors, however. Professor Welfens analyses the potential benefits of EMU and discusses the problems to be solved.

European Monetary Union will be a complex and a fragile transition process which raises many issues. The Euro brings with it the risk of increasing wage pressure in Euro countries with relatively low per capita incomes where workers translate the full price and wage transparency established by the Euro into higher wage demands. Such developments clearly could further raise the unemployment rate and force the EU to step up the structural funds and the cohesion fund, which represent some 40% of EU expenditures and distort the market allocation process. In countries with high unemployment rates and large state banks or industrial holdings (Spain, Italy, France and Greece) there could be pressure on banks to extend soft loans to ailing firms. This would not only undermine economic growth but could lead to a banking crisis in the case of adverse economic shocks or a shift towards restrictive monetary policy by the ECB. A slowdown in economic activity immediately after 1999 as well as major banking problems could cause a Euro devaluation, which would undermine the prospects of the Euro’s becoming a major international reserve currency. Developments of this kind, implying economic stagnation in the EU, are clearly undesirable. Given the worldwide increase in international capital mobility and the increasing likelihood that regional instability creates negative global spillover effects, a weak Euro or even a Euro currency crisis (a massive devaluation vis-à-vis the US dollar) should be avoided by means of prudent policies.

If such problems can be avoided, EMU could bring major benefits to the EU and the rest of the world. The EU may expect five benefits from monetary union:

- Savings on transaction costs which recently were estimated to reach about 1% of GDP in Germany. Major exporters should particularly benefit from this so that blue chips from the tradables sector will record higher stock market prices and windfall profits.
- Lower inflation rates as compared to the average inflation rates of the period 1957-95, thus creating positive wealth effects; starting from an inflation rate of about 2%, the starting conditions are favourable for establishing a solid record under the European Central Bank. Given the fact that disinflation causes output and employment losses, the fact that the inflation floor of 2% was reached in 1997 implies improved conditions for long-term growth in the EU.
- Lower long-term real interest rates that might, however, require specific steps beyond simple monetary integration; a lack of policy credibility on the part of the European Central Bank and an inconsistent policy mix in the early EMU stage could lead to a rise in real interest rates in the Euro area beyond simple business cycle effects. Assuming that there will be no major credibility problem and taking into account the savings in transaction costs which are relevant for banks and bond markets, low long-term interest rates can be anticipated in the Euro area. Since short-term interest rates in most EU countries except Germany are likely to fall in late 1998, the yield curve could be rather steep in the beginning assuming that rising investment will raise long-term credit demand in the Euro area. Investment is likely to pick up since the

3 See IFO: Ifo schnelldienst, No. 9, 1997.
switch to the Euro implies less exchange rate risk in Europe and hence reduced overall investment uncertainty. Welfens and Jungmittag found for Germany (and the Netherlands) that the investment output ratio is negatively affected by exchange-rate volatility, implying that the Euro would raise the investment output ratio by half a percentage point in Germany or roughly 3%.

Higher investment and growth, partly reflecting a higher marginal product of capital in the monetary union due to the fact that the integrated and fully transparent goods and stock markets will reinforce the selection function of capital markets.

A real exchange effect vis-à-vis the USA and Japan, which cannot be predicted with certainty.

The EU's two main problems are, firstly, the high level of EU structural fund expenditures, which undermine the potentially rising role of market forces in factor allocation after 1999, and secondly, the high unemployment rates, which hovered around 10% in most EU countries, with Denmark, Austria, the UK, the Netherlands and Portugal being positive exceptions. High unemployment rates not only mean political conflicts and hence the risk of instability which could translate into the Euro currency market, they also imply high deficit-GDP ratios and in the case of a recession in any case the risk of violating the 3% margin established in the Stability and Growth Pact. This case would, of course, create political conflict in the EU. There are no viable policy options in most EU member states to reduce the unemployment rates in a short space of time, since they largely reflect structural problems in Western Europe. Indeed the ongoing globalization of the economy implies a considerable risk that jobs for unskilled labour will be relocated from EU countries to Eastern European or Asian countries whose price competitiveness has increased as a consequence of the heavy depreciations suffered by most Asian countries in 1997. At the same time low import price increases are likely to reinforce low EU inflation rates in the run-up to EMU.

Theoretical Aspects of EMU

The main theoretical aspects with respect to EMU are:

- the link between the nominal volatility of exchange rates (and money supply growth) and investment growth and employment;
- the real exchange-rate effects of EMU and the induced changes of foreign direct investment inflows into the EU;
- the welfare effects of EMU and the associated income and wealth effects;
- the problem of fiscal policy coordination in the absence of political union and the consequences for the efficiency of stabilization policy;
- the appropriate fiscal and monetary policy mix in the EMU area and the overall effectiveness of a stabilization policy;
- the need for national and supranational policy reforms as a means of improving market-clearing mechanisms.

While the first three topics are more theoretical in nature, the last four refer to the political economy of EU integration.

The switch to EMU raises several important issues. Only the strategic ones can be addressed here, however. One important issue is exchange-rate volatility, given that investment and growth are known to be influenced by uncertainty and volatility. EMU will reduce this exchange-rate volatility and hence encourage investment. Since foreign direct investment became increasingly important in OECD countries after 1985, emphasis should be placed on the link between FDI and the real exchange rate (of the DM or the Euro) in the context of EMU. This already points to the welfare effects, as higher (lower) net EU FDI inflows will contribute to higher (lower) employment and income after 1999. Clearly, there are also critical policy issues which mainly concern the assignment of fiscal policy to the national and supranational levels and the coordination of fiscal policy under a new regime – including aspects of the Stability Pact. These issues naturally are subject to conflicts between governments, trades unions and employers' federations.

Redistribution and Transfer Aspects of EMU

In the EU transfers are mainly allocated via agricultural subsidies, the cohesion fund set up for Spain, Portugal, Greece and Ireland – countries with less than 90% of EU average per capita income (not on the basis of purchasing power parities but of nominal figures – in the context of the Maastricht