What Have We Learnt from Europe's Monetary Union?

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“Surely it is an advantage, rather than a disadvantage, of the scheme that it invites the member states and groups to abandon that licence to promote indiscipline, disorder and bad-neighbourliness which, to the general disadvantage, they have been free to exercise hitherto.”

John Maynard Keynes, *Proposals for an International Currency Union*, second draft, 18 November 1941

Issues

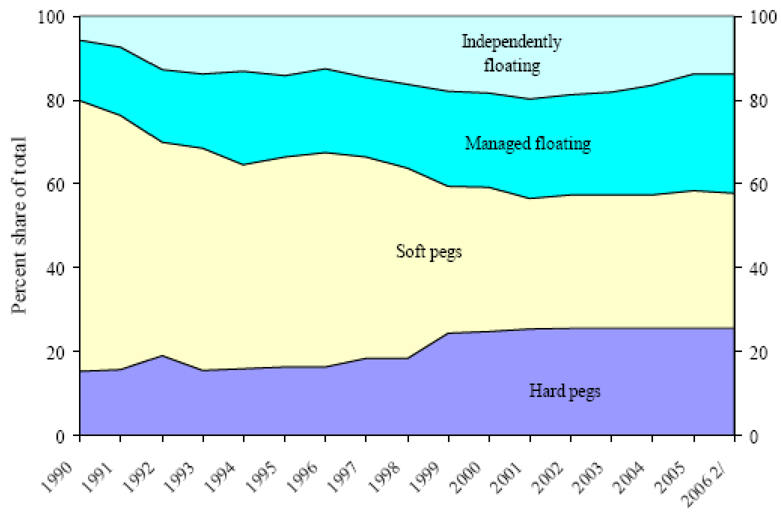
- A need to experiment new forms of political and economic governance in a globalized world
- Renewed thinking on exchange-rate regimes:
  - Financial crises of the 1990's and 2000's in emerging market countries
  - Ballooning 'Global imbalances' and accumulating foreign-exchange reserves
- In Asia, regional integration is moving forward and monetary cooperation is developing since Chiang Mai in the ASEAN+3 framework
- In Europe, the euro as a 'natural experiment' since 1999: what did we learn? Which lessons for Asia?

Plan

1. Exchange rate regimes: What did we learn?
2. 1998-2008: The European experience
3. Which lessons for Asia?

A new consensus on exchange-rate regimes

- The demise of intermediate exchange-rate regimes
  - The crises of the 1990's have condemned crawling pegs and target zones
  - The way forward: floating rates or har[d] pegs such as dollarization, currency boards and monetary unions
- The fallacy of floating exchange rates
  - Many emerging market countries are narrowly monitoring their dollar exchange rate, out of 'fear of floating'
- A European exception
  - Intermediate regimes remain perfectly valid as a transitory arrangement on the way to monetary union



Source: IMF (2006)

Towards a multipolar world?

- The 2000's have been the years of fixed and quasi-fixed exchange rates in emerging market countries, at the expense of floating and intermediate exchange-rate regimes
- This state of the world can be objected on several grounds
  - Distrust vis-à-vis the IMF has led emerging market countries to accumulate excessive foreign-exchange reserves as a self-insurance against financial market volatility
  - Choosing an anchor has to do with economical and political coordination
- The current, 'new Bretton-Woods' equilibrium which favors dollar pegs is suboptimal from a macroeconomic standpoint
  - Asymmetry in G-3 exchange-rate adjustment hurts the European economy
  - Foreign-exchange reserve accumulation generates political tensions (see the sovereign wealth fund discussion) that may ultimately harm free trade and investment
  - Insufficient incentives to develop local financial markets, in spite of regional (*Asian Bond Fund*) and G-8 initiatives

- **Monetary regionalism as an alternative model?**

1. Exchange-rate regimes: What did we learn?
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1999-2007 in retrospect

- ‘Monetary Union 101’: Defining debates
- 1999-2007 in retrospect
  - Differentiated integration
  - Strengthened euro governance
  - A functioning macroeconomic decision framework, with room for improvement
  - The euro and the world: A story which remains to be told

Defining debates (i): Is Europe an optimal currency area?

- Is Europe an optimal currency area (OCA)?
  - OCA theory since Mundell (1961), McKinnon (1963) and Kenen (1969) advises to freeze exchange rates between economies facing comparable shocks and/or where production factors are mobile
  - But Europe is more diverse than the US and labor mobility is limited
  - It has therefore been hard to identify it as an OCA, except within a limited, ‘core’ group of countries
- Can it become one?
  - Krugman (1993): lower transaction costs can favor production factor polarization and lead to more asymmetric shocks
  - Rose (2000): the mere existence of monetary union can boost intra-area trade and favor convergence

Defining debates (ii): Economic policy coordination

- From inception, OCA theory has raised the issue of how monetary union and policy domains coincide
- Should fiscal policies be coordinated between countries?
  - Isolated fiscal expansions generate both positive demand spillovers and negative interest rate spillovers, and the magnitude of these effects is debated
- Should fiscal policy and monetary policy be coordinated?
  - Both policies impact on output and prices and there is a risk of a sub-optimal, non-cooperative equilibrium
  - But monetary policy is more effective if it is independent
- Most European economists do not believe too much in coordination and favor a model where responsibilities are clearly outlined and "everyone does their homework". Economic policy coordination is nevertheless enshrined in the Maastricht Treaty.

Defining debates (iii): A federal budget?

- In the US as in EU Member States, the federal budget fulfills a insurance function against macroeconomic shocks
- This function dates back from 1929 only, 150 years after the Union was born
- In Europe, macroeconomic stabilization is entirely decentralized (structural funds have an allocation, not a stabilization role)
- Even though insurance provided to households by labor and financial markets is less developed than in the US

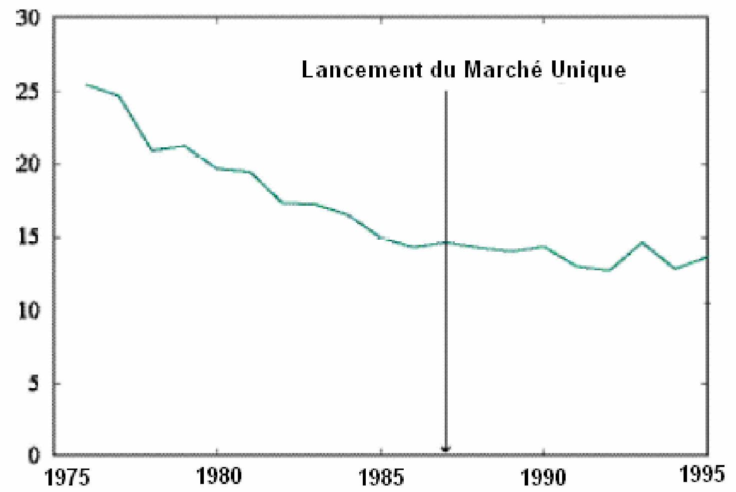
Differentiated integration

- Labor markets
  - Despite some political momentum (Employment title of the Treaty, ‘open method of coordination’, better transferability of occupational pensions), social policies are mainly operated at a national level
- Financial services
  - Integration was spurred by the ‘Financial Service Action Plan” but it remains differentiated across market segments
    - Wholesale market versus retail markets
    - In the wake of the 2007 credit crisis, the political focus has moved from the legislative process (the so-called ‘Lamfalussy’ process) to the architecture and scope of bank regulation

A boost for intra-Eurozone trade

- Baldwin (2006) survey
  - A 5 to 10% rise of trade volume between 1998 and 2005
  - Benefiting to sectors where size effects are presumably stronger (imperfect competition, increasing returns to scale)
  - No trade diversion effect on non-euro, EU members
- The euro adds to the impact of the Single Market, which benefited to intra-branch trade (Fontagné and Freudenberg, 1999)
  - Trade in substitute goods and services is more sensitive to transaction costs
- It is nevertheless difficult to disentangle the consequences of the Single Act and those of the euro

The Single Market and the Border Effect



The figure should be read as follows: in 1995, Member States traded 15 times less with each other than within themselves, as compared to 25 times in 1975.

Source: Head and Mayer (2002).

Deeper capital markets

Crating a deep capital market open to all economic players has far-reaching consequences for economic growth and stability:

- A lower cost of capital, conducive to a higher long-term growth
- Better insurance against risk against the background of a small federal budget
- Regional recycling of savings as a protection against global financial market volatility

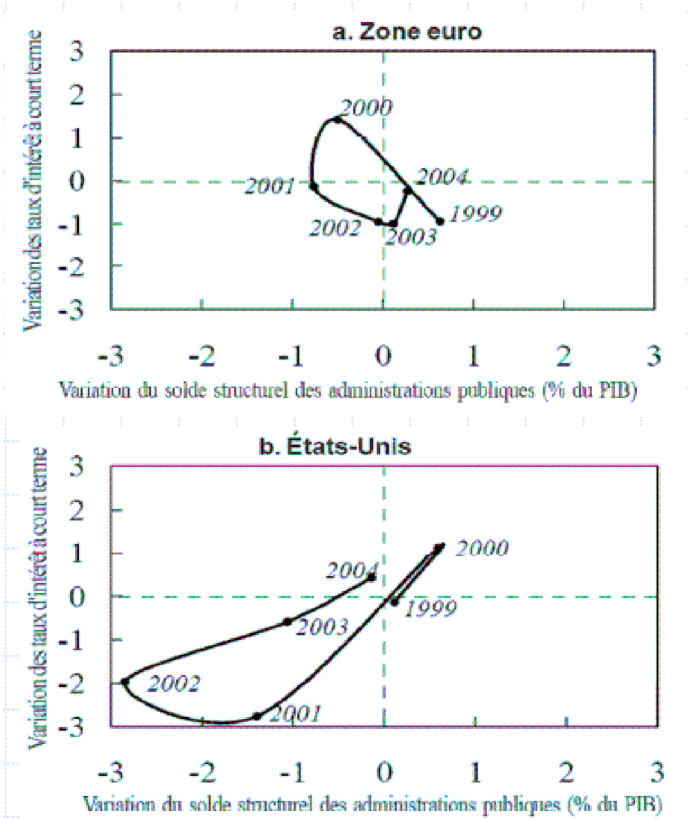
- A case in point: the euro-denominated bond market (see Appendix 1)

Continued strengthening of euro governance

- 1998: ECB is created, political agreement on the Euro group and the Stability and Growth Pact
- 2004: Election for a 2-year term of the Euro group Chairman
- 2005: Reform of the Stability and Growth Pact
- 2007: Lisbon Treaty (see Appendix 2)
  - Protocol on the Euro group
  - Eurozone decision capability on matters of common interest

A functioning macroeconomic decision framework…

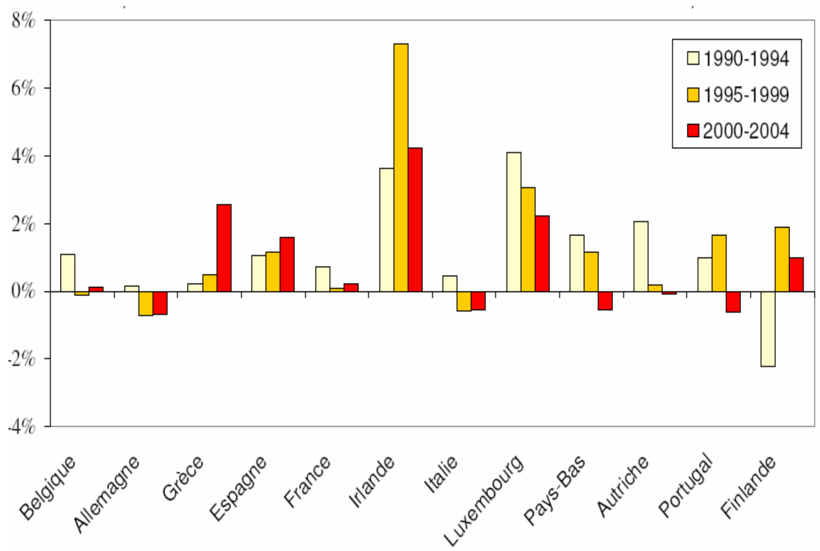
- The Euro group and the ECB have initiated a dialogue which does not impinge on the independence of the central bank
- The euro has shielded the area from destabilizing outside shocks
- Monetary and fiscal impulses have been less pronounced than in the US
  - See evidence on right-hand side figure
  - Should we regret it?



… with room for improvement.

- Fiscal rules have been improved only gradually, …
- … Member States have suffered from 'convergence fatigue' after euro accession, …
- … growth, inflation and current account asymmetries have been marked and persistent among Member States (Blanchard, 2006), …
- … and it is unclear whether the euro has accelerated structural reform (Duval and Elmeskov, 2005).

Difference with average Eurozone growth

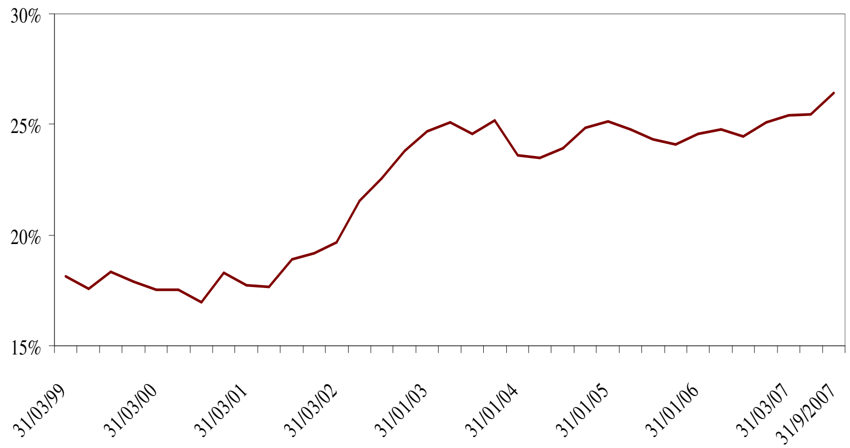


Source: European Commission, AMECO database.

The euro and the world: A story which remains to be told

- Achievements in the field of international coordination
  - Coordinated FX interventions in 2000, decisive liquidity provision by the Eurosystem in 2007
- Recognition of the euro's role as an international store of value
  - 26% of world FX reserves
  - 29% in emerging markets
- But a sense of an insufficient weight on the world scene, see Bini-Smaghi (2006), Jouyet (2008)
  - Reflection on external representation (single Euro seat at the IMF?) not to be settled by ongoing quota discussion
  - External representation fragmented according to policy domains (currency, trade, energy, environment …)

Euro share of international foreign-exchange reserves



Source: IMF, COFER database, 'allocated' reserves.

A fragmented power?

	Trade	Competition	Financial markets	Development	Migrations	Energy	Environment	International macro / money
Sector homogeneity	Medium	High	Low	High	High	Low	Low	High
Competence assignment								
Competence	EU exclusive for goods Shared for services and investment	Exclusive EU competence (above threshold)	Shared competence	Specific EU policy alongside (and "complementary to") MS policies	MS, but Commission has initiative. Also visa policy coordination in Schengen space	Shared competence	Shared competence (except marine biological resources which are exclusive EU competence)	EU exclusive for money + exchange rates (euro area). MS in other fields
Legal basis for EU competence	Explicit (Art. 133)	Explicit (Art. 81sq)	Implied, based on Single Market competence	Explicit (Art. 177)	Explicit (Art. 61) derived from free movement of persons	Implied, except for nuclear energy (EAEC Treaty, Art. 101-106)	Implied, based on Treaty provision on environment protection (Art. 174)	Explicit for exchange rates (Art. 111), implied for coordination (Art. 99)
Clarity	High for goods	High	Low	High	High	Low	Low	High
Governance								
Number and nature of international agreements	High Multilateral, regional and bilateral	Low Bilateral	High Multilateral and bilateral	High Multilateral and bilateral	Low Bilateral	High Bilateral	High Multilateral	Low Multilateral
Decision regime	Mostly QMV	Does not apply.	QMV	QMV	Unanimity	?	QMV	QMV for X rates (but does not apply)
External representation	Commission, on the basis of Council mandate	Commission	Commission and MS	Commission and MS	Does not apply	Commission and MS	Generally Council presidency with Commission support	Mostly MS, also ECB (G7, BIS), Eurogroup and Commission (G7)
Delegation / coordination mechanism	Supervised delegation to Commission	Unconditional delegation to Commission / some coord. via	Coordination	Mix of supervised delegation to Commission and	Coordination	Coordination	Mix of supervised delegation to Presidency and	Mix of unconditional delegation to ECB

Source: Cœuré and Pisani-Ferry, in Sapir (2007).

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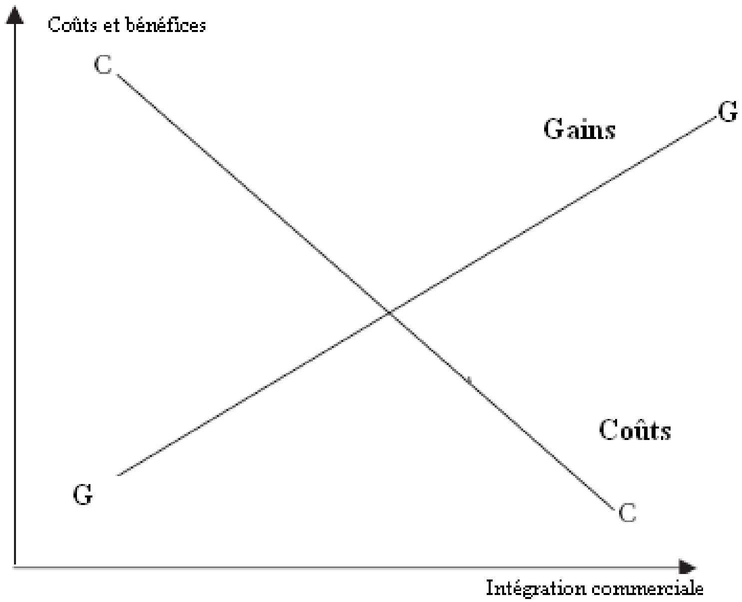
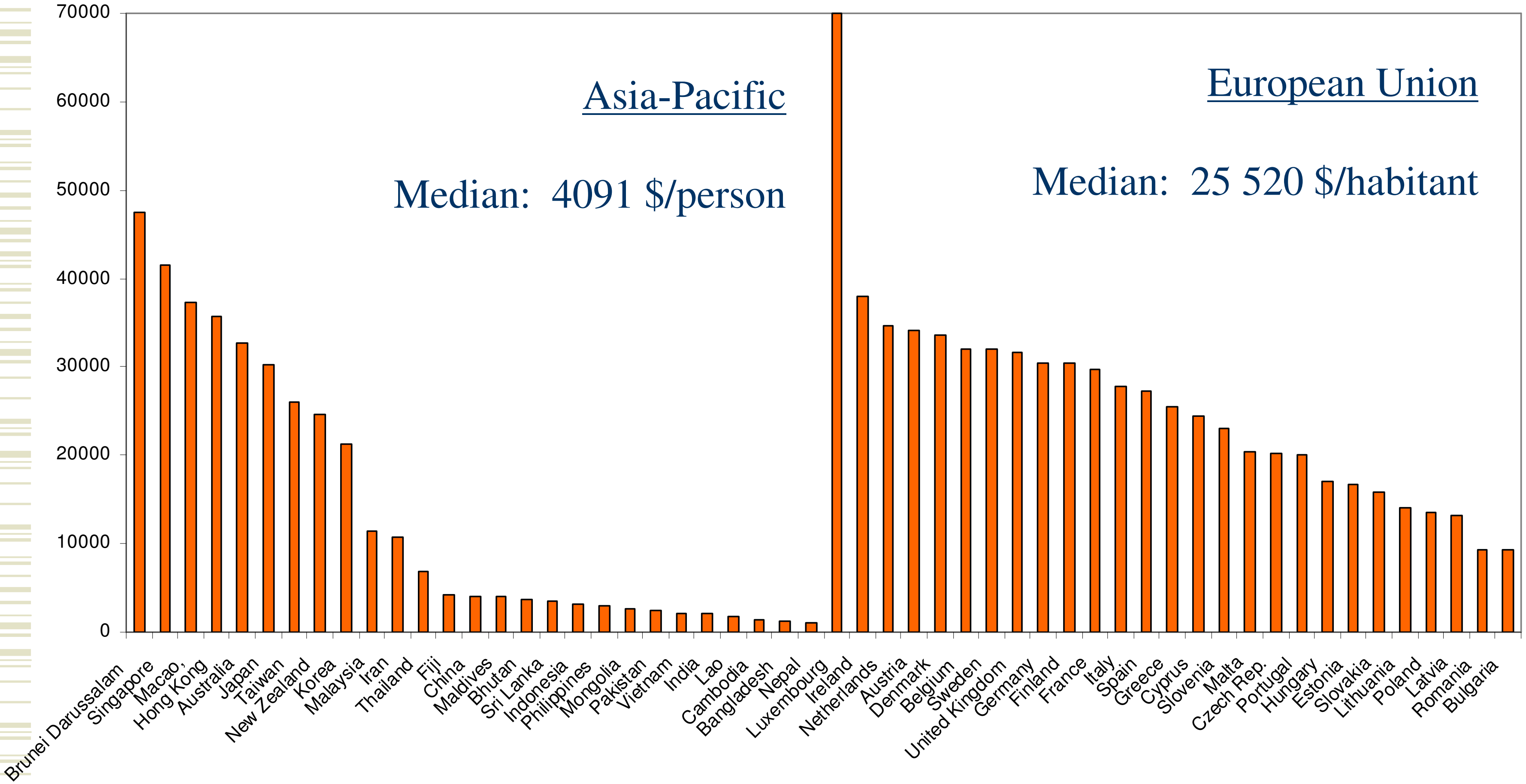
Is the cost/benefit assessment of European monetary union different from what it was in 1999?

- Intra-Eurozone trade flows deepen and their patterns are changing, but it is too early to disentangle the consequences of the Single Market and of the euro
- Business cycle have not converged, to the contrary
- Huge gains are to be reaped from capital market integration
  - The cost of capital is probably lower in average in the Eurozone, and much lower in former 'periphery' countries
  - More gains should be expected from further stock market integration, but how the MiFID will impact this dynamics remains unclear



Source: Krugman (1993) quoted by Artis (2005)

PPP GDP per capita, 2005



Source : World Bank (2007)

What does this cost/benefit trade-off look like in Asia?

Pros

- Asian economies are more open to trade and trade is more intense after taking distance into account (Wyplosz, 2001)
- Creating deep local capital markets to recycle local savings would generate huge economic benefits

Cons

- GDP per capita is more heterogeneous than in Europe and macroeconomic shocks are less well correlated
- Gains from exchange-rate stability may be smaller in the presence of inter-branch trade than intra-branch trade
- Willingness to transfer sovereignty and to organize fiscal solidarity even more limited than in Europe

Open questions

- Which endogenous effects would a Single Asian Currency unleash, in particular as concerns specialization dynamics?
- Shouldn't trade integration be given priority? Does monetary cooperation make sense without the perspective of monetary union (Eichengreen, 2003) ?
- European-style integration dynamics has been led by political will and consolidated step-by-step by judiciary activism, as in the early US (Simon, 2003). Is such a dynamics conceivable en Asia?

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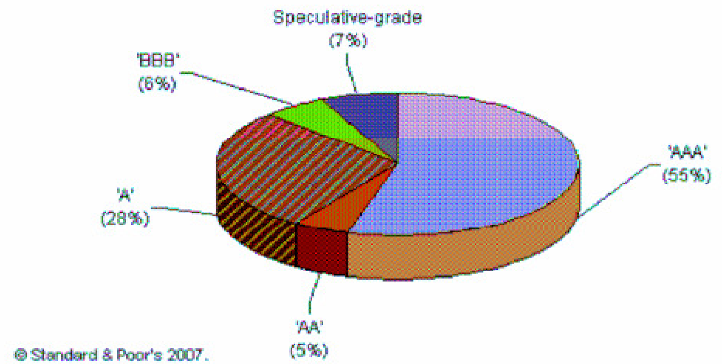
Appendix 1

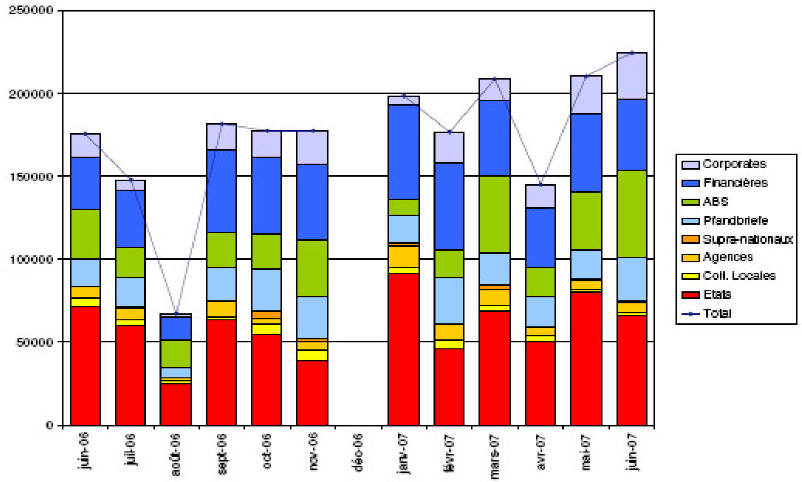
A case in point: The euro-denominated bond market

Diversity of credit

Sovereign bonds by rating category



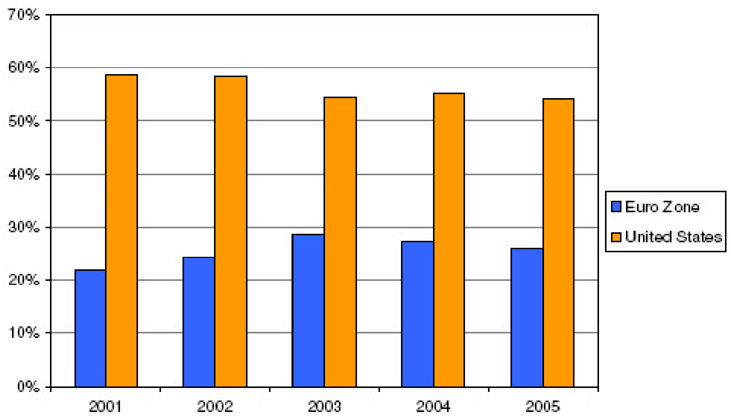
Bond issuance by type of issuer



Source: European Commission

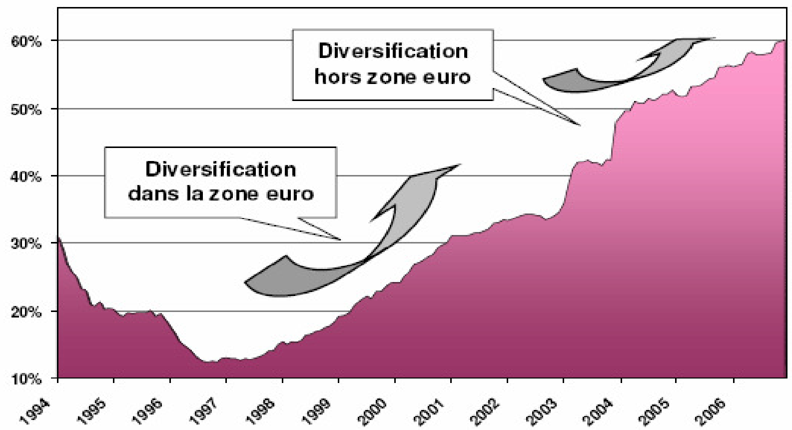
Increased openness to non-Euro zone investors

Bond holdings by international reserve institutions



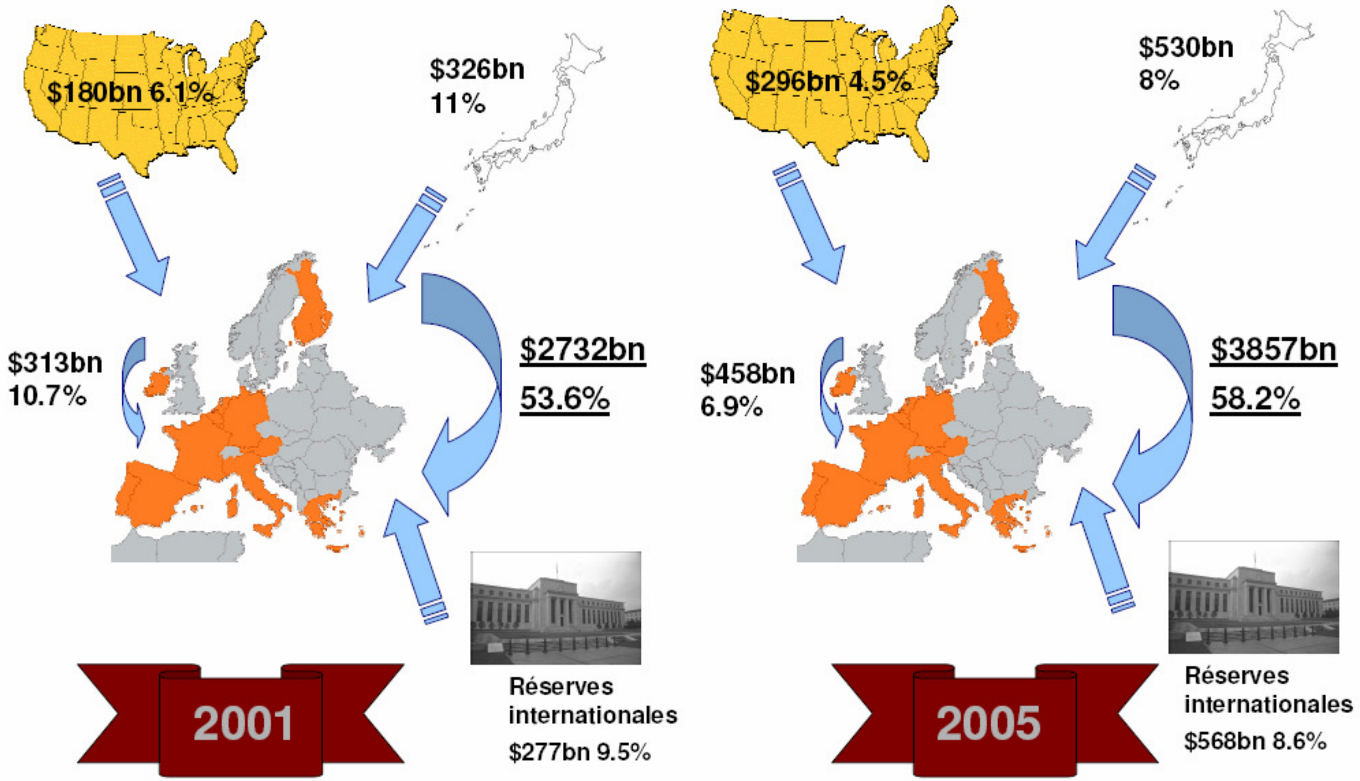
Source : IMF, Coordinated Portfolio Investment Survey

Share of non-French investors in French debt



Source : Banque de France

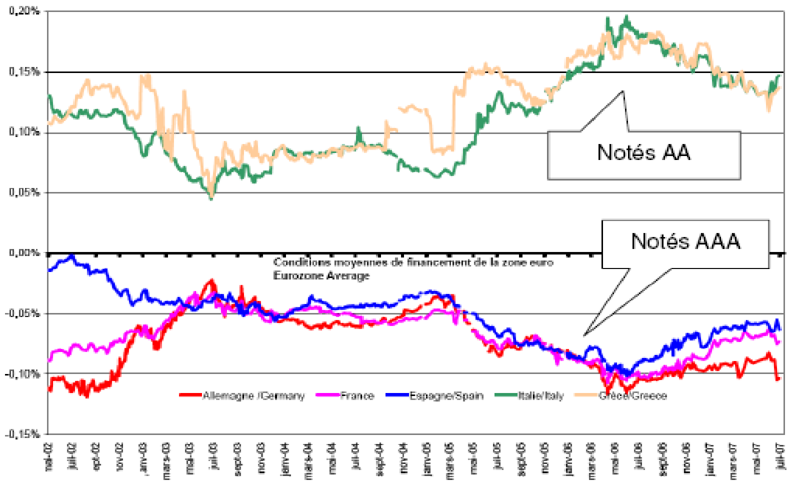
Holdings of long-term debt securities issued in the Eurozone



Source: IMF, Coordinated Portfolio Investment Survey

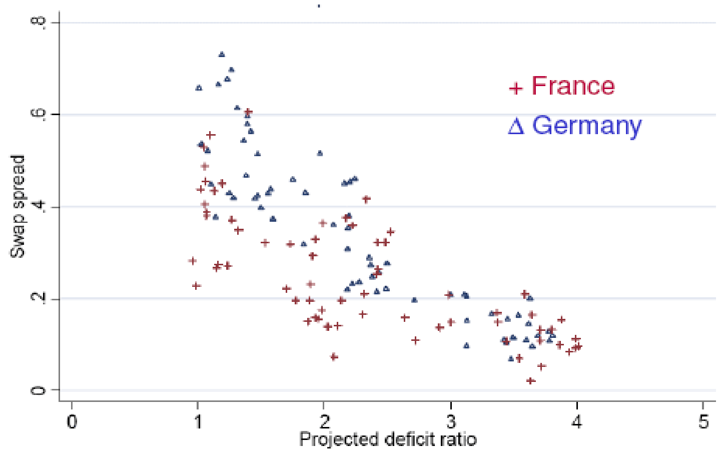
A significant but limited support to fiscal discipline

Average financing cost of Eurozone Member States



Source : AFT

Deficit forecast and swap spread, 1999-2004

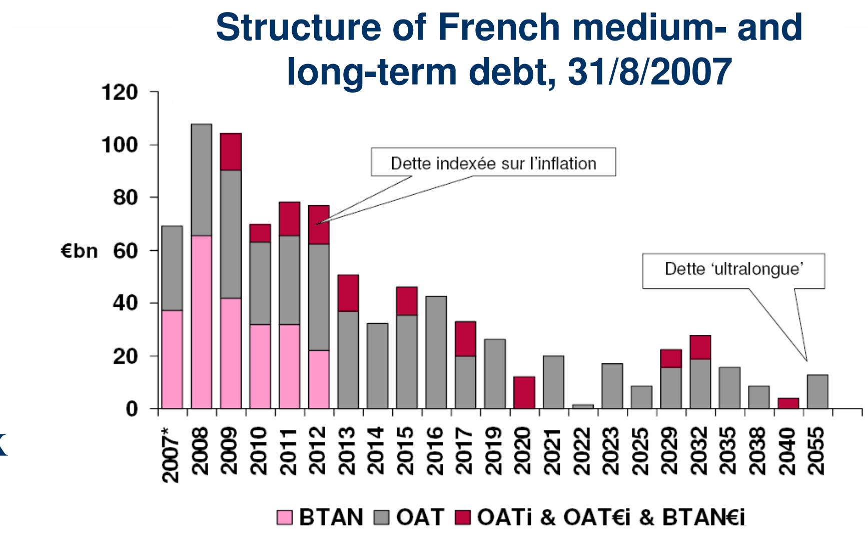


Source : Deutsche Bundesbank, 2004

Competition among issuers is conducive to innovation

Thirty years of innovation in French debt management

1986: Fungibility of bonds
1989: 30-year bond
1991: Strips
1996: Variable-rate bond
1998: Bond indexed to French price index
2001: Interest risk management using swaps
2001: Bond indexed to Eurozone price index
2005: 50-year bond
2007: Inflation strips



Appendix 2

New Lisbon Treaty Provisions on Euro Area Member States

Article 115 A

1. In order to ensure the proper functioning of economic and monetary union, and in accordance with the relevant provisions of the Treaties, the Council shall, in accordance with the relevant procedure from among those referred to in Articles 99 and 104, with the exception of the procedure set out in Article 104(14), adopt measures specific to those Member States whose currency is the euro:

   (a) to strengthen the coordination and surveillance of their budgetary discipline;

   (b) to set out economic policy guidelines for them, while ensuring that they are compatible with those adopted for the whole of the Union and are kept under surveillance.

2. For those measures set out in paragraph 1, only members of the Council representing Member States whose currency is the euro shall take part in the vote.

Protocol on the Euro group

THE HIGH CONTRACTING PARTIES,

DESIRING to promote conditions for stronger economic growth in the European Union and, to that end, to develop ever-closer coordination of economic policies within the euro area,

CONSCIOUS of the need to lay down special provisions for enhanced dialogue between the Member States whose currency is the euro, pending the euro becoming the currency of all Member tates of the Union,

HAVE AGREED UPON the following provisions, which shall be annexed to the Treaty on European Union and to the Treaty on the Functioning of the European Union:

- ARTICLE 1

The Ministers of the Member States whose currency is the euro shall meet informally. Such meetings shall take place, when necessary, to discuss questions related to the specific responsibilities they share with regard to the single currency. The Commission shall take part in the meetings. The European Central Bank shall be invited to take part in such meetings, which shall be prepared by the representatives of the Ministers with responsibility for finance of the Member States whose currency is the euro and of the Commission.

- ARTICLE 2

The Ministers of the Member States whose currency is the euro shall elect a president for two and a half years, by a majority of those Member States.