

## CHAPTER 8

Experience with the euro thus far<sup>1</sup>*Arne Jon Isachsen*

On 1 January 1999, 11 European currencies were replaced by the euro, the EU's new common currency. Initially, the euro existed merely as electronic money. Actual banknotes and coins did not appear on the market until three years later. After that things progressed quickly. In January and February 2002, some 300 million inhabitants of the 12 euro countries (Greece had joined in 2001) replaced their national currencies with the equivalent in euro.

The establishment of Economic and Monetary Union (EMU) in the EU was a venture into new and uncharted waters, both financially and politically. Successful navigation requires three things:

- The ability to be observant: What is happening?
- The ability to make sound analyses: Why is this happening?
- The ability to act: What should we do now?

It will take another decade before one can judge whether or not the common currency in Europe is a success. The ability and willingness to learn along the way, including the adaptability of institutions, are decisive to whether or not the EMU will meet expectations.

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1. Yngvar Tveit has done an outstanding job in updating the charts, reading the whole manuscript, correcting errors, and adding some paragraphs. Any remaining shortcomings are my responsibility.

## Background

Negotiations on the Treaty on Economic and Monetary Union were completed in the Dutch city of Maastricht in December 1991. The treaty was subsequently ratified by the respective EU member states, although the UK and Denmark were given the opportunity to opt out of the monetary union. Sweden, which joined the EU in 1994, did not reserve the right to retain its own currency. However, on 14 September 2003, it held a referendum to decide whether or not to join EMU. The result was a resounding “no” to the euro. Sweden chose to keep the Swedish krone, which has not altogether pleased the other EU member states.

Less than a year after the signing of the Maastricht Treaty, European currency markets experienced considerable turbulence. The UK left the Exchange Rate Mechanism (ERM) in September 1992. Italy, Spain, Ireland and Portugal all had to devalue their currencies against the German mark (DM), and Spain had to devalue no fewer than three times in nine months. The following autumn, the ERM’s fluctuation margins were enlarged from 4.5 per cent to 30 per cent. The idea of having fixed exchange rates between EU currencies did not seem at all realistic.

### Three years of parallel currencies

From 1999 to 2002, the EU had a rather unusual monetary system. The euro was the common monetary unit, at the same time as people could pay with marks in Germany, francs in France, escudos in Portugal, and so on.

Two things are required to establish a monetary union: first, exchange rates must be absolutely fixed. With 195.583 German marks (DM) buying EUR 100 and 655.957 French francs (FF) doing the same, the price of DM 100 became fixed at FF 335.385. Second, there must be one and only one body that governs the supply of money. That is the responsibility of the European Central Bank (ECB).

Actually, the situation was reminiscent of the one in the early 1970s. The work on a system based on fixed exchange rates between the then EEC states had just been presented when turbulence erupted on international currency markets. The Werner plan was put aside once and for all. However, 20 years later, unstable currency markets were unable to stop the Maastricht Treaty. Why this difference? Three factors were important here:

- In the intervening years, both theoretical and empirical research had indicated clearly that active monetary and exchange rate policies in individual countries had no lasting effects.
- Floating exchange rates, which the world largely ended up with in 1973, had resulted in unstable exchange rates and failed to have the beneficial real economic effects many had expected.
- Free capital movements proved difficult to reconcile with stable exchange rates. In the EU, fluctuations in exchange rates that were not based on real economic conditions could easily lead to political friction between countries that experienced an unwelcome weakening of their competitiveness, engendering problems with other countries in the union. With a single currency, free capital movements could be allowed without fear of triggering volatile exchange rates.

In addition, there was the “human factor”, as Graham Greene would have called it, in the person of Helmut Kohl, German chancellor for 16 years. Kohl saw a single currency as an important part of the efforts to build a united, peaceful Europe. He believed in peace through integration. Despite the fact that the Bundesbank would lose a great deal of power when EMU was established, and that the country would lose the prestige enjoyed by the German mark, the prime minister agreed to abolish Germany’s currency.

What did Kohl stand to gain? Perhaps the French prime minister’s acceptance of German reunification? For Helmut Kohl, it was probably more important to make the political point he himself expressed as follows: “Germany is our fatherland, but Europe is our future.”

Low inflation and a low interest rate, in addition to sound public finances, were clear requirements that a country had to meet in order to be able to use the euro. At the meeting of the European Council in Amsterdam in 1997 the heads of state or government of the EU countries agreed that the following two so-called convergence criteria should also apply *after* entry into EMU:

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- the ratio of the annual government deficit (including central, regional and local government) to gross domestic product (GDP) should not exceed 3 per cent.
- The ratio of gross government debt to GDP should not exceed the reference value 60 per cent or should be approaching the reference value at a satisfactory pace.

With its stability-oriented economic policy, Germany was the prime mover behind this Stability and Growth Pact. Since Germany had the most to lose by giving up its currency, it was not unreasonable that the country gained acceptance for the pact. The irony is that Germany, along with Portugal, was the first country to encounter problems as a result of this pact, and that Germany, along with France, exerted pressure to moderate it.

### What was expected?

The expected advantages of a common currency were of a *microeconomic* nature, i.e. it was expected that the individual markets would function better. The expected disadvantages of a common currency were related to the control of aggregate demand, i.e. they were of a *macroeconomic* nature.

One obvious advantage of the euro is that exchange rates among participating countries' currencies no longer apply. Further, it has become simpler for enterprises making cross-border transactions to keep their accounts in order, etc. Such simplifications were expected to result in one-off gains of about 0.4 per cent of GDP. Although banks lose money when the number of currency exchange transactions is reduced, there are obvious socioeconomic gains when one of every 250 people can be freed from no longer needed exchange activities to perform a more socially necessary job.

However, the most important advantage of a common currency is the following:

- Price signals are clearer and competition keener. This guarantees more effective utilisation of resources.

Among the other expected advantages of a common currency that generally result from price signals being clearer and markets larger are:

- Increased trade
- Deeper, more liquid capital markets
- Increased cross-border direct investment.

With a common currency, interest rates will coincide. The authorities in the individual EMU states can no longer use interest rates to influence overall demand. Nor is it possible to devalue an individual country's currency, even if a decline in competitiveness were to make this desirable. With a common currency, the authorities have a smaller number of instruments available for controlling aggregate demand in the economy in the short term.

This merits a few comments.

- Not being able to use the interest rate as a stabilisation policy instrument is less serious for countries (or regions) with a fairly similar cyclical situation. Why? Because the common interest rate entailed by the common currency will probably suit the countries well.
- The realisation that changes in interest and exchange rates are no longer available as policy instruments may change the way the economy functions in other areas. In the wake of the Soviet Union's dissolution in the early 1990s, Finland experienced a dramatic drop in exports to the Soviet Union and an equally dramatic rise in unemployment. There was an urgent need to improve Finnish competitiveness. The authorities tried and almost managed to implement a reduction in wage levels more or less across the board. But only almost. The alternative, i.e. a devaluation of the Finnish mark (FIM), was chosen instead. Had this alternative not existed, might a wage level reduction have succeeded?

### **A common currency and fiscal insurance**

It is easier to live with the same currency if regions experiencing cyclical downturns are helped by regions experiencing upturns. This is how things work within a country. If business activities in Bergen were to decline and unemployment to rise, more resources would be poured into Bergen since unemployment benefits are paid by the state rather than by the local authorities. Correspondingly, if Oslo has economic

problems, Bergen would have to contribute more for a time to the treasury than what its inhabitants receive in return.

The system outlined here is a sort of fiscal insurance. Estimates for the US indicate that for every USD 100 in reduced activity levels in one state, the population receives USD 20–30 through reduced taxes and increased transfers from the federal authorities. There is no comparable mechanism in the EU. An economic downturn in a country must be borne by the country's own citizens.

The absence of such insurance schemes has made many people sceptical of the common currency project in the EU. However, with a tax payment to the EU centrally of roughly 1.2 per cent of GDP, of which about half goes to support the Common Agricultural Policy and one quarter to structural policy measures, there is simply no funding available for such insurance schemes.

No one could know in advance how a common currency for the EMU states would work. Would cyclical differences create conflicts about what constitutes an appropriate interest rate policy? Would the requirement for balanced public finances be an obstacle to the functioning of automatic fiscal stabilisers? Would the capital markets become rapidly integrated and would cross-border direct investment rise dramatically? What about the labour market? Would the absence of separate currencies lead to more flexible labour markets, where local negotiations play a larger part?

## What has happened?

### Microeconomic experiences thus far

Trade among the EMU states rose by 20 per cent in the first three years of monetary union. During the same period, cross-border direct investment in the euro countries (the EMU area) increased by a factor of four. Simply put: enterprises in EMU spent four times more than before on establishing factories and other economic activities in each other's countries.

The UK, which used to receive about half the rest of the world's direct investment in Europe, has experienced a 50 per cent reduction in this share. In

other words, only a quarter of such new ventures are being set up in the British Isles. A large part of the explanation for this may well be that the UK has chosen to retain its own currency.

Equity market trends in the euro countries are showing a higher degree of correlation. A common currency combined with more integrated stock exchanges mean that diversification gains must increasingly be derived from the allocation of capital across sectors rather than across national borders.

A common currency has helped accelerate the pace of consolidation in the banking sector within each individual euro state, i.e. fewer and larger banks. However, cross-border integration is far slower. This is due to the reluctance of politicians and the public to seeing national "financial flagships" in foreign hands.

The short-term interbank market for the euro works exceptionally well. The major participants have an absolutely level playing field. Figure 8.1a illustrates the development of the three-month interbank interest rate for four countries from 1994 to 2006. Since 1 January 1999, the rates have been virtually congruent.

The introduction of a common currency has also resulted in the same interest rates for long-term government bonds, as is clearly shown in Figure 8.1b. However, the long-term interest rate differences are somewhat greater. This may be due to larger differences in liquidity, but could also be due to different assessments of credit risk. The European Central Bank (ECB) is not supposed to provide support if a euro state has trouble servicing its government debt.

The market for bonds issued by private enterprises is developing rapidly. Major enterprises that used to be confined to the domestic capital market, not least for fear of the consequences of unpredictable exchange rates in connection with loans in other currencies, now find themselves in a whole new situation. One prime example is Olivetti's takeover of Telecom Italia. This called for a huge amount of money, i.e. a bond issue for EUR 15.65 billion (roughly NOK 170 billion). Had the lire still been Italy's currency rather than the euro, Olivetti would mainly have had only Italian savers to whom bonds in the domestic currency could be sold. However, with the euro in place, there were six times as many potential buyers for Olivetti's bonds. Without the euro, one might question whether this merger would ever have taken place.

Companies in the EMU obtain a relatively small percentage of their funding directly from the market. While bonds issued by enterprises in the euro countries were equivalent to about 11 per cent of GDP in 2001, the comparable fig-

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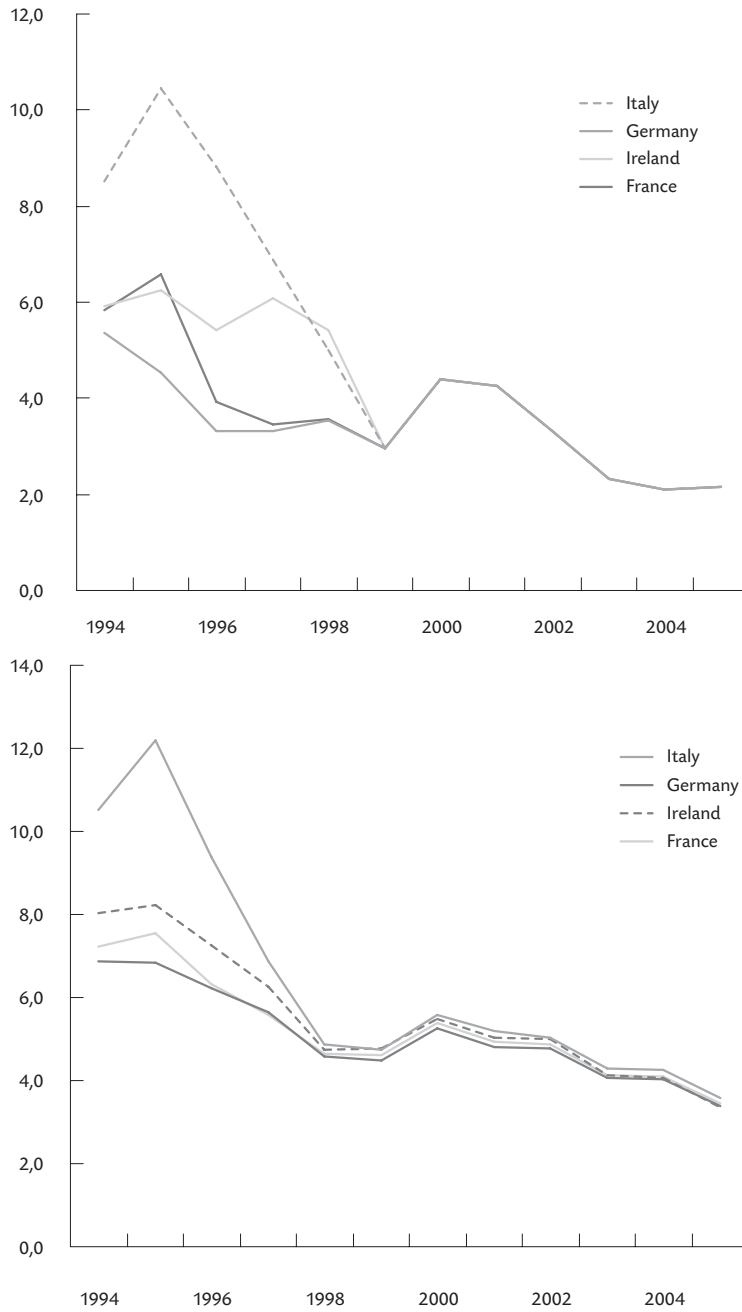


Figure 8.1 a) Interest on 3-month interbank rate b) Interest rate on 10-year government securities



ure was 27 per cent in the US. Instead, European enterprises borrow from banks (which, in turn, issue their own bonds). In 1999, business loans in banks were equivalent to no less than 45 per cent of GDP in the euro countries, compared with just 13 per cent in the US.

For households and small businesses, different legislative rules, different payment systems and different structures for funding economic activities indicate that the capital markets in euro countries will continue to be fairly segmented. Figures from the OECD show that interest rates on comparable mortgages in December 2001 varied from 4.5 per cent in Finland to 6.3 per cent in France. However, one problem for French people who would like to finance their houses in a Finnish bank rather than a French one is that there are different rules for collateral. Another is the lack of knowledge of these differences. And a third is all the trouble it would take to learn Finnish (or to use a translator).

The EU places great emphasis on harmonisation of rules and practices, e.g. for collateral. A plan of action has been drawn up listing 42 specific measures. However, translating words into action will also take time.

## What has happened? Macroeconomic experiences thus far

In the preparations for a common currency, many future euro countries had to conduct tight fiscal policies because of the criterion that the government budget deficits had to be less than 3 per cent of GDP. Further, relatively high interest rates to keep inflation low, had a dampening effect on overall demand. This policy resulted in higher unemployment. For the euro area as a whole, unemployment rose from some 7.5 per cent in 1990 to about 10 per cent in May 1998, when the decision was taken on which countries qualified for the new currency. The unemployment rate has been 8 to 9 per cent in recent years. In Ireland, however, there was a steep reduction in unemployment.

Compared with the "outsider", the UK, and with the USA, the EMU countries score rather poorly in terms of labour market trends in 1990 and beyond, see Figure 8.2b.

From 1990 to 1998, real economic growth in the EMU averaged 2 per cent. During the first three years of the euro (1999–2001), growth remained buoyant in the euro countries. Since 2002, economic growth has been well below 2 per cent in EMU, see Figure 8.3b.

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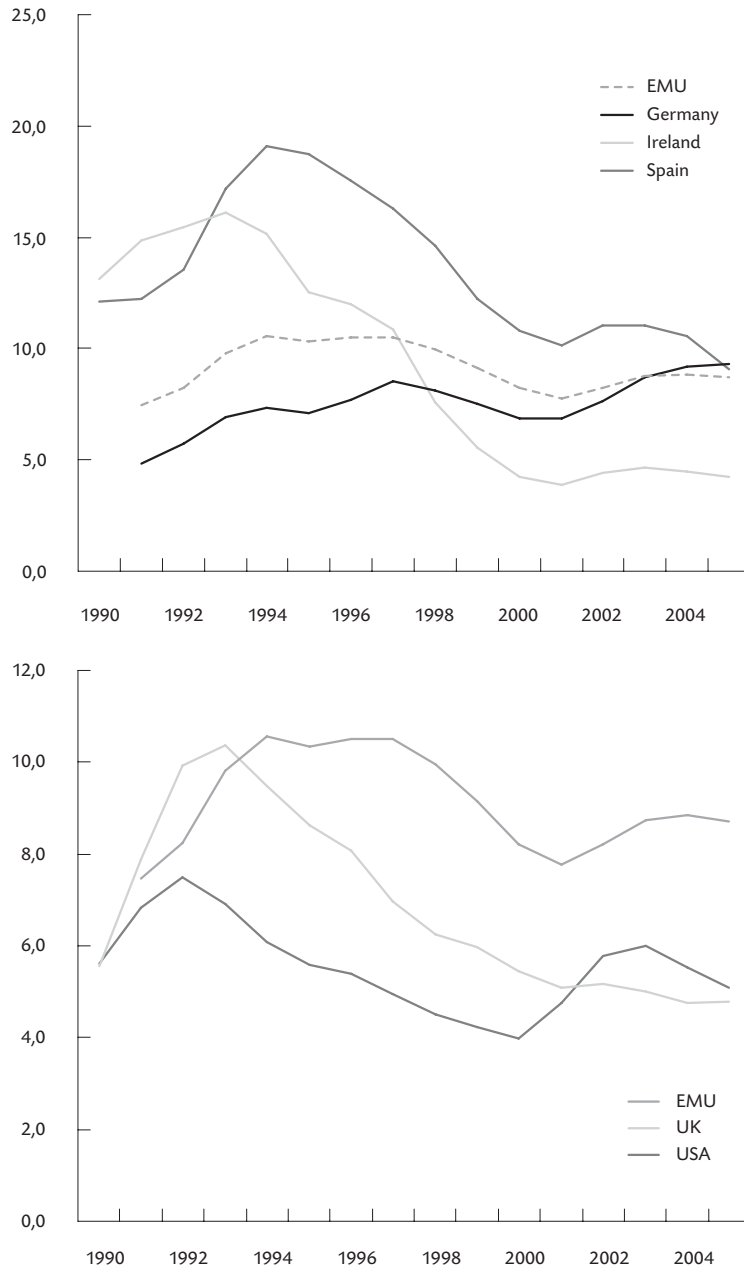


Figure 8.2 Unemployment 1990–2005

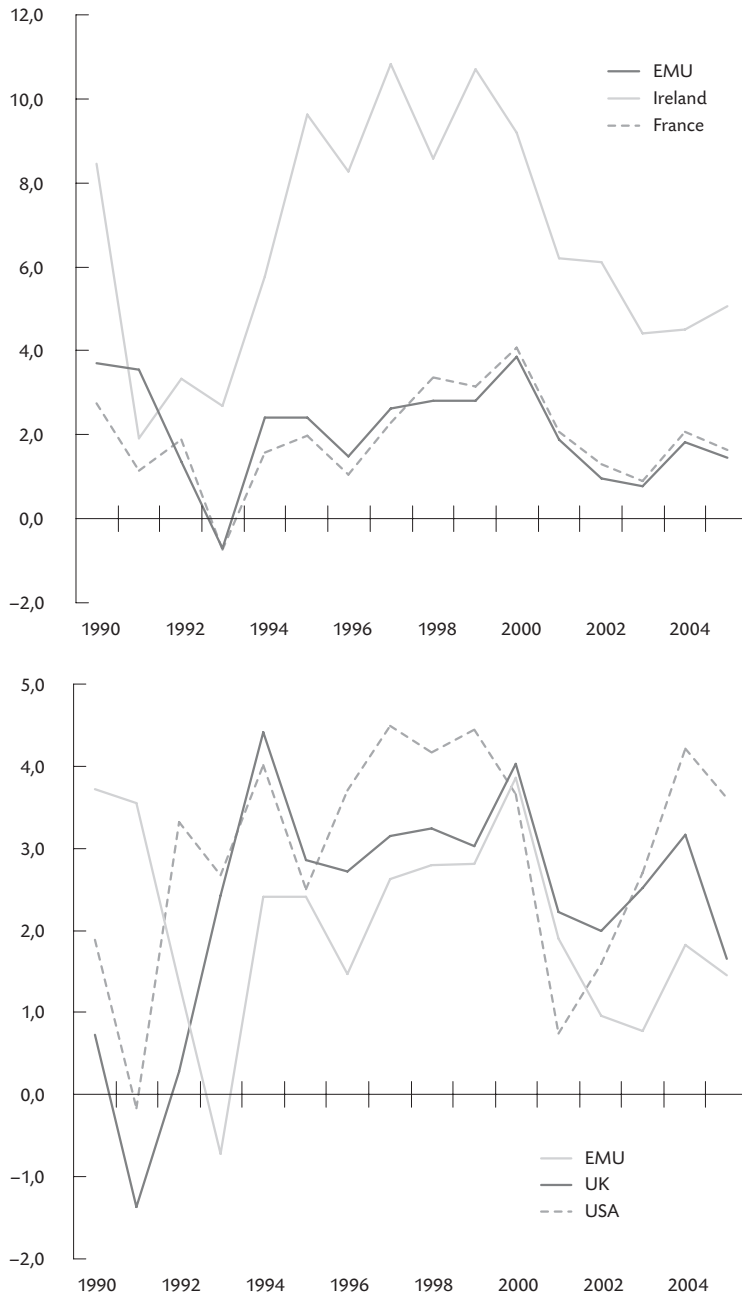


Figure 8.3 Real economic growth, 1990–2005

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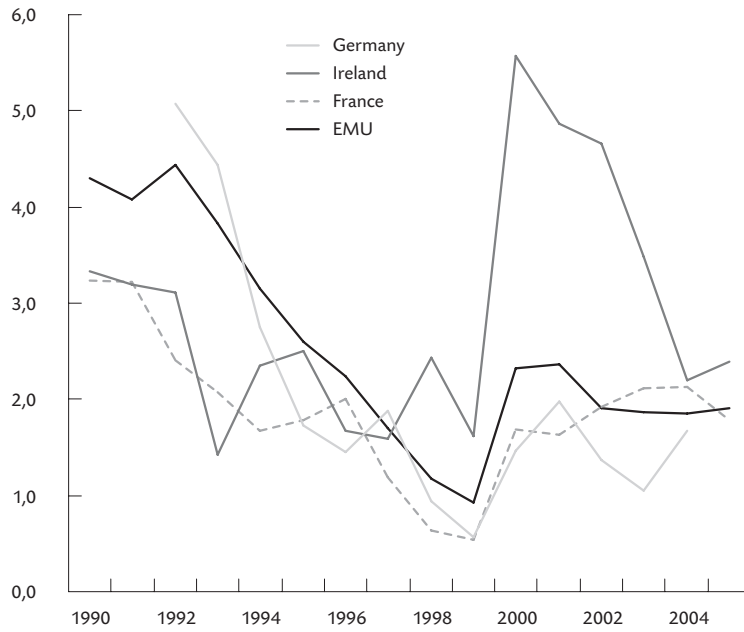


Figure 8.4 Annual consumer price index (CPI), 1990–2005

Compared with the US and the UK, economic growth in EMU has not been particularly strong since the 1990s. However, the great optimism in the USA in the late 1990s about the potential for sustained growth in productivity has gradually declined. The NASDAQ technology stock exchange index plummeted from 5049 on 10 March 2000 to 1423 some 18 months later.

Figure 8.4 shows the changes in inflation during this period. The following developments are of interest.

From 1990 to 1997/98, inflation in the euro countries converged towards a common level of 1.5 per cent. The four curves in Figure 8.4a all intersect at this point. In the subsequent period, once the euro was well established, inflation rates diverged once again. In Ireland the inflation rate rose to above 6.5 per cent measured over rolling 12-month periods. Spain also ranks high on the list of countries where inflation tends to be high.

Is this a tenable situation? Does having the same currency not also entail having the same inflation rate, if countries are not to lose competitiveness in relation to one another? This was the thinking that prevailed in ECOFIN (the EU's forum for finance ministers), causing the ministers to criticise Ireland and Spain. However, differences in inflation can be an expedient mechanism for moving towards equilibrium (more on this later).

The inflation rate in the euro area has generally been on a par with the US, and somewhat less volatile than in the UK, see Figure 8.4b.

Based on these simple graphs, we can sum up by saying that the introduction of a common currency in Europe in 1999 has been accompanied by:

- Falling unemployment until mid-2001, followed by a rising trend;
- Solid economic growth in the early years of the common currency, followed by stagnation;
- On the whole, weaker economic developments in EMU than in the USA in the seven-year period (1999–2005);
- Clear convergence in inflation among the EMU states until the introduction of the common currency, followed by increasing divergence.

The reality was neither the great success for which the optimists had hoped nor the failure predicted by the pessimists.

## More on the European Central Bank (ECB)

In spring 1998, the European Central Bank was established, with Wim Duisenberg of the Netherlands as president. The ECB continued the development started by its predecessor, the European Monetary Institute.

Amendments to the statute that established and that governs the activities of the ECB require unanimity among all EU states. The ability to learn and to adapt to prevailing parameters is vital to a successful monetary policy. Have those in charge at the ECB demonstrated an aptitude for learning over time? Has the combination of firmness and pragmatism been appropriate? How good have the monetary policy decisions been?

The statute of the ECB has been severely criticised on two important points:

- a) The ECB is not to seek nor to take instructions from any EU institutions or bodies or from any EU government as regards the implementation of monetary policy. Granted, the Bank must meet with the relevant committee of the European Parliament a few times a year, but the ECB is not accountable to the European Parliament or to any other politically elected body, in the sense of taking instructions about how to conduct its business.
- b) The authorities in Norway and the UK have mandated their respective central banks to ensure that inflation is kept at about 2.5 per cent and 2.0 per cent respectively, with a margin of 1 percentage point in either direction. The ECB has a less precise mandate, i.e. to maintain price stability. The most important decision-making body in the ECB, the Governing Council, has interpreted price stability to mean an annual inflation rate that is positive, but not higher than 2 per cent. In spring 2003, the ECB set an inflation rate of close to but not higher than 2 per cent as its target. The Governing Council consists of six permanent members in addition to the governors of the central banks in the 12 euro countries.

Does not the absence of accountability to politically elected authorities mean that Europe's common central bank is exempt from democratic control? And is not this absence of control made even clearer by the fact that the ECB itself can set the operational target for its own activities?

Words are one thing. Deeds and results are something else again. The important point is whether the ECB succeeds in conducting a sound monetary policy and, over time, whether it manages to communicate well with market

participants, politicians and the rest of society about what it is doing. This requires good observation, sound analyses and a capacity for action. If the ECB manages to meet these challenges, the criticism will probably die down.

Conducting monetary policy basically means setting the short-term interest rate. Figure 8.5 illustrates the developments in the key rate for the ECB since its establishment on 1 January 1999, with an interest rate of 3 per cent.

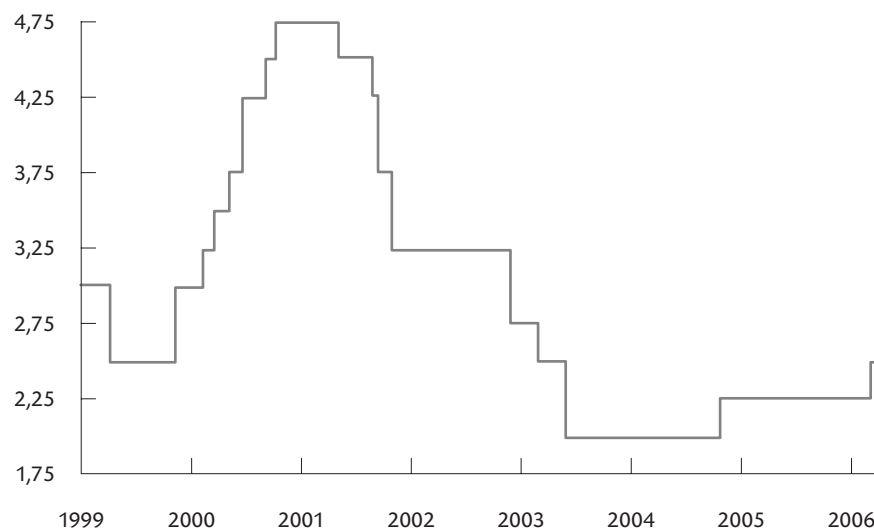


Figure 8.5 ECB's key rate, 1999–2006

The London-based Centre for Economic Policy Research (CEPR) monitors the activities of the European Central Bank closely, paying special attention to the setting of the interest rate. The CEPR has been and remains highly critical of the emphasis the ECB places on money supply growth (M3) as an indicator of future inflation. In the opinion of the academics at the CEPR, given the rather unstable demand function for money there is little reason to believe that growth in the money supply will be a good indicator of future inflation.

On the other hand, growth in the money supply in excess of growth in production can indicate future inflation. As long as the ECB has a pragmatic approach to M3 growth, this problem does not appear to be very serious.

After all, the ECB places no constraints on its setting of interest rates in response to occasional growth in the money supply that far exceeds its reference value.

Correspondingly, the ECB appears to take a pragmatic approach to inflation. Inflation in the euro area has more often been higher than the upper limit for inflation than in the interval from 0 to 2 per cent. When developments in the real economy have called for reductions in the interest rate, these have been implemented despite an inflation rate somewhat above the target range. On this point, the criticism is aimed more at the ECB for delaying interest rate reductions which are usually a couple of months too late, according to the CEPR.

It seems rather imprudent for the ECB to pretend to attach more importance to M3 growth and price stability in its interest rate policy than it actually does. As the CEPR states on page 37 of its report dated March 2001:

“The ECB, however, has shown, overall, good judgement in its actions. If there is a problem, it is the link between what it says and what it does.”

#### More on the reference value for M3 growth

The reference value for M3 growth, i.e. growth in the money supply, has remained stable at 4.5 per cent since the establishment of the ECB. To find this figure, the quantity theory of money is a useful point of departure, where  $\dot{M}$  is growth in the money supply,

$$\dot{M} = \dot{P} + \dot{Y} - \dot{V}$$

and where the right-hand side variables are assigned the following values:

Change in price level	$\dot{P} = 2\%$
Real economic growth	$\dot{Y} = 2\%$
Change in the velocity of circulation	$\dot{V} = -0.5\%$

Please notice that the velocity  $V$  has declined steadily for many years in the euro countries. It is assumed this trend will continue.

Generally, M3 growth has been substantially higher than its reference value. In autumn 2001, M3 growth was as much as 8 per cent. Falling share prices and growing economic uncertainty throughout 2001 led to an increasing interest in bank deposits at the expense of shares and bonds. On top of this came the terrorist acts in the USA on

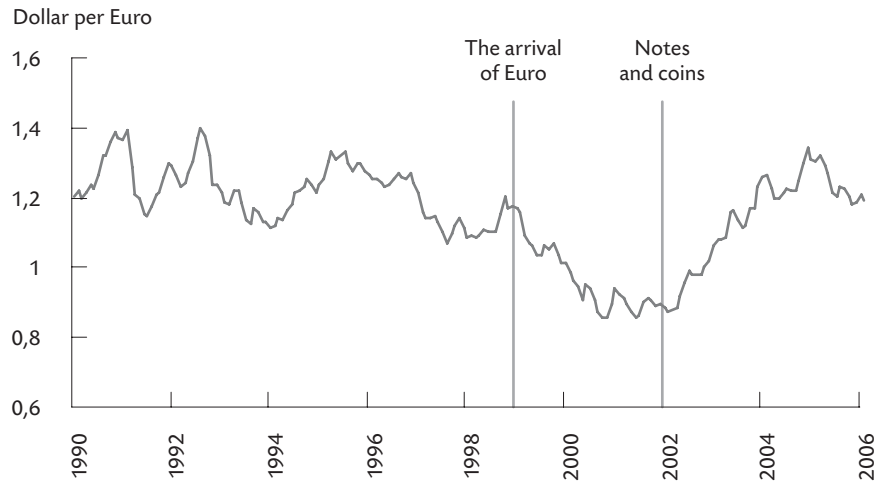


11 September, reinforcing a cyclical downturn that had already begun. Despite the fact that money supply growth was far above the reference value, the ECB reduced the interest rate during this period more aggressively than ever, i.e. by half a percentage point in September 2001 and another half a percentage point in November (see Figure 8.5). The interest rate reduction on 17 September was made in parallel with a corresponding reduction by the Federal Reserve.

Solely in terms of monetary policy, how would the 11 September crisis have been met if the euro countries had kept their respective currencies in a vulnerable fixed exchange rate regime? Without EMU, the individual countries would have reduced their key rates to stimulate their economies. Uncoordinated interest rate changes could easily have led to destabilising capital movements and the abandonment of fixed exchange rates, as was the case in the autumns of 1992 and 1993. Inasmuch as the 11 September shock struck all the EMU states equally, a common currency was the perfect monetary policy regime for dealing with this challenge.

When the euro was introduced in January 1999, it cost USD 1.18. Over the next 18 months, the euro experienced a steep decline against the dollar, see Figure 8.6. In September 2000, the ECB, along with the Federal Reserve and the central banks of Japan, Canada and the UK, intervened and bought euro to buttress the currency. In October, the euro continued its descent, reaching its lowest level at USD 0.83. The ECB intervened once again, this time alone. However, the market understood the signal. The intervention established a floor for the euro, and seemed thereby to have functioned according to intention.

From early 2002 and for the next three years, the euro continued to appreciate against the dollar, peaking at USD 1.36. At the time of writing (April 2006), the exchange rate between euro and USD is back to about USD 1.20 = EUR 1, i.e., close to where it started seven years ago.



**Figure 8.6** Exchange rate USD/ECU (1990–1998) and USD/euro (1999–2006). Monthly observations

## The Stability and Growth Pact

Has the transition from separate currencies to a common currency had any impact on how fiscal policy works in the individual countries? Should participation in a monetary union have consequences for the individual country's opportunity to run deficits on its government budget?

A common currency gives a very clear picture of what goods and services cost both at home and in other countries with the same currency. This means that import leakages in response to an expansive fiscal policy are likely to be greater in a monetary union. All else being equal, this would reduce the stimulus to the domestic economy of increased public spending. But all else is not equal. Fiscal policy is likely to have more impact in a monetary union for two reasons:

- Higher public expenditure in the individual country has little impact on the interest rate in the euro market as a whole. This means that “crowding-out effects”, i.e. when higher interest rates resulting from the increased public expenditure crowd out private demand, do not apply.
- An expansive fiscal policy will often lead to higher interest rates and currency appreciation. Increased public demand will then be at the expense of net exports. A common currency does not allow room for such an effect.

The negative effects of higher interest rates due to a more expansionary fiscal policy in *my country* are very marginal. Furthermore, they are dispersed across all the countries in the monetary union. "Free-riding", i.e. doing what is right for the individual country, without regard for the common good, becomes possible. If many countries think and act in this way, the bill for doing so will inevitably end up on the desk of the president of the ECB: the common interest rate for the common currency must be raised to ease price and demand pressures resulting from the expansionary fiscal policies in the countries belonging to the monetary union.

In the light of such reasoning, a stability and growth pact for the EMU was adopted in 1997 for the purpose of bringing budgetary positions close to balance. To implement a counter-cyclical policy in an economic downturn, allowance was made for a deficit in the government budget of a maximum of 3 per cent of GDP. Further, the gross debt of the public sector was not to exceed 60 per cent of GDP. Many EMU countries have a government debt far in excess of this limit. However, they qualified for adopting the euro in 1999, based on the presumption that the proportion of government debt in relation to GDP was declining steadily. Countries that failed to comply with the deficit requirement of a maximum of 3 per cent of GDP had to follow their own procedures, with follow-up from the Commission, to come under the limit the following year. If not, the Commission can impose sanctions on the country in the form of fines.

### Criticism of the Stability and Growth Pact

The Stability and Growth Pact is often criticised, sometimes severely. It is noteworthy that, when he was President of the EU Commission, Romano Prodi used the expression "Stupidity Pact" about what was supposed to be a "Stability Pact".

What does this criticism consist of?

- a) *For a country joining EMU, monetary policy is no longer available as a tool for managing aggregate demand; the interest rate is set by the ECB and the exchange rate instrument is gone. With only fiscal policy remaining as a policy instrument to regulate overall demand, governments cannot be restrained here.*

If we acknowledge the danger of free-riding, as discussed in the main text, this argument loses much of its force. Since most people acknowledge this danger, there is growing consensus about the need for rules that limit the individual EMU countries' freedom of action in terms of fiscal policy.

- b) *The 3 per cent and 60 per cent reference values have been arbitrarily selected and are too restrictive. Given the need for automatic fiscal stabilisers, the framework for expansive fiscal policy should have been far more generous.*

It is true that the figures were somewhat arbitrarily selected. Nonetheless, the criticism is not warranted. The 3 per cent reference value was chosen precisely to allow some scope for automatic fiscal stabilisers and discretionary fiscal policy. The problem is that many EMU countries, especially the big ones, have not taken advantage of favourable periods to consolidate their finances. 3 per cent may then be inadequate in an economic downturn. Also, if, say, 50 per cent is a reasonable target for gross government debt and the growth rate of nominal GDP is 4 per cent, a budget deficit of 2 per cent of GDP would be required. In an economic downturn, countries should be allowed to have deficits exceeding the normal level by more than one percentage point.

- c) *The market will discipline countries that pursue an expansive fiscal policy by simply demanding a considerably higher interest rate on the government securities issued.*

Experience in recent years does not suggest that market participants are good at pricing the risk on government debt, cf. events in countries such as Mexico, Argentina, Thailand and Indonesia. Moreover, there is an assumption that the ECB, or another EU body, would assume responsibility if an EMU state were to have trouble servicing its government debt.

d) *The figures 3 per cent and 60 per cent must be viewed in context. A country with a relatively small government debt must be given a chance to temporarily operate with a larger budget deficit than countries that have a far larger government debt.*

This argument is a good one. In 2002, the German government had a fiscal deficit of 3.8 per cent of GDP, compared with 2.1 per cent for Italy. However, Italy's public debt was 110 per cent of GDP, compared with just 61 per cent for Germany. Perhaps there was at least as much reason to be sceptical of Italian fiscal policy as of German fiscal policy for the year 2002?

Countries have had mixed experiences with the Stability and Growth Pact. Small countries have followed up well by consolidating their government finances in good years (1999 and 2000). Large countries have not done the same. When Germany and France found it hard to comply with the budget deficit requirement in 2004, the pact was put to the test. Although the deficit in German and French government finances clearly exceeded the maximum limit, the countries were not willing to subject themselves to deficit programmes imposed by the Commission. Despite vehement protests by several of the small countries, these two economic leviathans rallied enough support to set the pact aside.

This process led to several adjustments in the Stability and Growth Pact:

- *The efforts* to prevent member countries from incurring excessive deficits have been reinforced by placing more emphasis on the need to save during favourable periods. At the same time, countries with low levels of government debt and a high growth potential will be allowed to run a deficit of 1 per cent of GDP in their government budget rather than being forced to be in balance over the business cycle.
- Agreement was also reached on showing *more flexibility* in connection with large deficits. Most people realised that the previous timetable for rectifying an excessive deficit (the year after it is shown) was too tight and could actually exacerbate an ongoing cyclical downturn. The revised pact makes it possible to spend up to four years before moving on to the next step in the

procedure to correct the deficit through closer follow-up on the part of the Commission.

- Germany also won support for the idea of taking reunification into account when assessing the budget deficit. The same applies to the net contribution a country makes to the EU's budget ("the unification of Europe"). A domestic budget deficit will also be assessed less stringently if it is ascribable to a high level of spending on research and development, or to high public expenditure on structural reforms pursuant to the Lisbon Strategy.
- In the negotiations on a revised pact, the new member states gathered support for the idea that countries that increase the funding for pension expenditure should be allowed to run a larger deficit during a transition period. This will make it easier for countries such as Poland, Hungary and Slovakia to join EMU from 2009–2010.

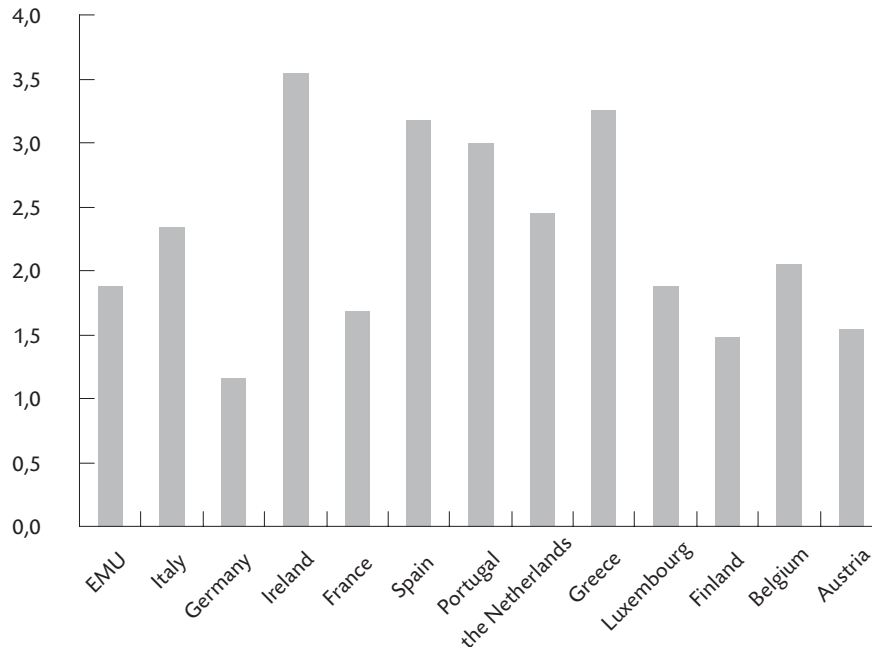
The discussion was between large countries, with Germany and France in the lead, and a group of small countries headed by the Netherlands and Austria. While the first group tried hard to increase the flexibility inherent in the pact, the smaller countries tried to retain most of the provisions. For them, it was crucial to sustain fiscal policy discipline and prevent the exercise of too much discretion (thus increasing the danger of inequitable treatment of different member countries). The process that led to the revision of the Stability and Growth Pact bears clear witness to the fact that big countries have more power than small ones also in the Community comprising the EU.

### Persistent differences in inflation – is this possible?

Figure 8.7 shows that the average CPI inflation rates have varied considerably in the 12 euro countries during the seven years of the euro's existence: from 3.5 per cent for Ireland to 1.7 per cent for France and 1.2 per cent for Germany.

Can this trend continue? Or do countries with a common currency have to have the same inflation rate?

Differences in CPI inflation between countries (or regions) with the same currency may be acceptable if the developments in the real economy are different. In the case of Ireland, having higher inflation than the other EMU countries has been necessary for two reasons: rapid productivity growth in the tradable sector compared with the non-tradable sector, and the need to check competitiveness to some degree.



**Figure 8.7** Average annual inflation in the 12 EMU states from 1999 to 2005, measured by the consumer price index (CPI)

Thus, higher CPI inflation is not necessarily a problem. Under certain circumstances different inflation rates constitute an equilibrating mechanism. The following example, based on some simplified assumptions, will clarify this point:

- Average annual growth in labour force productivity in Ireland from 1987 to 1995 was estimated at 6 per cent for the tradable sector and 2 per cent for the non-tradable sector. Assume this is still the case.
- Productivity growth in the German economy is set at 1 per cent and is the same in the two sectors.
- Competitiveness between German and Irish companies in the tradable sector is unchanged, i.e. price trends are similar.
- The percentage wage increase is the same in the two sectors in both countries.
- Capital and labour account for constant shares of value added.

Table 8.1 is based on these assumptions. The calculation below the table indicates that the average inflation rate in Ireland is as much as 4.4 per cent, more than twice the German inflation rate of 2 per cent. The strong wage growth in the non-tradable sector in Ireland, due to productivity growth there being far below that in the tradable sector, accounts for this difference.

**Table 8.1** Differences in real economic growth can lead to differences in inflation

	Ireland	Germany
Productivity growth in the tradable sector	6 %	1 %
Wage growth in the tradable sector	8 %	3 %
Price increases in the tradable sector	2 %	2 %
Productivity growth in the non-tradable sector	2 %	1 %
Wage growth in the non-tradable sector	8 %	3 %
Price increases in the non-tradable sector	6 %	2 %

If we assume that the tradable sector accounts for 40 per cent and the non-tradable sector for 60 per cent of the activities in both countries, we have:

$$\text{Average inflation rate in Germany: } 0.4 \cdot 2 \% + 0.6 \cdot 2 \% = 2.0 \%$$

$$\text{Average inflation rate in Ireland: } 0.4 \cdot 2 \% + 0.6 \cdot 6 \% = 4.4 \%$$

This difference is due to the more rapid rate of growth of productivity in the tradable sector than in the non-tradable sector in Ireland, compared with the case in Germany.

Given that Ireland has a surplus on its current account and can therefore allow itself an increase in domestic expenditure, inflation of slightly more than the 4.4 per cent in the above table may be needed.

Countries experiencing rapid productivity growth in the tradable sector will often need a higher *real interest rate* than countries with more sluggish growth. The above example shows that the outcome can easily be the opposite: with the same nominal interest rate, a rapidly expanding Irish economy has a higher inflation rate and thus a lower real interest rate than a stagnating German economy. Based on the Taylor rule for the stipulation of interest rates, an appropriate nominal interest rate for Ireland was estimated at 6.4 per cent in autumn 2002, compared with 2.4 per cent for Germany. The common key rate set by the ECB at the time was 3.25 per cent.



### Does enlargement provide scope for a higher target rate of inflation?

Assume that EMU consists of "A" countries with the same productivity growth as Ireland, and "B" countries' in the same situation as Germany. Let the A countries initially be given a weight of 10 per cent and the B countries 90 per cent. Based on the figures from Table 8.1, average inflation for the EMU area would then be:

$$0.1 \cdot 4.4 \% + 0.9 \cdot 2 \% = 2.24 \%$$

i.e. slightly more than the desired rate of 2 per cent. To bring the average inflation rate for the EMU area as a whole down to 2 per cent, and retaining the inflation differences between the countries, both A and B countries must reduce their inflation rates by 0.24 percentage points. After some time, the targets will be reached, i.e. inflation in A countries will be 4.16 per cent and in B countries 1.76 per cent.

Let EMU be enlarged. The new members are countries of type A, changing the distribution from 10/90 to 20/80. Given that inflation in the new A countries is the same as in the old ones, the average inflation rate for the EMU area as a whole is once again 2.24 per cent, since

$$0.2 \cdot 4.16 \% + 0.8 \cdot 1.76 \% = 2.24 \%$$

Keeping to the target ceiling of 2 per cent as the average inflation rate for the EMU area as a whole will call for yet another round of reducing the inflation rate in all the countries by 0.24 percentage points. As a typical B country in this context, Germany's inflation rate must be pared down to about 1.5 per cent.

Recent research seems to indicate that inflation of approximately 2.5 per cent is better for real economic development than an inflation rate of just 1.5 per cent. The 10 new EU states, which are mostly type A countries, will in time adopt the euro. If the targeted rate of inflation for the whole of EMU remains at 2 per cent, countries like Germany may have to strive for an inflation rate of not more than 1 per cent. Or perhaps the EMU-wide target of 2 per cent will be raised to the Norwegian level, i.e. 2.5 per cent.

## What we can expect in future?

In spring 2005, the French and the Dutch voted “no” to the new EU Constitutional Treaty.

In France, the negative outcome was predicated on general dissatisfaction with economic trends, i.e. persistent unemployment and slow growth. With this “no” to the new treaty, for the first time ever, France currently has no European Union project to fight for. In the Netherlands and other small EU states, many are concerned about the democratic deficit in the EU. The bureaucrats in Brussels take most of the decisions. By rejecting the new treaty, the Netherlands took a firm stand.

The Commission will eventually come back with a revised proposal for a new constitutional treaty. An important element in this context is a more streamlined decision-making process in the EU. The Nice Treaty of 2002, which was adopted under the French presidency, is almost unusable. It will be interesting to see what kind of changes will be necessary before a revised proposal can be adopted.

Most of the countries that joined the EU in May 2004 will be adopting the euro in due course. In many ways, these countries have a different structure than the established economies of Western Europe (see box page 211). Formulating a common monetary policy for more than 20 countries will be no mean feat.

The absence of balanced budgets in the EMU countries can be ascribed to a weakening of budgetary discipline since the introduction of the euro. After their efforts to fulfil the requirements for EMU membership, fiscal policies became too relaxed. Elections in 2001 and 2002 contributed to expansionary government budgets in the large countries, as did the substantial one-off revenues from the sale of UMTS licences.

Weak economic trends have also helped undermine fiscal policy. In 2005, government budget deficits in the EMU countries averaged 2.6 per cent of GDP. Portugal, Greece and Italy breached the new Stability and Growth Pact. Germany and France may also end up on the wrong side of the line if they fail to reinvigorate their economies. Will Angela Merkel and Nicolas Sarkozy, if he is elected president of France in 2007, be more faithful to the Community's rules?

Today, the service sector accounts for about half the employment in the OECD area. This percentage will probably grow in the years ahead. One major difference between the Eurozone and English-speaking countries is that the latter have higher employment and productivity growth than euro countries in the service sector. In autumn 2005, Gerhard Schröder lost the election on his Agenda 2010, which was based on making the labour market more flexible. In spring 2006, the police are quelling protests by students and workers in many French cities. The reason was the same: reluctance to moderate archaic rules in a labour market that has grown far too inflexible.

With monetary and foreign exchange policy taken out of the hands of the authorities in the individual countries, and with strict constraints imposed on fiscal policy through the Stability and Growth Pact, the introduction of a common currency requires a flexible labour market. What we can expect in the years ahead? That the EMU countries will finally realise that if a common currency is to live up to expectations, the labour markets must be allowed to work.

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