The consequences of the monetary union—an introduction

Lars Calmfors*

According to the Maastricht Treaty, a monetary union with a single currency will be established within the EU on January 1st, 1999. This is a unique experiment in monetary history. Earlier monetary unions have usually come about as a by-product of political integration, usually in connection with the emergence of new nations. In contrast, the EMU project represents a deliberate attempt to use monetary integration as a means to achieve economic and political goals.

Thirteen out of fifteen EU member states have agreed, in principle, to joining the monetary union when circumstances permit. Denmark and the UK are exceptions. These countries have negotiated specific clauses that allow them to opt out of the monetary union. Although Sweden has no opt-out clause, the Swedish government declared that the ultimate decision on membership in the monetary union rests with Parliament. A decision will be taken during the autumn of 1997.

1. The Swedish Government Commission on the EMU

To prepare the decision on whether or not to participate in the monetary union and to stimulate the public discussion in Sweden, a *Government Commission on the EMU* was appointed in October 1995. The commission consisted of five economists from the Economic Council—Lars Calmfors (chairman), Harry Flam, Nils Gottfries, Ewa Rabinowicz, and Anders Vredin—and three political scientists—Janne Haaland Matlary, Rutger Lindahl, and Magnus Jerneck. In addition, Christina Nordh Berntsson acted as the secretary of the commission.

* *Chairman of the Economic Council of Sweden and Chairman of the Swedish Government Commission on the EMU. He is also Professor of International Economics and Director of the Institute for International Economic Studies at Stockholm University.* *He is grateful for comments from Anders Björklund, Harry Flam, Christina Nordh Berntsson, Eva Rabinowicz, and Anders Vredin.*

The commission was instructed to analyze the following issues:

1. General consequences of the monetary union.
2. Consequences for Sweden of participating versus not participating in the monetary union.
3. Appropriate economic policies in Sweden in the cases of participation and non-participation in the monetary union, respectively.
4. Appropriate exchange-rate arrangements between participants and non-participants in the monetary union.

In November 1996, the government commission presented its report *Sweden and EMU* in Swedish. In mid-1997, Kluwer will publish an English version of the report. As part of the work, Swedish and non-Swedish experts (16 economists and 5 political scientists) wrote 21 background reports for the commission. The aim was to survey existing knowledge and to highlight specific areas where more research was needed. All the background reports are published in Swedish. Six of the reports are also published in English in this issue of the *Swedish Economic Policy Review*. Another seven will be published in the next issue.

2. The articles in this issue

The aim of a credible low-inflation policy has played an important role for the design of the monetary union. For many EU countries, membership in the monetary union may be seen as a method to achieve price stability. In "The credibility problem: EMU and Swedish monetary policy," **Alex Cukierman** analyzes these issues. His paper surveys the literature on the relationships among institutions, monetary-policy strategies, credibility, and inflation. It discusses how well the credibility problem is likely to be solved in the monetary union and in Sweden, if it remains outside.

A central conclusion in Cukierman's paper is that Sweden is well advised to increase the independence of the *Riksbank*, its central bank, regardless of whether or not the country joins the monetary union. Cukierman also stresses the large uncertainties surrounding the formation of the monetary union and the associated option value of waiting with a decision until more is known. This leads him to recommend that Sweden should not join the union in the first wave in 1999.

Credibility issues also play a large role in **Jürgen von Hagen's** article on "Monetary policy and institutions in the EMU." The article analyzes which monetary policy the institutional design of the monetary union is likely to lead to. von Hagen discusses various operational definitions of price stability and various monetary-policy strategies (for example, intermediate money-supply targets versus inflation targets).

A central theme in von Hagen's analysis is the size and composition of the monetary union. He stresses how the union may develop in very different ways depending on whether it will consist of only Germany and a few other countries, which have in the past shown a strong preference for price stability and stable exchange rates (a *core EMU*), or of most EU countries (a *large EMU*). For a large EMU, von Hagen sees great risks of political conflicts regarding monetary policy. He fears that the desired low inflation may not be delivered.

In "Problems of transition and initialization of the EMU," **Paul De Grauwe** focuses on the process of setting up the monetary union. His paper stresses the political—rather than the economic—character of the convergence criteria for joining the monetary union. In his analysis, the convergence requirements can be seen as giving Germany an option to postpone the start of the monetary union in order to become more certain about the non-inflationary credentials of other potential members.

De Grauwe worries that the transition process will cause serious political tensions between the states that are allowed to join and those that are not. To avoid this risk, he argues for a flexible interpretation of the convergence criteria. To allay German inflation fears, he proposes a strengthening of the future monetary institutions, for example, by making the European Central Bank (ECB) more accountable for its policies. Finally, De Grauwe emphasizes the need for joint monetary decision-making before the start of Stage Three of the EMU in 1999 and for a firm German commitment to complete the switch-over to the euro once Stage Three starts.

A problem with most analyses of the consequences of joining the monetary union is that the alternative is not clear. **Hans Genberg** makes an attempt to clarify this in "Monetary and exchange-rate policy outside a European monetary union." Genberg analyses the advantages and disadvantages of various monetary-policy strategies under different circumstances. He stresses the difficulties of maintaining narrow exchange-rate bands between the currencies of those countries that do not participate in the monetary union and the euro in the event of speculative attacks.

Although Genberg emphasizes that the success of monetary policy is likely to depend on more fundamental institutional factors than the chosen monetary-policy strategy, he favors a floating exchange rate and an inflation target, if Sweden decides to stay outside the monetary union for a long time. At the same time, Genberg's conclusion is that if Sweden ultimately wants to join, there are no gains from waiting to do so. Rather, it is better to establish the "new rules of the game" as quickly as possible.

Exchange-rate arrangements between the participants in the monetary union (the *ins*) and the non-participants (the *outs* or the *pre-ins*) is a central theme in **Ronald McKinnon's** analysis of "Alternative exchange-rate regimes, the EMU and Sweden: the fiscal constraints." The paper also extends this analysis to the case where the monetary union never materializes. The author's preferred solution is one of "virtual exchange-rate stability", where exchange rates are stabilized under normal conditions, but where the exchange-rate goals can be temporarily suspended in the case of massive speculative attacks. But at the same time, central banks would have to observe a "restoration clause". As with the traditional gold standard, this would oblige them to return to the original parities when circumstances permit.

The other main theme in McKinnon's paper is the risk that joining the monetary union could provoke a fiscal crisis. The explanation is that the emergency exit of issuing new money to finance government budget deficits is closed. This increases the risk of outright default on government debt with possible severe consequences for the interest rates that governments must pay and ultimately their access to capital markets. McKinnon argues that more stringent fiscal-policy rules than in the Maastricht Treaty must be imposed to reduce the risk for self-fulfilling fiscal crisis.

Torben Andersen's article on "Fiscal Policy in the EMU and outside" partly overlaps with McKinnon's. Andersen focuses on the appropriateness of the fiscal-policy rules in the Maastricht Treaty. He surveys the main reasons why the policy mix may be biased toward expansionary fiscal policy and contractionary monetary policy in a currency union. He agrees that this motivates fiscal-policy rules.

But Andersen also stresses the risk that the fiscal-policy rules will reduce the scope for active stabilization policy and the possibilities for risk sharing that capital markets provide in the case of macroeconomic disturbances. His main argument is that the budget-deficit norm requires that the government budget becomes less sensitive to business-cycle fluctuations. This will interfere with the working of automatic stabilizers. In contrast to McKinnon, Andersen concludes that the fiscal-policy norms in the Maastricht Treaty (and in the Stability and Growth Pact) are probably too tight. But he is careful to point out that more freedom in fiscal policy may not necessarily be achieved outside the monetary union. The reason is that expansive fiscal policy in a non-participating country will probably exacerbate the credibility problems for monetary and exchange-rate policy that may be caused by a decision not to join the monetary union.

Conclusions

The papers in this issue testify to the conclusion by the Swedish Government Commission on the EMU that it is not possible to arrive at an unambiguous evaluation of the effects of a monetary union based on economic research. The uncertainties regarding the EMU project are just too large. Economic researchers often disagree on crucial aspects, such as the evaluation of the fiscal-policy rules in the Maastricht Treaty or whether fixed or floating exchange rates are preferable for countries staying outside the monetary union—although they do seem to agree that institutional changes to increase the credibility of low-inflation policy is desirable both inside and outside the monetary union. Each reader must make up his or her mind on how to assess the different arguments. By highlighting different aspects of the EMU issue, the papers here should help in this assessment.