

II. EMU: OBJECTIVES, EXPECTATIONS AND ISSUES

Summary

To place in context Member States' adjustment experience in the early years of monetary union, it is helpful to review upfront what were the goals and expectations at the time the euro was created. This is important in order to establish whether the euro project is "on track" – developing along the lines and at the pace anticipated. It should also help identify issues where deeper analysis is called for, and where there may be challenges for policy to enhance the functioning of the euro area. Looking back, plans and preparations for monetary union advanced at an uneven pace from the end of the 1960s. The landmarks were a series of official reports, culminating in the Maastricht Treaty on European Union. The reports include notably the Werner Report, the MacDougall Report and finally the Delors Report. The ultimate goal – to establish Economic and Monetary Union (EMU) in Europe – remained unchanged, but the design philosophy evolved substantially. One key influence on official thinking was the ongoing academic debate about prerequisites for a successful monetary union. A second and important influence was experience, during the intervening decades, of economic management and policy co-ordination in a setting of progressively opening capital accounts. These factors influenced the final architecture of monetary union, and shaped the goals and expectations held when it was established in 1999. The key analytic issue that emerged during this policy debate and emerging experience was the way in which national economies would respond to country-specific shocks – including as the existence of monetary union brought about further changes in the real and financial sectors, and in policy performance. Events have borne out the assessment that this would prove a key issue. The launch of the euro was impeccable; the euro has transformed the face of international financial markets; and the euro area economy has coped well with common shocks. But there have been marked and protracted divergences in growth and inflation among euro-area members, accompanied by sizeable shifts in real effective exchange rate and current account imbalances. This experience confirms that adjustment dynamics in the euro area are a key topic for further analysis, and they are thus the main focus of this Review.

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EMU: OBJECTIVES, EXPECTATIONS AND ISSUES

1. EMU: Shaping the ideas

EMU is among the most intensively researched steps in the history of European integration. Since the goal of EMU was endorsed by the Hague Summit in 1969, and especially since it was revived by the European Council in Hannover in 1988, a complex and extensive body of work on EMU has grown. Much of this research has taken the form of cost-benefit analysis, with economists weighing the expected gains from a single currency against its expected negative side-effects. On the benefit side, there has been widespread discussion of both the microeconomic advantages of a single currency – including transaction-cost savings, reduced uncertainty, greater price transparency in the context of an integrating EU economy – and the macroeconomic rewards of EMU's stability-oriented monetary-policy framework. On the cost side, the macroeconomics of adjustment to country-specific shocks and country-specific responses to shocks have dominated academic discussions.

The crux of the debate on the cost side has been whether EMU – with its irrevocably fixed exchange rates and one-size-fits-all monetary policy – allows sufficient degrees of freedom for Member States to adjust to economic shocks with country-specific effects. This section revisits the academic and policy research debate on adjustment under EMU in the period running up to the launch of the euro.

The sheer quantity of research on EMU makes it difficult to provide a well-focused snapshot of where opinions stood on the issue of adjustment to country-specific shocks on the eve of EMU. What is clear, however, is that the theory of optimum currency areas was a common thread running through much of this debate. The point of departure was an influential paper by Friedman (1953) which implies that countries giving up flexible exchange rates – e.g. by forming a monetary union – will find it difficult to adjust to country-specific shocks in the absence of a high degree of price and wage flexibility. Building on this analysis, Mundell (1961) argued that members of a supranational monetary union could still adjust to country-specific shocks without relying on price and wage flexibility if countries possess a sufficient degree of capital and labour mobility. McKinnon (1963) questioned Friedman's analysis further, arguing that flexible exchange rates make ineffective adjustment mechanisms in more open economies as fluctuations in the nominal exchange rates will be offset by price-level changes. Under such circumstances, the adjustment options of open economies may be no worse under monetary union than under flexible exchange rates. Both McKinnon (1963) and Kenen (1969) introduced fiscal policy into their analysis, arguing that budgetary stabilisers could help to cushion the impact of country-specific shocks, following the irrevocable fixing of exchange rates.

This early work on optimum currency areas prompted a number of economists to explore the ex-ante optimality of EMU. By and large, this literature was sceptical about the optimality of a monetary union among EU Member States. In the first place, the evidence suggested that country-specific shocks were likely to occur under EMU, especially among economically peripheral Member States. Bayoumi and Eichengreen (1993), for example, found that economic disturbances, particularly on the supply side, were both smaller and more closely correlated among the EU "core" of Germany, France, Belgium, the Netherlands and Denmark than among "peripheral" Member States, such as Portugal, Ireland, Greece and Spain. Furthermore, there was a widespread perception that labour mobility among EU Member States was too low and prices and wages too rigid to allow for a sufficient degree of adjustment to country-specific shocks under EMU (Eichengreen, 1993; Decressin and Fatás, 1995; OECD, 1994).

This scepticism about the ex-ante optimality of EMU should be treated with caution for a number of reasons. Firstly, as Buti and Sapir (1998) argue, the effectiveness of the exchange rate as a shock absorber will depend on the category of shock in question. Only in the exceptional case that economic shocks stop at the national border, are

exogenous and temporary in nature and originate from variations in aggregate demand, they suggest, can the exchange rate be considered a plausible channel of adjustment. Secondly, empirical evidence implies that the exchange rate and macroeconomic imbalances were driven by different categories of shock in the pre-EMU period. Canzoneri, Viñals and Vallés (1996), for example, find that relative output between EU Member States during the pre-EMU period was driven by supply shocks while the exchange rate was driven mainly by monetary and financial shocks. Thirdly, it is doubtful whether any monetary union can be considered optimum in a strict sense of the term. Krugman (1990), for one, casts doubt on the optimality of the US monetary union by asking, provocatively, whether a Mid-Western dollar might not have promoted a smoother adjustment to regional shocks in the 1980s. Fourthly, there is a growing body of evidence to suggest that the criteria for an optimum currency area may be endogenous. Frankel and Rose (1997) implied that the creation of EMU would of itself generate the conditions necessary for a smoothly functioning monetary union over time, as economic structures and business cycles adjust to the single monetary policy and exchange rate and the incidence of country-specific shocks diminishes.

The theory of optimum currency areas also inspired an extensive literature in the 1990s on the ex-post optimality of EMU. The key issue in this strand of the debate was not whether EMU would be an optimum currency area at the moment of its launch but how Member States could enhance the euro-area's optimality once the single currency was a reality. In tackling this issue, economists focused on two inter-related research questions. The first concerned the exposure of Member States to economic shocks with country-specific effects. The second concerned the adaptability of Member States to such shocks.

The literature in the run up to EMU on exposure offered contrasting views on the likely impact of the euro. Some economists argued that EMU would decrease Member States' exposure by reducing the scope for policy errors and smoothing adjustment to certain categories of shock. Buti and Sapir (1998), for example, suggested that the EMU could, *ceteris paribus*, dampen the 'political business cycle' in macroeconomic policy-making by curtailing opportunistic behaviour in interest-rate and budgetary decisions. Buiter (1995) argued that EMU could reduce the exposure of Member States on the grounds that flexible exchange rates tended to complicate adjustment to money-demand and money-supply disturbances. Other economists were more cautious about the impact of EMU on exposure. A particular point of contention here was whether EMU would lead to convergence or divergence between the economic structures of euro-area members. Krugman (1991) argued in favour of divergence, suggesting that European economic integration would spur industrial diversification thus increasing the potential for idiosyncratic shocks among Member States. Funke, Hall and Ruhwedel (1999) presented partial evidence in favour of convergence, noting that the comparative importance of industry-specific shocks had fallen in OECD countries since the 1970s.

There is a positive relationship between the extent of exposure and the need for adaptability under EMU in so far as Member States that face a high probability of economic shocks with country-specific effects will be more reliant on adjustment mechanisms. Two main approaches to adaptability were explored by economists in the run up to EMU, the first focusing on enhancing policy-based adjustment and the second focusing on market-channels.

Following McKinnon (1963) and Kenen (1969), a recurring argument in the run up to EMU was that the irrevocable fixing of exchange rate reinforced the need for enhanced budgetary stabilisation in the face of country-specific shocks. Economists were divided, however, on the question of whether such stabilisation should take place at the Member State or EU level. Eichengreen and Wyplosz (1998) were among those who argued that Member States' automatic budgetary stabilisers should be allowed to cushion the impact of country-specific shocks. Other economists argued that an EU-level stabilisation mechanism could be a second-best solution for a monetary union characterised by low factor mobility and regulatory barriers in product, labour and capital markets (Goodhart and Smith, 1993; Obstfeld and Peri, 1998). An unresolved issue in this literature concerns the extent of centralised stabilisation in other monetary unions. In a widely cited study, Sachs and Sala-i-Martin (1992) argue that the US federal budget plays a significant role in cushioning the impact of economic shocks with asymmetric effects. Their estimates indicated that between 1970 and 1988 federal taxes and transfers in the US absorbed 40 cents of every 1 dollar shock to regional personal income. These results have been criticised, however, for confusing the stabilisation and redistribution roles of the US federal budget by focusing on the levels of regional personal income (von Hagen, 1993).

A related issue in the policy-based adjustment literature concerned the likely impact of EMU on wage-bargaining and practices at the Member States level. Economists were less certain on this point, in part, because EMU was expected to subject national wage bargaining systems to competing pressures. On the one hand, by removing a traditional plank of the national policy mix – i.e. monetary policy – EMU was expected to complicate efforts to ensure wage moderation through centralised agreement at the Member State level. On the other hand, by fostering increased economic integration and greater competitive pressures, EMU was expected to provide incentive for a centralised commitment to wage moderation so as to protect market shares. For Danthine and Hunt (1994), the pressures towards decentralisation as a result of increased economic integration in Europe were likely to outweigh the incentives for greater centralisation, as Member States with centralised wage bargaining were expected to be slower to adjust to economic shocks with asymmetric effects. Soskice and Iversen (1998) disagreed with this line of

reasoning, suggesting that the pursuit of a non-accommodating monetary policy from the ECB and the need for enhanced fiscal stabilisation under EMU would provide incentives to pursue wage moderation through social pacts.

On the eve of the euro's launch, few economists expected EU Member States to adjust to country-specific shocks via policy-based channels alone. For this reason, considerable attention was devoted to the question of how to enhance the functioning of market-based channels of adjustment. One strand of this literature considered the possibility of fostering greater geographical labour mobility in the EU, with economists who viewed the comparative immobility of the EU labour force as the product of linguistic and cultural differences (Jonung and Sjöholm, 1999) being more circumspect on this issue than those who concentrated on less immutable obstacles, such as deficiencies in inter-regional job matching, the non-portability of pension rights and social security entitlements (Braunerhjelm et al., 2000). A second strand of this literature asked whether EMU would provide a sufficient catalyst for structural reform in product, labour and capital markets. Wyplosz (1991) sounded a positive note, suggesting that the pursuit of a non-accommodating monetary stance by the ECB had the potential to speed up the adjustment of prices and wages to their equilibrium values. Bean (1998) assumed a more agnostic position on the grounds that the necessity of greater flexibility under EMU must be weighed against, *inter alia*, the potentially complex interactions between the euro-area's one-size-fits-all monetary policy and uncoordinated structural reform efforts. For Buti and Sapir (1998), EMU alone was unlikely to produce structural reforms, leaving it up to policy makers to respond to the irrevocable fixing of exchange rate by stepping up the pace of structural reforms. A related issue, although one which was comparatively neglected in the literature, concerned the role of financial markets in the process of adjusting to country-specific shocks. One study by Asdrubali, Sørensen and Yosha (1996) found that financial markets play a pivotal role in the adjustment to regional-specific shocks in the USA, with capital and credit markets smoothing over 50% of shocks to gross state product over the period 1963-90 as compared with less than 15% by the federal budget. Buti and Sapir (1998) argued that a comparable degree of adjustment could be achieved under EMU providing the euro spurred integration in bond and credit markets.

In sum, a number of economists were sceptical about EMU's ex-ante optimality, while others were more positive about the options available to policy makers to promote ex-post optimality. In the first place, many economists stressed the need to enhance policy-based adjustment to country-specific shocks by enhancing budgetary stabilisers and encouraging greater responsiveness among wage setters. There was also a broad consensus on the need to enhance market-based mechanisms of adjustment including labour mobility, price and wage flexibility and financial market integration. At the same time, there were a number of open questions in this debate, including the merits of budgetary stabilisation at the Member States versus the EU level, the likely effect of the euro on wage bargaining institutions and the extent to which EMU would provide sufficient incentives for Member States to reform product and labour markets.

2. EMU: Policy initiatives and market experience

During some thirty years of discussion, the blueprint for EMU remained faithful to the original vision of establishing a full economic and monetary union. But it evolved significantly in light of global economic circumstances as well as changes underway in the European Union. In the development of official thinking about the architecture of EMU, it is possible to distinguish three phases, which reflected in turn: (i) the economic reasoning presented in the Werner Report of 1970, from which the blueprint for a single currency originated, and which addressed the basic pre-requisites of OCA theory; (ii) the specific experience of the oil-price shocks in the 1970s, which ultimately established a stability-oriented policy orthodoxy across the EU; and (iii) the crisis in the European Monetary System (EMS) in 1992/3, which demonstrated the limitations of intermediate exchange-rate arrangements and reinforced the political commitment to launch (the third stage of) EMU by the 1999 deadline. The effects of these influences are considered below.

2.1 Early policy initiatives

At the Hague Summit in 1969 a high-level group of experts was established under the chairmanship of the Luxembourg Prime Minister, Pierre Werner, to examine how the creation of a single currency could be achieved. The Report proposed that the final stage of EMU be launched by 1980. It called for: (a) the progressive stabilisation of exchange rates among the Member State currencies, leading to the irrevocable fixing of rates implied by the adoption of a single currency; (b) the establishment of a Centre of Decision for Economic Policy which would exercise "a decisive degree of influence over ... the essential features of the whole of the public budgets, and in particular variations in their volume, the size of balances and the methods of financing or utilising them"; (c) a lowering of the remaining barriers to trade in goods and services between Member States; and (d) more specifically in relation to the financial sector, the liberalisation of capital movements and a degree of "technical" harmonisation in the activities of financial markets and intermediaries (Werner, 1970).

The blueprint for a single currency proposed in the Werner report in part reflected the terms of the debate, underway since the early 1960s, on whether the European Economic Community (EEC) was in fact an OCA. The proposals in

the Werner Report can be interpreted as recognition that further progress was required in terms of market integration for this to be the case. Thus, a key area in which the Werner Report set the tone for future discussions of EMU was that it accepted the concept of an EMU that did not entirely fulfil the criteria for an OCA at the time of its launch. Instead, the report proposed flanking policies to promote the ex-post optimality of EMU by enhancing Member States' capacity to adjust to country-specific shocks. Secondly, the Werner Report's choice of flanking policies combined policy-based and market-based modes of adjustment. In particular, it highlighted the importance of budgetary stabilisers at the Member State level – albeit by giving the Community a significant coordinating role in this field – and measures to increase the responsiveness of prices and wages to country-specific shocks by linking EMU to the need for further trade and financial market integration.

Financial market developments, however, intervened to arrest the process of implementation of the Werner report: strains emerged in the Bretton Woods system and, amid a wave of instability in foreign exchange markets, the system effectively collapsed in 1973. The single-currency project was postponed for many years but, nevertheless, there are clear echoes of this original blueprint in the architecture of EMU today.

Despite the collapse of the Bretton Woods system, the EU commitment to exchange-rate stability endured in the form of multilateral pegging arrangements, such as the Snake and the EMS. Exchange rate management via these arrangements was, however, complicated by the absence of a clear anchor currency (to substitute for the US dollar in the now defunct Bretton-Woods system) and the effects of successive oil-price shocks. From the mid-1970s to the mid-1980s, a combination of low economic growth and high inflation was accompanied by episodes of severe exchange rate tension among EU currencies, and repeated realignments of their multilateral pegs. Such realignments typically entailed a high economic and political cost for devaluing Member States and had a profound effect on the approach to macroeconomic management across the EU.

Accordingly, when the blueprint for the single currency was revived in the late 1980s, it reflected not only the implications of OCA theory but also lessons learned from the experience of stagflation. The source of this stagflation was to be found in macro-economic policy failures, notably in responding to the supply shocks implied by higher oil prices via accommodative monetary and budgetary policies. As these policy failures became apparent, active demand management strategy fell from favour as a means to durably support economic growth. Macroeconomic stability, as the basis for sustainable growth, moved into the ascendancy and was to be delivered by a monetary policy targeted uniquely on price stability and budgetary discipline.

In this context, the relative success of the German economy in weathering stagflation had established the deutschemark as the de facto anchor currency within the EU and so extended the role of the EMS from being an instrument of exchange-rate stabilisation to being also a mechanism for disinflation via the imported policy credibility of the Bundesbank. Furthermore, the anchor-currency role of the deutschemark ensured that the Bundesbank's concept of central banking – based on principles of independence, credibility and rules-based policy conduct – became the preferred model for other Member States. This emphasis on deeply embedded macroeconomic stability, as well as the policy framework and institutional arrangements to deliver it, were integral to the concept of EMU eventually adopted in the Maastricht Treaty of 1991.

While concrete plans for EMU were essentially "on hold" by the late 1970s, official attention to the link between adjustment to country-specific shocks and the irrevocable fixing of exchange rates continued. At the request of the Commission, an influential "Report on the Role of Public Finances in European Integration" was prepared by an independent team of economists led by Ronald MacDougall (European Commission, 1977). A key premise of the MacDougall Report was that EMU would entail a substantial increase in the Community budget to help cushion the impact of economic shocks which may occur within the currency area. Although the MacDougall Report was also never fully implemented, its conception of adjustment under EMU is interesting for two reasons. Firstly, like the Werner Report, the MacDougall Report envisaged a key role for the Community in budgetary stabilisation, in this case through the creation of a Community budget in the region of 5-7% of GDP. Secondly, unlike the Werner Report, the MacDougall Report was sceptical of market-oriented mechanisms of adjustment, justifying its proposals for Community based stabilisation, in part, as a way of avoiding "excessive levels of migration" in the currency area.

2.2 Through the exchange rate turbulence of the early 1990s

At the European Council in Hanover in 1988, EU leaders reaffirmed their commitment to the goal of EMU and charged an independent committee, led by the Commission President Jacques Delors, with the task of proposing concrete stages towards its realisation. Like its predecessors, the Delors Committee recognised that flanking policies would be required to enhance EMU's ex-post optimality. In a break from the Werner and MacDougall Reports, however, the Delors Report argued that the responsibility for adjustment to country-specific shocks should remain primarily with the Member States, with the EU being given a limited role in this field (Committee for the Study of Economic and Monetary Union, 1989). This departure may have been due to a number of reasons, including concerns that a supranational economic authority, such as the Werner Report's Centre of Decision for Economic Policy, could jeopardise the independence of the European Central Bank (Dyson, 2001) and that an EU-level

stabilisation mechanism could create a problem of moral hazard by encouraging Member States to leave themselves unnecessarily exposed to country-specific shocks (Delors, 1989).

Like the Werner Report, the Delors Report favoured a combination of policy-based and market-oriented modes of adjustment to enhance the ex-post optimality of EMU. More specifically, it proposed a three-pronged strategy to economic adjustment under EMU. Firstly, it called for a strengthening of competition policies including a stepping up of anti-trust measures and a reduction in distortionary government subsidies. The underlying assumption here was that well-functioning markets were a key requirement under EMU but that the single currency alone was unlikely to foster the necessary reforms (see Bean, 1998). Secondly, the Delors Report called for enhanced regional and structural policies with a view to, inter alia, improving the process of resource allocation under EMU and narrowing regional and structural imbalances under monetary union. The fact that such funds were to be focused on poorer Member States revealed a concern among the committee that economically peripheral Member States may find it harder to adjust under EMU (Delors, 1989). Thirdly, the report called for a coordination of macroeconomic policies to ensure a policy mix that is consistent with the smooth functioning of EMU. In the budgetary sphere, it proposed that rules would be required to govern "the size and the financing of national budget decisions" while leaving budgetary policies in the hands of national and regional authorities in keeping with the principle of subsidiarity. The implication here was that adjustment under EMU would entail increased budgetary stabilisation at the national level but that due regard should be given to the potential side effects of higher deficits among other members of EMU (Buti and Sapir, 1998).

The heightened focus on stability in macroeconomic management in the Member States should, in principle, have facilitated multilateral exchange-rate management in the period leading up to the launch of EMU. While there was a period of unchanged exchange rates from 1987 to 1992, exchange-rate management was again complicated by two important factors – one originating in financial markets and the other in the real economy.

- The first factor was the opening of capital accounts. The proposals in the Werner Report on market integration, which had been carried over into the EMU project, were delivered by completion of the Single Market Programme (SMP) in 1992. One element of the SMP was the liberalisation of capital movements, which was largely achieved by the SMP deadline and so considerably ahead of the scheduled EMU launch date of either 1997 or 1999. The progressive opening of Member State capital accounts - in conditions where the scale of international financial flows had grown dramatically and financial markets had become highly sophisticated relative to the late 1960s – fundamentally altered the operating environment of the EMS by creating the so-called inconsistent trinity of exchange-rate fixity, monetary policy independence and free movement of capital.
- The second factor was strains in the exchange rate mechanism (ERM) of the European Monetary System (EMS) resulting from the interaction of economic effects from German unification and the policy tensions created by the liberalisation of capital movements as discussed above. More specifically, inflation pressure caused by the positive demand shock to the then west-German economy caused the anchor role of the DEM to malfunction, and the other Member States were required to defend their exchange-rate pegs with interest rates that were inappropriate to their domestic economic conditions. As economic imbalances – many of which had emerged long before German unification - accumulated in Member States, exchange rates became increasingly misaligned. Ultimately, efforts to preserve fixed exchange rates proved futile, amid a wave of speculation fuelled by massive international capital flows. The outcome was a sequenced realignment of exchange rates and a loosening in the formal exchange-rate constraints within the EMS.

In the immediate aftermath of the EMS crisis, Member States were confronted with a clear choice between a return to free-floating exchange rates (implying another indefinite postponement of the single-currency project) and a reinforced commitment to EMU by intensifying the stability orientation of their macro-economic policies. Moreover, it was clear that the launch of EMU could not be delayed for too long, because the inconsistent trinity meant that the EMS would not be sustainable over time.

The decision to opt for a reinforced commitment to EMU cemented the underlying commitment to macroeconomic stability as the basis for a sustainable single currency. It also established 1999 as the absolute deadline for adopting the single currency, triggering an accelerated process of convergence toward the required levels of macroeconomic stability among the Member States. While an acceptable level of stability was achieved by the deadline, it involved considerable pressure on Member State economies – in particular in bringing fiscal policy in line. In this setting, it is the policy agenda for enhancing market integration and flexibility was, de facto, a secondary priority in many Member States. The euro area was created in 1999 in conditions – as regards the impact of structural reforms – that fell well short OCA criteria. These initial circumstances implied a period of transition to a long-run steady state in which full OCA criteria would be met.

3. Stabilisation and adjustment in EMU

3.1 Policy assignment under EMU

The priority given to macroeconomic stability is clearly reflected in the assignment of policies within EMU. Moreover, the architects in the end stuck closely to the Delors Report by establishing a system of economic governance that was designed, *inter alia*, to enhance policy-based and market-oriented modes of adjustment mechanisms while preserving Member States' autonomy over budgetary policies and structural reform.

In simplified terms, this policy framework can be described as follows:

- An independent **monetary policy** is conducted by the European Central Bank (ECB) and targets the maintenance of price stability at the euro-area level as its primary objective. Monetary policy can contribute to the broader economic and social objectives of the EU, but only to the extent that price stability is not jeopardised. Price stability is defined as an inflation rate close to but below 2%. While the Treaty provisions and a clear medium-term orientation exclude the use of monetary policy as an instrument for *directly* stabilising the euro-area economy, the medium-term orientation – guided by the objective of price stability – helps to ensure that monetary policy focuses on those shocks that it can effectively address and does not itself become a source of instability.¹ Of course, the price-stability objective applies to the euro area as a whole and, therefore, monetary policy does not respond to inflation conditions in individual Member States.
- **Budgetary policy** remains a Member State responsibility, but is co-ordinated via Treaty provisions. National budgetary policies are conducted so as to support the area-wide monetary policy in maintaining stable prices at the national level, while acting as an instrument of cyclical stabilisation (mainly through the operation of the automatic stabilisers) within the constraints of the excessive deficit procedures in the Treaty, as elaborated by the Stability and Growth Pact (SGP). The assumption is that a stability-oriented budgetary policy at national level will, by extension, contribute to a stability-orientation in the aggregate stance of policy for the euro area. This specific role for national budgetary policy in supporting the centralised monetary policy in achieving its price stability objective is, of course, additional to the more classical roles of resource allocation and income distribution. Moreover, the Treaty provisions on budgetary policy co-ordination also have a longer-term focus, with the objective of ensuring sustainability in Member States' public finances.
- Within an environment of stability-oriented macroeconomic policies, **structural policies** (at both meso- and micro-economic levels) also remain a Member State responsibility and are conducted so as to maximise productive potential. In addition, structural policies should be designed to enhance the flexibility of markets so as to increase the resilience and adaptability of the Member State economies – and by extension the euro area as a whole – to shocks. There are no specific Treaty provisions governing the conduct of structural policies in the Member States, although co-ordination in this area is envisaged through the Broad Economic Policy Guidelines. The Lisbon strategy for growth and employment has provided a framework for relatively loose co-ordination of structural policies among the Member States.

To the extent that EMU is in the steady state and economic policies are conducted in a manner consistent with their assigned objectives, this policy assignment can be expected to provide the conditions for sustainable economic growth at both euro-area and Member State levels. At the euro-area level, the orientation of monetary and budgetary policies is intended to stabilise economic output around potential, while appropriate structural policies at both euro-area and Member State level enhance both potential output and economic flexibility.

However, even in the steady state, the EMU framework has implications for economic management in individual Member States relative to the pre-EMU period, notably in terms of their access to stabilisation policies. The most obvious constraint in this respect is the loss of a national monetary policy as an instrument of nominal adjustment, with monetary conditions in the individual Member States determined exogenously via the stance of the single monetary policy and exchange rate. The loss of national exchange rates also has implications for nominal adjustment, although the vast majority of the Member States had been operating under a quasi-fixed exchange-rate regime for many years prior to the launch of EMU.

3.2 Exposure and adaptability to shocks

As Member States are no longer able to adjust the stance of monetary policy to sustain non-inflationary growth, the burden of macroeconomic stabilisation shifts to budgetary policy, which remains a national responsibility. Budgetary policy already plays a stabilisation role via the operation of the automatic stabilisers within the strictures of the

¹ See speech by Otmar Issing, Member of the Executive Board of the ECB, at International Conference “Stability and Economic Growth: The Role of the Central Bank”, Mexico City, 14 November 2005.

Treaty-based procedures on budgetary discipline. While this stabilisation role can be extended beyond an automatic response to cyclical conditions – again within the Treaty strictures – the limitations of discretionary budgetary policy as an instrument of stabilisation have been widely documented, notably the tendency toward pro-cyclicality in the policy stance due to long inside lags and/or due to biases linked to the political cycle. Two further limitations can be identified in the more specific context of EMU. First, the relative openness of the Member States limits the scope of budgetary policy in influencing either output or inflation at the national level due to leakage effects. Second, the need to safeguard longer-term public-finance sustainability – in the context of often already high public debt ratios and demographic pressures – means that discretionary budgetary policy is not available during the down-cycle in most of the Member States. On this basis, budgetary policy is available to stabilise Member State economies but cannot substitute fully for national monetary policy.

The constraints which the EMU policy framework imposes on macroeconomic stabilisation in the Member States highlight the need for compensating measures elsewhere in the economy. Within these macro-stabilisation constraints, the economic cycle in an individual Member State can be expected to follow a largely unhindered progression determined by real exchange-rate movements and, to a lesser extent, by offsetting movements in the real interest rate (except, of course, for the effects of the automatic budgetary response). Changes in the real exchange rate will influence the cycle through the so-called competitiveness channel and, in turn, depend on the degree of integration and underlying flexibility of markets. If markets are insufficiently integrated and/or flexible, the cycle is likely to be extended amid a slow adjustment in relative prices. A progressive appreciation in the real exchange rate can be expected in the up-cycle, as domestic demand rises (fuelled by a decline in real interest rates) and inflation pressures mount relative to trading partners. The loss of competitiveness implied by the real appreciation will ultimately trigger a down-cycle in the economy, with the risk of significant output and employment losses associated with real exchange rate depreciation through disinflation.

As predicted by OCA theory and reflected in the blueprint for the single currency in both the Werner Report and EMU, the risk of such extended cycles in Member State economies is reduced in an environment where relative prices can adjust freely in conditions of integrated and flexible markets. While the EMU policy framework is solidly founded on the principle of macro-economic stability, smooth adjustment in Member State economies – and by extension the smooth functioning of the euro-area economy – depends crucially on the conduct of appropriate micro-economic policies. Once these microeconomic policies have delivered the necessary degree of market integration and flexibility, EMU can be said to be in the steady state (always allowing for the absence of a centralised budgetary policy and significant cross-border labour mobility) and the constraints on macroeconomic stabilisation in the Member States are no longer a major concern.

During a transitional period, however, risks remain of a less efficient or predictable process of economic stabilisation in the Member States. In this context, it was recognised from the outset that, during the early years of EMU, some euro-area members would be more vulnerable to economic shocks with country-specific effects. Firstly, the fact that several countries entered EMU with budget deficits of close to 3% of GDP limited their room for budgetary manoeuvre until such time as compliance with the Stability and Growth Pact's medium-term objectives had been achieved (Eichengreen and Wyplosz, 1998). Secondly, given the complexity of Europe's product and labour market institutions, it was clear that structural reforms to enhance the responsiveness of prices and wages to economic shocks would not be achieved over night (Buti and Sapir, 1998). Indeed, some authors, such as Jacquet (1998), predicted that it was not until EMU's macroeconomic framework was in place that the urgency of structural reform in some Member States would be fully understood. Thirdly, it was argued in some quarters that the launch of EMU itself might give rise to temporary asymmetries. Buti and Sapir (2001), for example, warned of a transitional "EMU shock" as Member States that had previously been part of the DM zone adjusted to a monetary policy based on economic conditions in the euro area rather than Germany and economically peripheral Member States absorbed the demand-side effects of the sharp drop in interest rates triggered by accession to the euro area. Under such circumstances, it was recognised that the main task of economic policy in the early years of EMU was to 'manage economic disturbances while "ferrying" the new regime towards its steady state by reducing exposure to asymmetric shocks, increasing the adaptability to symmetric and asymmetric shocks and ensuring price stability' (Buti and Sapir, 2001).

4. Experience with country-specific shocks under monetary union

During the three decades of analysis and debate that led up to monetary union, the core issue in research and policy debates lay in the internal dynamics of EMU in the face of country-specific shocks, or common shocks affecting members differently. How large might such asymmetric effects be in practice, in light of recent business cycle experience in Member States? Would product and (particularly) labour markets respond sufficiently flexibly to such shocks, avoiding serious output and employment costs? To what degree should the modest size of the EU budget be a cause of concern, in terms of the capacity for buffering shocks to national economies?

Broadly, experience in the early years of monetary union confirms that this has been the key challenge. The creation of the euro was implemented with exceptional efficiency. The common monetary policy achieved strong credibility,

as evidenced in the low rates of inflation and of inflationary expectations. The role of the euro has transformed international capital markets, and it rapidly took its place as a leading currency in global markets. Moreover, the economy of the euro area has successfully weathered a series of common shocks – including the dotcom boom, the impact of 9/11, the recent rise in oil prices, and the emergence of large global imbalances. Thus many of the concerns expressed prior to the launch have not materialised. While there have been significant difficulties in implementing the procedures for budgetary co-ordination among the Member States, the fear of a generalised breakdown in discipline in the euro area – when the constraints of preparations for euro adoption had been removed – has proven to be unfounded.

By contrast, questions have arisen in the policy community and among academics about the internal adjustment process within the euro area, and in particular protracted divergences in growth and inflation among the Member States. These have involved some major shifts in intra-euro real effective exchange rates, accompanied in some cases by large current account imbalances. The German economy, for example has grown very slowly and experienced steep real depreciation, while the reverse has been the case in Spain. Ireland underwent strikingly successful real convergence, but in Portugal the same process aborted quite soon after euro adoption. The situation in Italy has become strained in terms of both macroeconomic policy challenges and underlying competitiveness.

Some element of these differences in inflation rates and – to a lesser extent – growth rates can be traced to the dynamics of real convergence within the euro area, as the less-developed Member State economies catch up with the more developed Member States. However, the extent of differences has focused attention on the efficiency of adjustment under monetary union, and whether it is fostering increasingly optimal conditions through endogenous effects and policy initiatives.

To a degree, the issues raised by this experience can be traced to concerns identified in the run-up to monetary union. The economies experiencing adjustment problems under the euro typically had not advanced as much as hoped in creating flexibility – either fiscal, or structural, or both. So adjustment problems, and their spillovers, could be attributed to a reform deficit.

But the recent period also raises some questions about adjustment within the monetary union that may not have been fully anticipated. For example, it was anticipated that national real interest rates could, for a time, undergo a perverse shift during adjustment to country-specific shocks; but experience has raised questions whether asset markets potentially amplify this effect, particularly in the conditions of ample global liquidity that have applied since the late 1990s. The risks of a consciously pro-cyclical fiscal policy had been well identified; but a question also arises about the scope of inadvertent pro-cyclicality during extended booms, when revenues are swollen by asset market developments and a consumption-rich composition of GDP. There had been marked concern about low labour mobility, but the possibility of weak or delayed responsiveness in prices and wages at times of cyclical slack had perhaps not been systematically identified. The scope for national fiscal, financial and labour market developments to interact in a mutually-reinforcing manner also deserves to be probed more than in the past. And spillovers of fiscal policy had been considered, but the scope of spillovers from private sector activity – for example, when there are strong housing booms in many euro-area economies – deserve to be explored also.

The remainder of this study therefore focuses primarily on adjustment to country-specific shocks in the euro area. It seeks to elucidate how flexibly economies have responded in conventional OCA terms, but also to shed light on aspects of policy and market dynamics that had not been fully anticipated. This allows some conclusions on: whether adjustment under the euro is functioning stably over the medium-term; where there are stresses, what forces or rigidities are driving these; and in light of these findings, what policy improvements at the national or euro-area level could help improve the efficient working of the monetary union.