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**Evidence submitted to the Select Committee on the European Union
Sub-Committee A (Economic and Financial Affairs, and International Trade)**

on

The Euro's Progress – Inquiry into some issues related to the Euro zone

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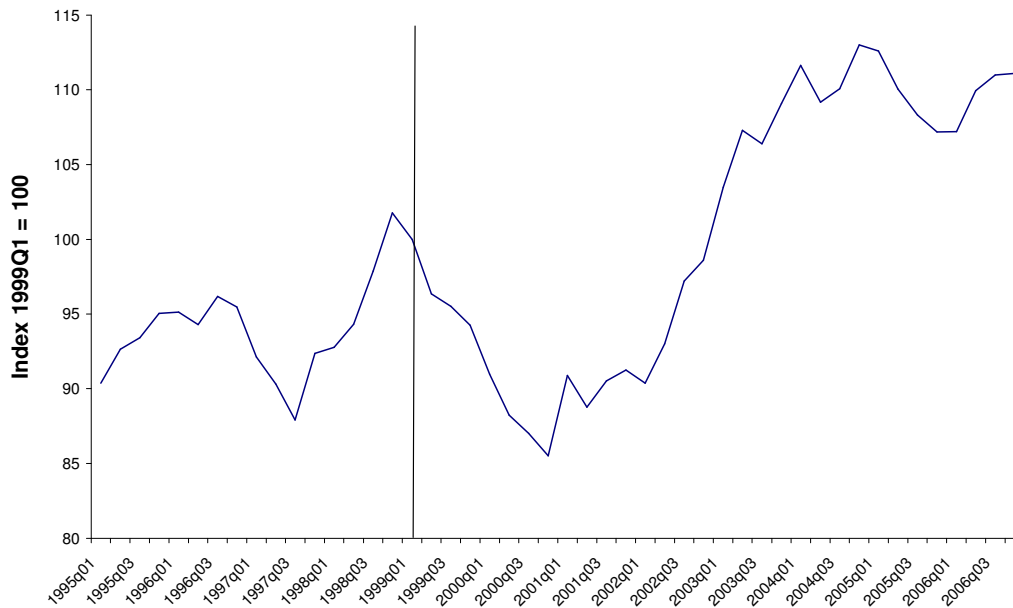
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Are there any lessons to be drawn from the changes in euro exchange rates since 1998?

1. During its first two years of existence the euro displayed considerable weakness in foreign exchange markets, depreciating nearly 15 percent on an effective trade-weighted basis between 1999:Q1 and 2000:Q4 (see figure on next page). The surprising weakness of the common currency during that period threatened to push up inflation in the euro area, implying higher euro interest rates. The authorities responded to the drop in the euro by intervening in foreign exchange markets in late 2000. In the event, the euro began to recover in early 2001 and has been on a steep upward path since then. Over recent months, against a backdrop of a pick-up in economic growth and rising interest rates in the euro area, the euro has posted sharp gains vis-à-vis the dollar and has soared to record highs versus the yen. The euro-pound exchange rate has remained stable within a relatively narrow range over the past four years.
2. Ambiguities remain about who is responsible for exchange rate policy in the euro area. These ambiguities complicated efforts to coordinate intervention in foreign exchange markets in autumn 2000. According to the EMU Treaty, responsibility for exchange rate policy is divided between the Council of Ministers and the ECB. The Council chooses the exchange rate regime under certain provisions and subsequently the national central banks in the euro area carry out the interventions. Article 111 of the Treaty does give the Council power to “formulate general orientations for exchange rate policy.” These orientations have not yet been used and it is unclear how the Council might use this power.
3. The euro’s position as an international currency has been increasing since its launch in 1999, but so far the euro has posed less of a challenge to the U.S. dollar as a global currency than observers had expected. The dollar remains the world’s premier invoicing currency, and the vast majority of foreign-exchange transactions involve the dollar. Moreover, the bulk of official reserves continue to be held in the form of dollar assets.
4. A major concern for policymakers in the euro area is that a disorderly unwinding of global current account imbalances may lead to an excessive appreciation of the euro. While the euro might reasonably be expected to strengthen further against the dollar in the context of global adjustment, further appreciation of the euro on an effective trade-weighted basis does not seem justified. It follows that currencies in Asia will need to appreciate significantly both on an effective basis and against the euro.

Euro: Nominal Effective Trade-Weighted Exchange Rate
1995:Q1 to 2006:Q4



Source: Eurostat.

Note: Data before 1999:Q1 refer to the value of a synthetic euro. An increase in the index refers to an appreciation.

Was the recent reform of the Stability and Growth Pact appropriate?

5. Few issues have stirred as much controversy since the launch of the euro as the Stability and Growth Pact (SGP). To its supporters the pact is the cornerstone of the rules governing the single currency, which must be upheld to ensure monetary stability and economic growth. To its detractors the pact is “a nuisance”, whose strict application is detrimental to short-term or even long-term economic performance. One reason why the SGP generated so much controversy was that there is no consensus over its rationale. In fact, it was designed to address three main issues: avoiding that fiscal profligacy in one country spills over into other countries; ensuring sufficient macroeconomic stabilisation; helping fiscal consolidation in the face of ageing population. Over time, the third factor has gained clear prominence and is now often seen as the primary motivation for the SGP.
6. Fiscal consolidation is clearly needed in many euro area countries to ensure sustainable public finances. However, it is doubtful whether the SGP is the right instrument to address this issue and above all whether the electorate’s perception matches the view of their economic authorities. Take the issue of pensions, which is clearly a primary concern for most European voters. Most citizens seem to be aware that important reforms are needed to ensure the sustainability of their pension system. But very few perceive a link between the SGP and pension

- reform, which is normal since the original pact had no reference to public finance sustainability or pensions.
7. In the mind of the public, the SGP basically means that government deficits must remain below the 3 percent limit, although this obligation was already contained in the Maastricht Treaty. By contrast, the central tenet of the pact, namely the requirement to respect ‘the medium term objective of budgetary positions of close to balance or in surplus’, was never grasped by the public. The upshot is that fiscal consolidation stalled as soon as the single currency was adopted, despite the fact that five of the eleven initial members had *actual* deficits of around 3 percent at the launch of the euro, indicating potential problems for respecting the ‘close to balance or in surplus’ requirement. Four of these countries had deficits above 3 percent for several years after the 2001 economic downturn, which shows that the SGP suffered from two mutually reinforcing problems: a lack of political ownership by national authorities and the public; and an absence of a clear timetable for compliance with the medium-term objective of the pact.
 8. The combination of tough but ill-grounded and weakly enforced rules that characterised the original pact was bound to break under the weight of repeated violation by the four countries, which together account for more than 70 percent of the euro area GDP. The question now is whether the revised SGP adopted in 2005 will fare better than its predecessor. The new SGP is definitely more flexible than the old one. So the question really is whether it offers better grounded and more strongly enforced rules than its ill-fated forerunner.
 9. The new SGP is certainly clearer in terms of rationale. In particular, it now states unambiguously that its main concern is fiscal consolidation, including pension reforms. But will the new pact be enforced better than the old one? Enforcement should be easier now that the pact has a stronger and clearer economic rationale. But effective enforcement also requires that national authorities share a sense of ownership towards the rules of the pact in general and towards fiscal sustainability in particular. A positive development in this respect has been the change of German leadership and the determination of Chancellor Merkel to abide by the German-inspired rules. Her determination seems to have been noticed by the governments in the other delinquent countries which have also adopted measures to respect the limit of 3 percent of GDP. But the real test of the new SGP will come when the next downturn occurs.

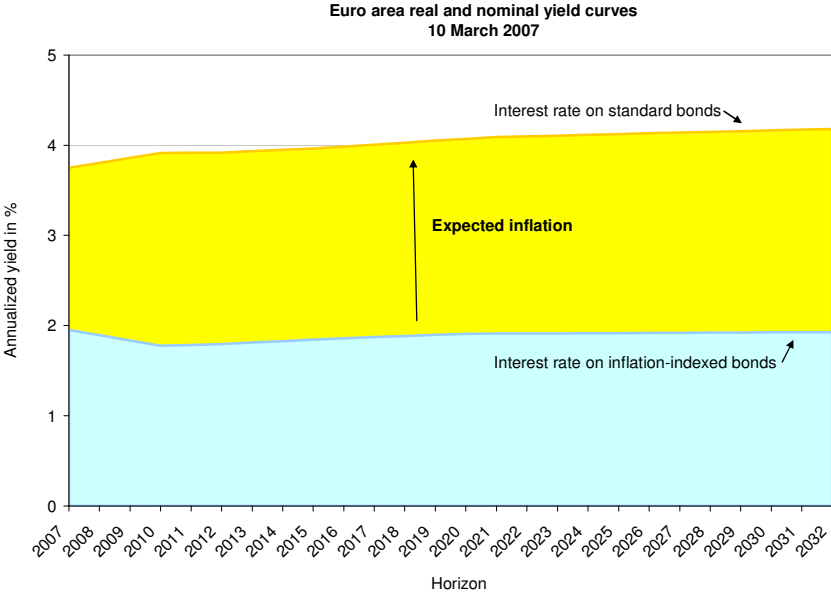
What effect has the introduction of the euro had on individual member countries’ economic development?

10. In the eyes of its promoters, the single currency had three main internal economic objectives: to ensure lasting macroeconomic and especially price stability in participating countries; to facilitate economic integration within the EU; and, indirectly, to foster growth.
11. The first objective has by and large been achieved. Consumer price inflation in the euro area has remained very close to the “below, but close to 2 percent” target

- of the ECB. Furthermore, long-term price expectations derived from the market for inflation-indexed bonds are in line with this objective (see figure on next page). This is a remarkable achievement for an area composed of countries whose inflation record is far from homogenous.
12. Two provisos should nevertheless be added. The first is that throughout the euro area, perceived inflation differs from measured inflation: Surveys consistently indicate that households blame the euro for higher inflation. The explanation is that on the occasion of the changeover in 2002, several service sectors experienced very significant price hikes. While the corresponding items do not have a large weight in price indices, they often correspond to frequent purchases and therefore have a larger weight in perceptions. This has contributed to a gradual weakening of popular support for the euro. The second proviso is that price developments are far from homogenous in the euro area. Inflation in Spain, Portugal and Ireland has exceeded average euro area inflation by more than one percentage point per year. While in the case of Ireland this reflects a catching-up phenomenon, the same cannot be said of Portugal, nor probably of Spain. The risk is that sustained divergence in inflation rates will result in the overvaluation of real exchange rates in certain countries and as a consequence will require a painful correction process.
 13. Economic integration within the euro area was expected to result from the elimination of exchange rate uncertainty and transaction costs as well as from increased price transparency. The corresponding process is by nature long-term and the full effects of the euro remain to be observed. So far, only its impact on financial markets has been dramatic. The money market has become completely integrated and yields on euro-denominated bonds and other assets of the same class have converged. Furthermore, the share of bonds and equities of other euro area countries in national portfolios has risen significantly. Domestic and foreign investors tend to consider the euro area as a single entity. Only credit markets remain fragmented, due to regulatory and tax differences across countries and the very limited extent of cross-border competition among banks. In the case of trade, nothing of this magnitude can be observed, yet careful evaluations suggest that the single currency has already increased trade within the euro area by about 10 percent, certainly much less than some analysts had expected but nevertheless a non-trivial effect. Labour markets, however, remain as fragmented as ever. The process of integration triggered by the euro can therefore be described as effective, but uneven.
 14. The growth effect of the euro has not, at least not yet, been observed in the area as a whole. Countries in which convergence came late such as Spain and Portugal have benefited from the demand effect of the drop in long-term nominal interest rates, but on the whole the supply-side effects widely expected from the move to a single currency have not materialised. Evidence is scant, but if anything the euro does not seem to have acted as an accelerator of structural reforms. It may even have had the opposite effect due to the removal of the threat of exchange rate crises and to the constraints placed on using monetary and fiscal policy to

alleviate the short-term costs of reforms. Here again, however, it is too early to tell whether the adoption of the euro will ultimately lead to structural changes.

Market expectations of inflation at various horizons, euro area



Source:
Reuters