

**Dealing with the Euro:**  
Implications for Policy, Banking,  
and Business

# Dealing with Policy

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# Brief History of European Monetary Integration

- 1970: Werner Plan for European Currency
- 1973: Collapse of Bretton Woods System
- 1979: European Monetary System (EMS)
- 1992/93: EMS Crises
- 1994: Establishment of EMI
- 1999: Establishment of EMU
- 2002: Introduction of Euro Notes and Coins

# Theory of Optimum Currency Areas

- Degree of trade integration
- Degree of labor mobility
- Degree of correlation of shocks
- Existence of fiscal transfer system

# The US meets the Criteria for an Optimum Currency Area

	Europe	United States
■ Trade integration		✓
■ Labor mobility		✓
■ Correlation of Shocks		✓
■ Fiscal Transfers		✓

# Characteristics of the euro area

	<b>Euro Area</b>	<b>United States</b>
<b>Population</b>	<b>292</b>	<b>270</b>
<b>GDP (share of world GDP)</b>	<b>15.0</b>	<b>20.2</b>
<b>Exports of Goods</b>	<b>13.6</b>	<b>8.5</b>
<b>Imports of Goods</b>	<b>12.0</b>	<b>11.1</b>
<b>Government Receipts</b>	<b>46.7</b>	<b>35.9</b>
<b>Government Expenditures</b>	<b>49.1</b>	<b>34.5</b>

Source: ECB, Monthly Report, January 1999

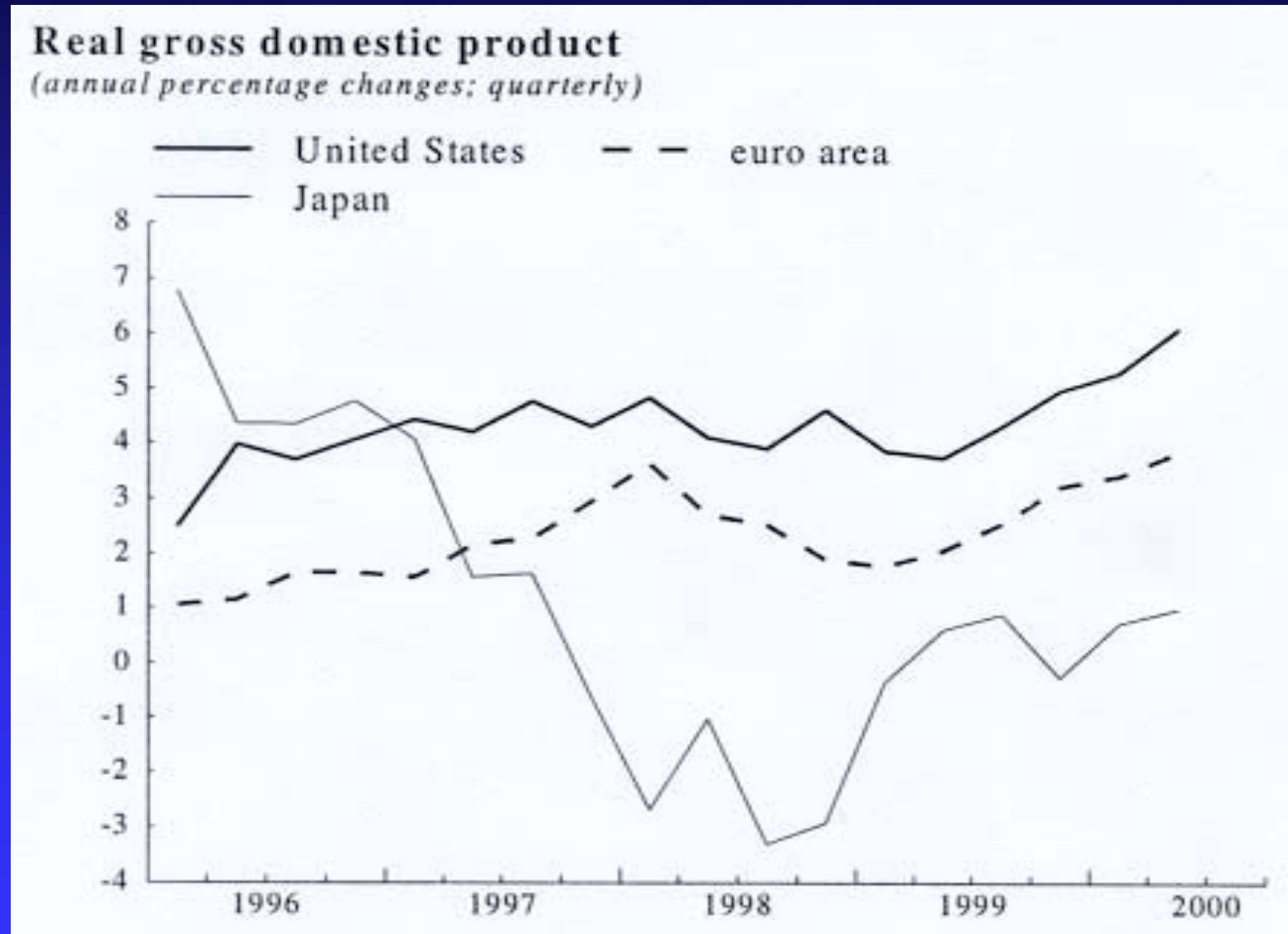
# Financial Characteristics

	<b>Euro Area</b>	<b>United States</b>
<b>Stock market capitalization</b>	<b>90.2</b>	<b>179.8</b>
<b>Debt securities</b>	<b>98.8</b>	<b>166.2</b>
<b>issued by government</b>	<b>54.9</b>	<b>48.4</b>
<b>issued by banks</b>	<b>36.4</b>	<b>46.8</b>
<b>issued by corporations</b>	<b>7.4</b>	<b>29.0</b>
<b>Bank assets</b>	<b>175.4</b>	<b>98.8</b>

Percentage of GDP in 1999

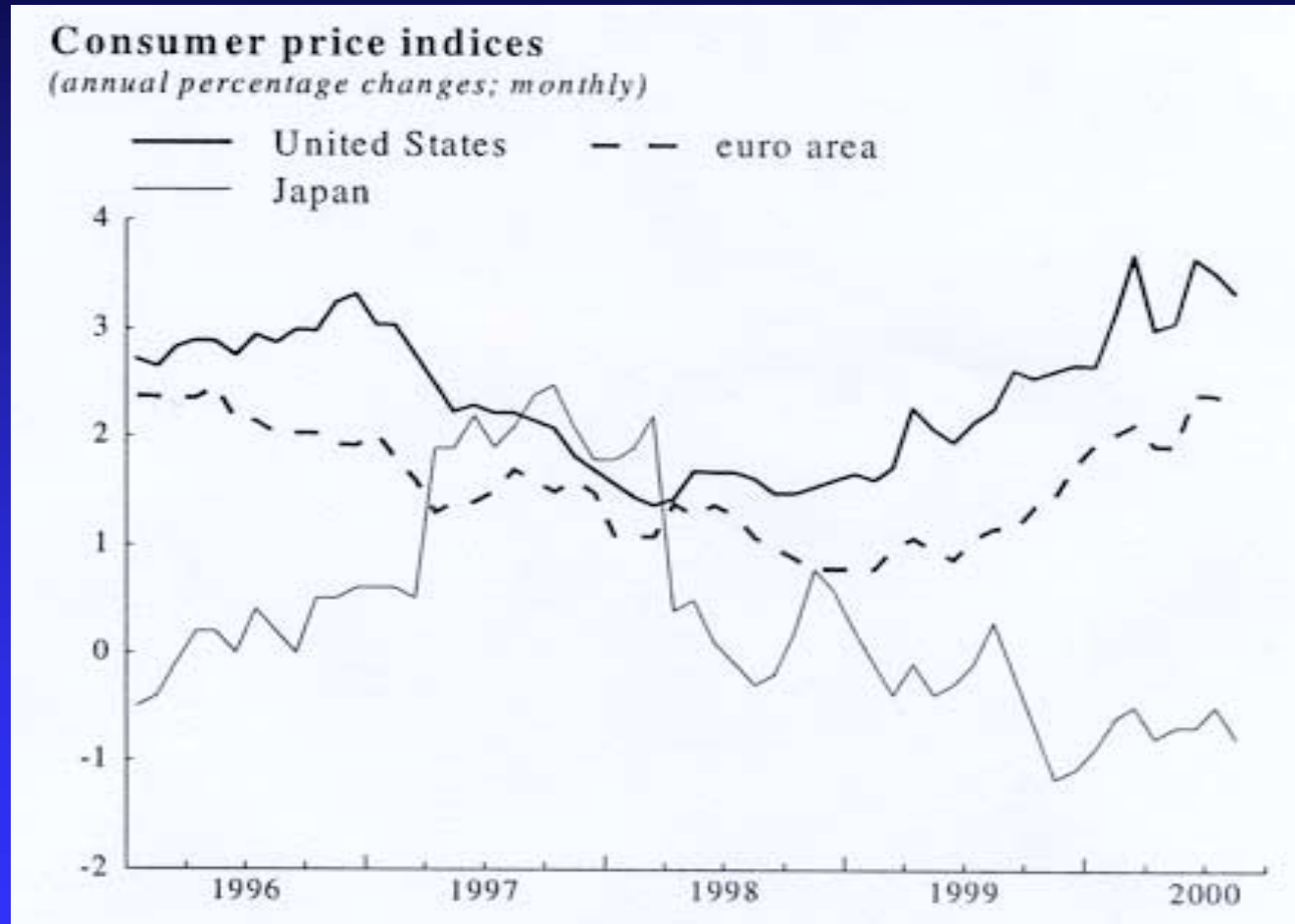
Source: ECB, Monthly Report, July 2000

# Relative Growth Performance



Source: ECB, Monthly Report, October 2000

# Relative Inflation Performance

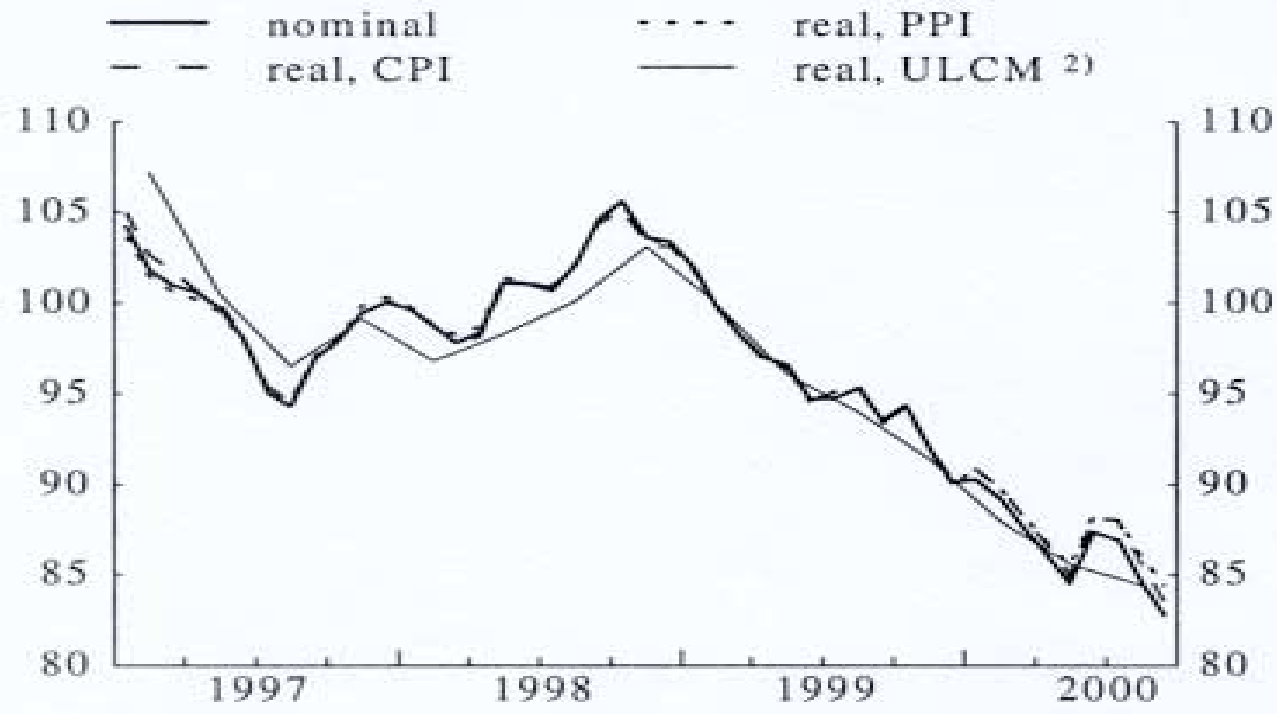


Source: ECB, Monthly Report, October 2000

# Performance of the euro

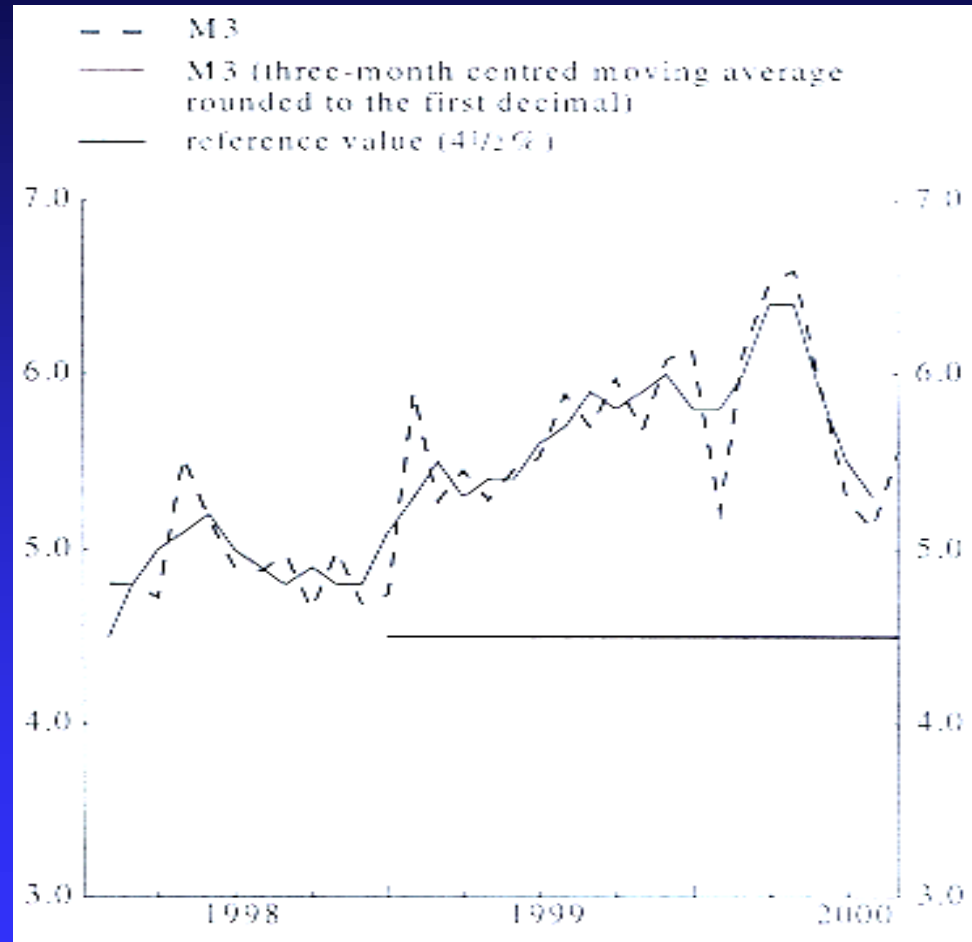
## Nominal and real effective exchange rates <sup>1)</sup>

(monthly/quarterly averages; index: 1999 Q1 = 100)



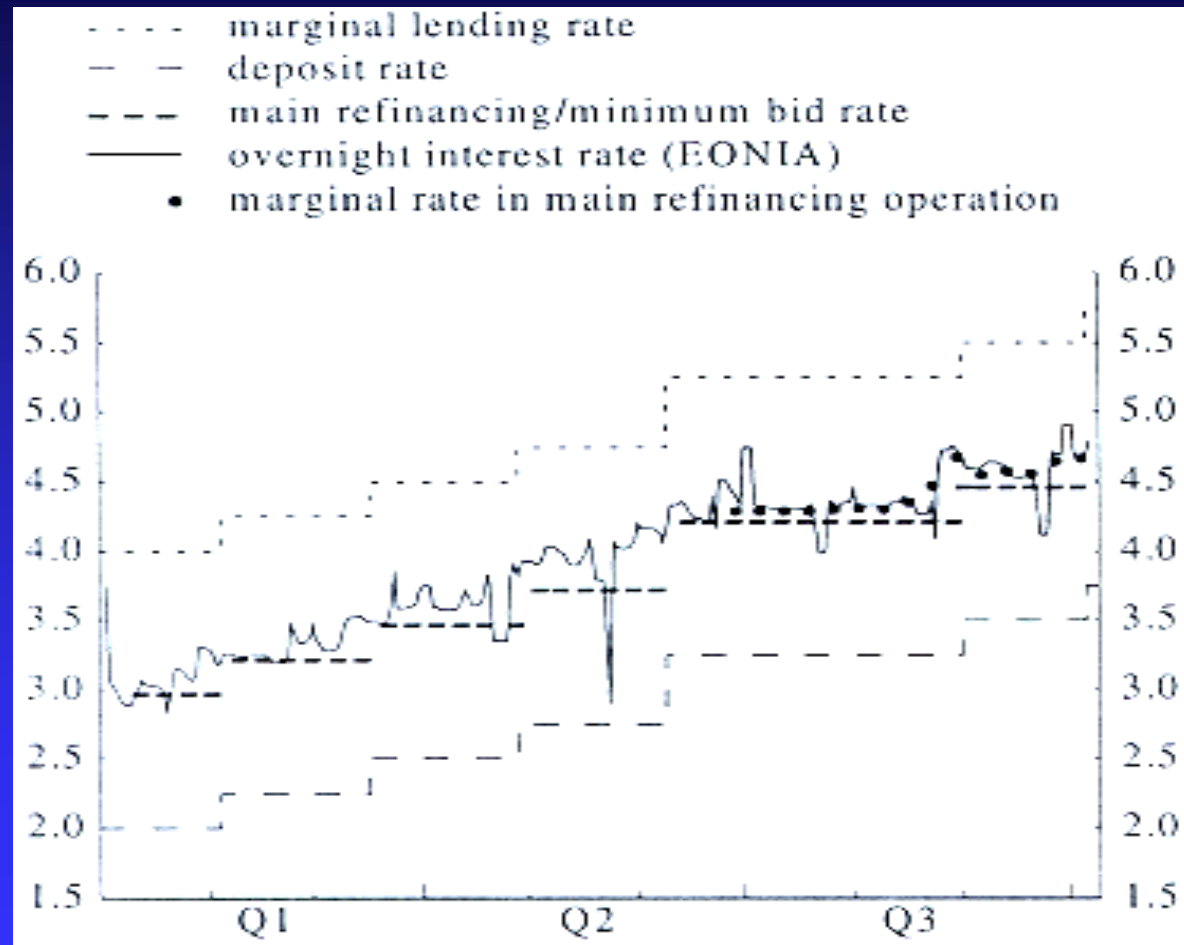
Source: ECB, Monthly Report, October 2000

# Design of Monetary Policy



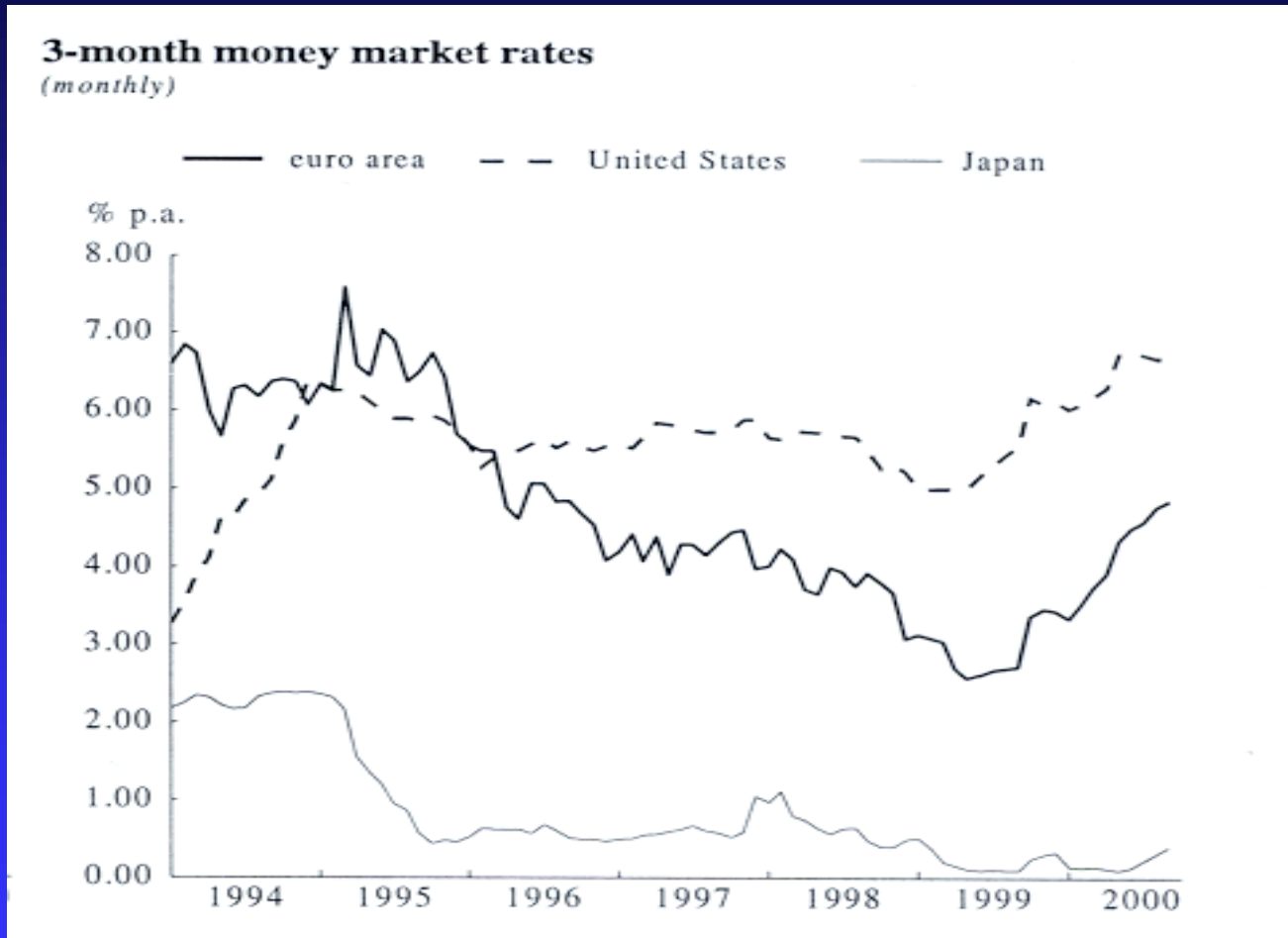
Source: ECB, Monthly Report, October 2000

# Monetary Policy and Short-term Interest Rates



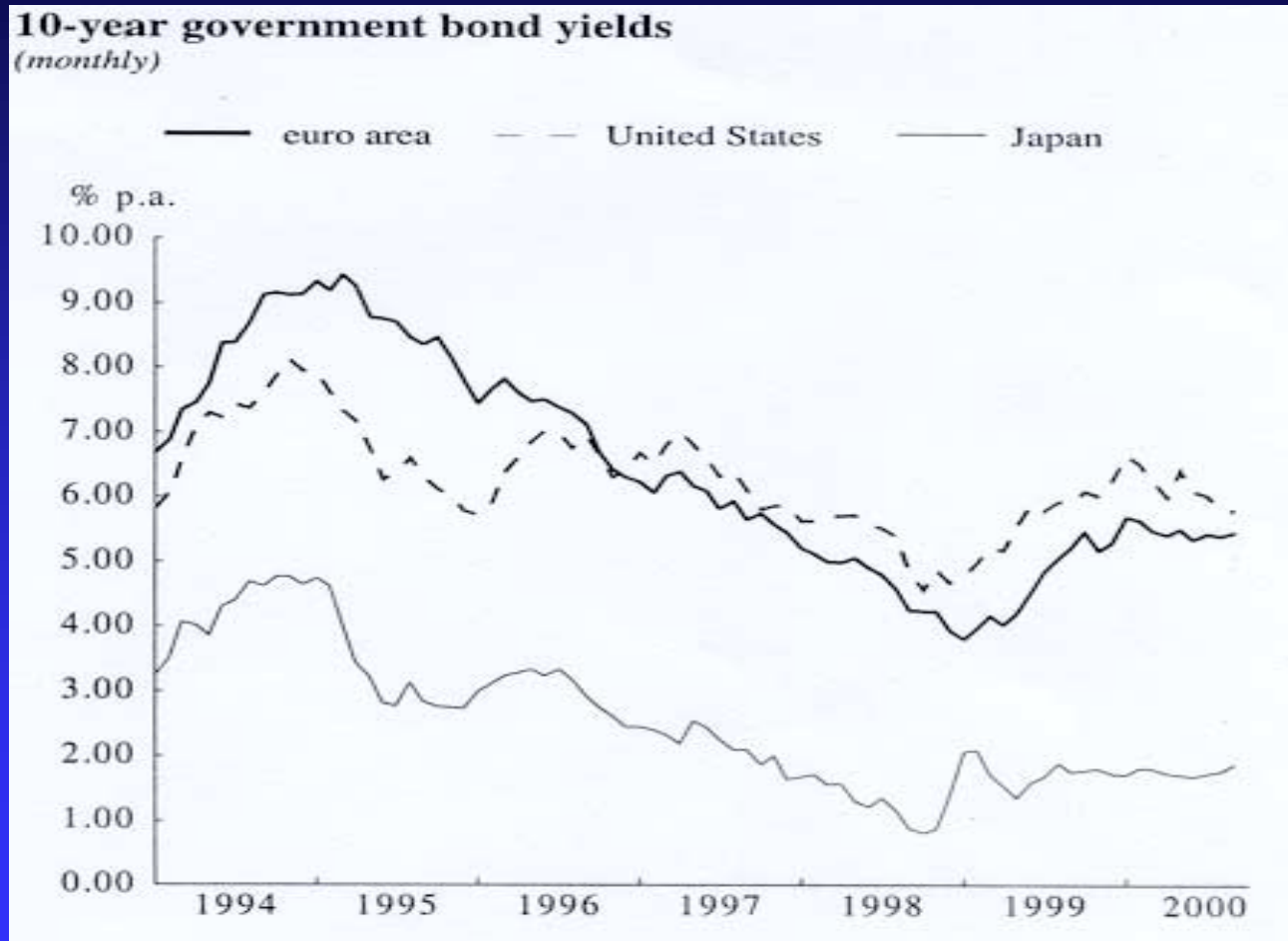
Source: ECB, Monthly Report, October 2000

# Stance of Monetary Policy



Source: ECB, Monthly Report, October 2000

# Credibility of ECB Policy



Source: ECB, Monthly Report, October 2000

# Perspectives of European Monetary Integration

- Pre-Ins: Greece (2001), UK, Denmark, Sweden
- Future EU and EMU members:
  - “Luxembourg Group”: Hungary, Poland, Estonia, Czech Republic, Slovenia and Cyprus
  - “Helsinki Group”: Romania, Slovakia, Latvia, Lithuania, Bulgaria and Malta

Different Accession Scenarios

# Convergence Criteria as Conditions of EMU Membership

- EU membership
- Membership in the ERM II
- Fiscal Criteria
- Price Stability
- Interest Rate Convergence

# Conditions for the International Role of a Currency

- Economic Size
- Well-Developed Financial Markets
- Reputation for Stability
- History

# Implications for Policy

## Europe

- Stability Pact and Fiscal Policy
- Deregulation in Goods and Labor Markets
- Banking Regulation

## US

- Challenges through “new European spirit” in different policy areas



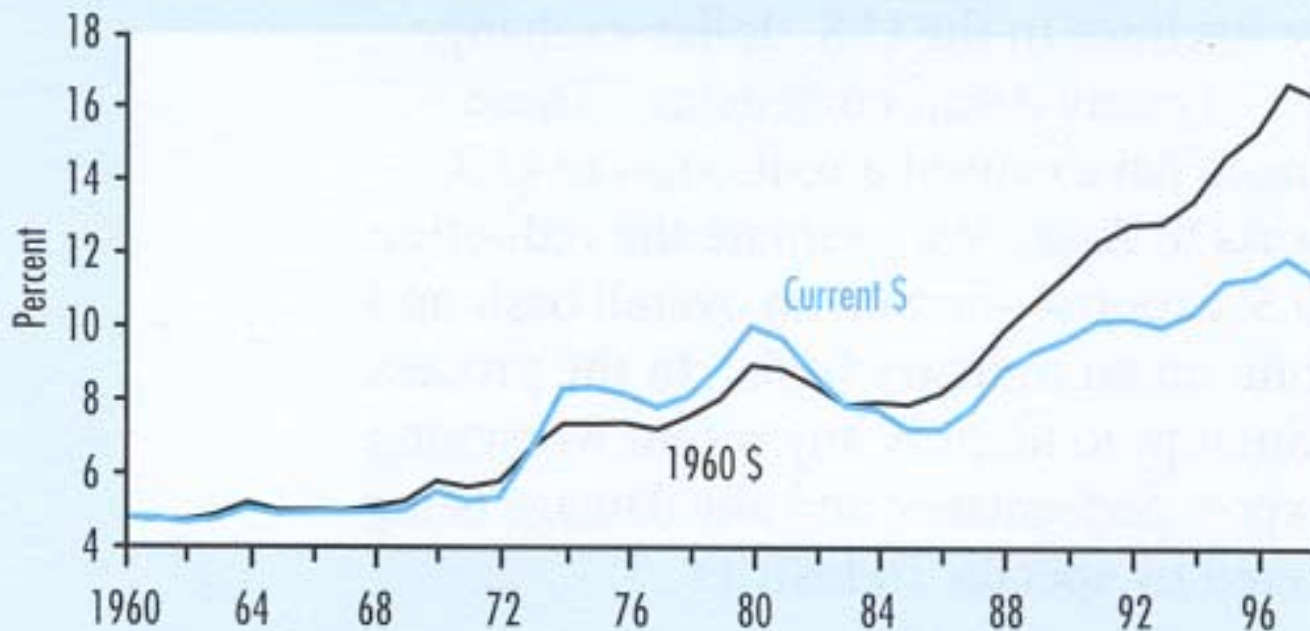
# Challenges for US Business

- Cyclical spillovers from euro area  
(growth, exchange rate, interest rate)
- Structural adjustments in the euro area
  - ◆ Trade Diversion Effects
  - ◆ Foreign Direct Investment

# Implications for Business: Role of Exports for US economy

## Exports of Goods and Services

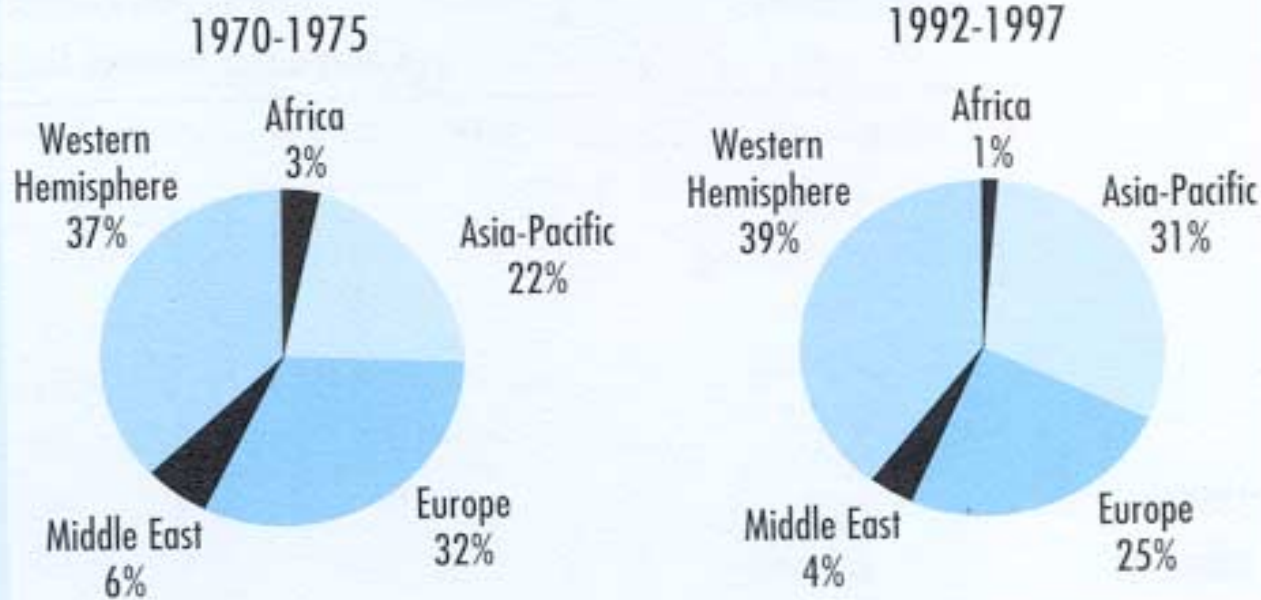
Percent of GDP, 1960-98



Source: U.S. Department of Commerce, Bureau of Economic Analysis.

# Implications for Business: Regional Distribution of Exports

## Global Distribution of U.S. Goods Export



Source: U.S. Department of Commerce, Bureau of the Census

# Implications for Business: Main Export Trading Partners

## Top Ten Destinations of U.S. Goods Exports

(By Share of Total U.S. Exports)

1970-75		1992-97	
Country	Share (Percent)	Country	Share (Percent)
Canada	21.4	Canada	21.5
Japan	10.2	Japan	10.4
Germany	5.4	Mexico	9.3
United Kingdom	4.9	United Kingdom	5.2
Mexico	4.4	Germany	3.9
Netherlands	3.9	Korea	3.8
France	3.1	Taiwan	3.2
Italy	2.9	Netherlands	2.8
Brazil	2.7	France	2.6
Belgium- Luxembourg	2.3	Singapore	2.5

Sources: U.S. Department of Commerce, Bureau of the Census and International Monetary Fund, *Direction of Trade Statistics*.

# Implications for EU Banking

- EMU reinforces global trends in banking as globalization, disintermediation, IT
- Loss in revenue from FX trading
- Increasing competition resulting from market expansion and loss of home market advantage
- Margin pressures e.g. corporate lending or cross border payments
- Specialization in the Banking Industry



# Summary

- Euro is a success as a new international currency, but not as investment currency
- Euro has the potential to challenge the dollar as the main international currency
- Adjustment problems in EMU smaller than OCA theory predicts
- EMU implies major challenges to European policy, business, and banking

