Robert Schuman Centre for Advanced Studies

Implications of the euro for international monetary relations: a pole of attraction in Europe and in the Mediterranean basin

Giorgio Gomel

RSC No. 2001/ 34

Mediterranean Programme Series

EUI WORKING PAPERS

EUROPEAN UNIVERSITY INSTITUTE

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Printed in Italy in October 2001
European University Institute
Badia Fiesolana
I – 50016 San Domenico (FI)
Italy

Mediterranean Programme

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The Mediterranean Programme has received generous financial support for Socio-Political Studies from three major institutions who have guaranteed their support for four years: ENI S.p.A, Ente Cassa di Risparmio di Firenze, and Mediocredito Centrale. The European Investment Bank, Compagnia di San Paolo and Monte dei Paschi di Siena have offered generous financial support for four years for studies in Political Economy which will be launched in Spring 2000. In addition, a number of grants and fellowships for nationals of the Southern and Eastern Mediterranean countries have been made available by the Italian Ministry of Foreign Affairs (for doctoral students) and the City of Florence (Giorgio La Pira Fellowship for post-doctoral fellows).

For further information:

Mediterranean Programme
Robert Schuman Centre for Advanced Studies
European University Institute
via dei Roccettini, 9
50016 San Domenico di Fiesole (FI)
Italy
Fax: + 39 055 4685 770
http://www.iue.it/RSC/MED/

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Abstract

The paper sheds some light on the emergence of the euro as a key international currency two years since its inception. It looks at the main stylised facts concerning the use of the euro as an anchor, as a reserve asset, as a private financing and investment currency, and for pricing and invoicing. It then moves on to discuss the implications of a large, economically and monetarily integrated area in Europe for the architecture of the world monetary system and the evolution of international monetary affairs. One of the prominent issues here is whether Economic and Monetary Union in Europe makes the process of international policy coordination easier or more difficult.

Further, the paper suggests that the extent to which the euro will be able to play an international role will depend to a large degree on its ability to become a pole of attraction for a wider economic region, in Europe and beyond, particularly for developing countries. It is argued that the preconditions for such an outcome already exist and will become stronger over time. The trade and financial channels through which EMU and the adoption of the euro affect economic activity and structure in third countries are analysed by distinguishing European countries that are in the process of becoming EU members and other countries that maintain close economic and historical ties with EU members.

Finally, the analysis is focussed on the economic, financial and currency relationships the Mediterranean countries are likely to develop with EMU nations as the euro gains importance and EMU progresses towards deeper integration.

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1. INTRODUCTION[*]

The creation of the euro has been the most important change in the international monetary system after the collapse of the Bretton Woods regime in 1971. This paper sheds some light on the emergence of the euro as a key international currency two years since its inception; secondly, it offers some conjectures on the implications of the creation of a large, economically and monetarily integrated area in Europe for the architecture of the world system, taking account of the new economic and financial environment as well as of the novel structure of interactions among policy actors in the international arena; thirdly, it explores the implications of the euro and of deeper integration in the European Union for the economic, financial and currency relationships between Europe and the Mediterranean area.

The issues explored in the paper are organized around four central questions:

- Is the euro becoming a key international currency?
- Does Economic and Monetary Union in Europe (EMU) make international policy coordination easier?
- Will the euro become a pole of attraction for a wider economic area, in Europe and beyond? Under what conditions?
- What implications will the euro have for Mediterranean countries?

2. THE EURO AS AN INTERNATIONAL CURRENCY

We define an international currency as a currency which is accepted and used as a means of payments, store of value and unit of account by economic agents or institutions residing in a country other than that where the currency is issued. Table 1 presents the standard taxonomy of the functions of an international currency, distinguishing the type of agents (private or official) using it.

As the table shows, the international use of a currency has several dimensions, all of which are closely interrelated and tend to be mutually reinforcing. For example, if a currency is widely used in trade invoicing, agents will tend to issue and hold financial instruments denominated in it, in part to hedge against the exchange risk of future outlays and receipts. If there is a high volume of financial transactions in a currency and this is used as a vehicle currency, this will tend to increase the liquidity of markets and to lower

[*] This paper was presented at the Second Mediterranean Social and Political Research Meeting, Florence, March 21-25, 2001, Mediterranean Programme, Robert Schuman Centre for Advanced Studies, European University Institute.

transaction costs, thus stimulating an even wider use. If a large share of a country's trade and financial transactions with the rest of the world is denominated in a currency, that country will have an incentive to set its exchange rate policy with reference to that currency, and will tend to hold official reserves denominated in it to support such a policy.

Table 1
Taxonomy of functions of international currencies

Money function	Private use	Official use
Medium of exchange	Payment/Vehicle currency (*) (i) in exchanges of goods and services (ii) in currency exchange	Intervention currency
Store of value	Investment/Financing currency	Reserve currency
Unit of account	Pricing/Invoicing currency	Anchor currency

Source: IMF
(*) Transactions in which two currencies are not exchanged directly, but through a third currency ("vehicle").

Two preliminary considerations are in order at the outset.

First, normally there is some degree of inertia in monetary history such that the time span in which currencies become key international currencies may be rather lengthy. In the case of the euro there are no historical antecedents to the birth of a single, transnational money that comes into being as a substitute for a multitude of existing national monies. This very discontinuity might possibly speed up the international use of the euro. This will in turn depend on two chief characteristics: the size of the underlying economy (see Table 2) and the speed of the move from nationally segmented financial markets to a single, integrated and deep European financial market.

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Table 2
Shares of world GDP, trade, population and degree of openness (1999)

	GDP[1]	Trade[2]	Population	Openness[3]
USA	21.9	14.0	4.6	13.3
Euro area	15.8	16.2	4.9	15.4
Japan	7.6	6.7	2.1	9.1

Source: IMF
1) In PPP terms.
2) Exports of goods and services. For the Euro area, excluding intra-area trade.
3) Imports of goods and services as a percentage of country or area GDP.

Second, the speed at which the international use of a currency increases may vary in relation to the different functions it performs: the process may be slower for the "vehicle-currency" function since it involves economies of scale which tend to change with some inertia and for the use as a reserve asset, whereas it may be speedier for the use as a private financing and investment currency.

3. SOME OBSERVED FACTS

3.1 The euro as an anchor

A large variety of exchange rate regimes adopted by countries currently involve a link to the euro in some form or another. According to data compiled by the European Central Bank (see Table 3), more than 50 countries peg more or less closely their currencies to the euro. Those countries are clustered in Central and Eastern Europe (chiefly, "accession" countries), in the Mediterranean area and in Africa. They are, to a large degree, countries that have close trade and financial links with the euro area. Yet, the aggregate share in world GDP of countries linking their currencies to the euro or for that matter to the dollar is relatively small. Moreover, the dollar remains the only currency to which a number of countries located outside its "region" anchor their currency. The currencies that gravitate around the yen are limited in number both locally and globally. All in all, currency pegs or anchors are to a predominant degree "regional" in character, although it is difficult to discern a clear trend towards a "tripolar" (i.e. euro, dollar, yen) set of currency relationships in the world.

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Table 3
Exchange rate regimes involving a link to the euro or to a basket of currencies including the euro

Exchange rate regime	Number of countries	Countries
Exchange rate arrangements with no separate legal tender	5	French territorial communities of Saint-Pierre-et-Miquelon and Mayotte. The Republic of San Marino, the Vatican City and the Principality of Monaco will be entitled to use the euro as their official currency subject to an agreement with the European Union. Negotiations are currently in place with Monaco, and have been concluded with San Marino and Vatican City.
Currency board arrangements	3	Bosnia-Herzegovina, Bulgaria, Estonia
Peg arrangements (including pegging to the SDR and other currency baskets including the euro)	18 9 8	Pegging only to the euro: Cyprus, Denmark, 14 African countries of which the CFA franc is the legal tender, Cape Verde, Comoros Pegging to the SDR: Latvia, Bahrain, Botswana, Jordan, Libyan Arab Jamahiriya, Myanmar, Qatar, Saudi Arabia, United Arab Emirates Pegging to other currency baskets including the euro: Iceland, Malta, Bangladesh, Burundi, Chile, Morocco, Seychelles, Vanuatu
Crawling fluctuation bands	3	Hungary, Israel (basket), Tunisia
Managed floating with the euro used as a reference currency	6	Burundi, Croatia, Czech Republic, FYR Macedonia, Slovak Republic, Slovenia
	Total: 52	

Source: European Central Bank

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3.2 The euro as a reserve asset

At the end of 1999, according to IMF data, the euro accounted for 12.5 per cent of world official reserve holdings of foreign exchange (see Table 4). The euro share of world reserves was roughly identical to the combined sum of its constituent parts (the predecessor European currencies) one year earlier, once the appropriate correction is made for the decline caused by two technical adjustments.[1]

More recent data tend to confirm that no significant changes in the share of the euro in world foreign currency reserves have occurred. In fact, in 2000 for G-10 countries the share of the euro was unchanged relative to that of the constituent national currencies at the end of 1998 (around 16 per cent). For non-oil developing countries, the share of the euro – around 13 per cent – had increased as compared with the pre-EMU situation (10 per cent). Among the candidate countries for entering the European Union – the so-called "accession countries" – the euro accounted for a very sizeable share of their official reserves (nearly 50 per cent, in excess of the US dollar, and on a slightly increasing trend). Conversely, the dollar remains the predominant currency in the reserves of both Latin American and oil exporting countries' monetary authorities.

Overall, the prevailing attitude among official holders of reserves seems to be one of "wait and see", although some, e.g. the Hong Kong monetary authority, have stated their intention to increase significantly the share of the euro in their total reserves. Such attitude is consistent with inertia in reserve-holding habits. The currency composition of central banks' reserves is slow to change because habits are slow to change. And central banks are hesitant to bring about radical changes in their portfolios for fear that this will signal a lack of policy continuity.

[1] First, at end-1998 the Eurosystem converted back into gold and US dollars the official ECUs that had been issued to EU central banks through revolving swaps against the contribution of 20 per cent of their gross gold holdings and US dollar reserves during the operation of the European Monetary System. Second, with effect from 1 January 1999, the Eurosystem's reserves previously denominated in former euro-area national currencies and private ECUs became domestic assets.

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Table 4
Share of National Currencies in Official Holdings of Foreign Exchange
(end of year, in percent)

	1990	1995	1998	1999
All countries				
U.S. dollar	50.6	56.8	65.7	66.2
Euro	-	-	-	12.5
Japanese yen	8	6.8	5.3	5.1
Pound sterling	3.0	3.1	3.8	4.0
Swiss franc	1.2	0.8	0.7	0.7
Deutsche mark	16.8	13.5	12.1	-
French franc	2.4	2.2	1.3	-
Netherland guilder	1.1	0.4	0.3	-
Ecu	9.7	6.8	0.8	-
Unspecified currencies	7.1	9.6	9.9	11.6
Industrial countries				
U.S. dollar	45.5	51.8	66.7	68.3
Euro	-	-	-	11.0
Japanese yen	8.8	6.6	6.6	5.8
Pound sterling	1.7	2.1	2.2	2.3
Swiss franc	0.9	0.1	0.2	0.1
Deutsche mark	19.8	16.4	13.4	-
French franc	2.5	2.3	1.3	-
Netherland guilder	1.1	0.2	0.2	-
Ecu	14.5	13.4	1.9	-
Unspecified currencies	5.2	7.0	7.4	12.4
Developing countries				
U.S. dollar	61.1	61.9	65.0	64.6
Euro	-	-	-	13.6
Japanese yen	6.4	6.9	4.3	4.5
Pound sterling	5.7	4.2	5.1	5.2
Swiss franc	1.8	1.5	1.1	1.1
Deutsche mark	10.7	10.5	11.0	-
French franc	2.4	2.1	1.2	-
Netherland guilder	0.9	0.6	0.5	-
Ecu	-	-	-	-
Unspecified currencies	11.0	12.3	11.8	11.0

Source: IMF, Annual Report 2000

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3.3 The euro as a private financing and investment currency

The increase in the international use of the euro as a financing currency by non-residents of the euro zone, in particular in the area of international debt issuance, represents the most important and novel development in regard to the internationalization of the euro.

According to the BIS definition, which captures the truly "international" component of debt issues denominated in euros, i.e. securities denominated in euros issued by borrowers who are non residents of the euro area plus euro-denominated securities issued by euro-area residents, but where the targeted investors are non-euro area residents, in 1999 euro-denominated gross issues of debt securities – money market instruments, bonds and notes – accounted for 38 per cent of total issues of international debt securities. This compares with 26 per cent of total gross issuance accounted for by the aggregate share of the former euro-area national currencies and the ECU in 1998.

The development has been the result of the interplay of demand and supply-driven factors: on the one hand, greater breadth, depth and liquidity of financial markets in Europe moving away from national segmentations towards a unified, integrated European market. On the other, growing market size and the obvious attraction of a currency composition of external debt with a larger share of a weak currency [2]. In other words, a peculiar instance of a successful market and a not-too-successful exchange rate going together!

The more telling currency shift is the one shown by sovereign borrowers outside Euroland. Since January 1999 these outside governments have issued 13 per cent of their international debt in euros compared with 4 per cent in the predecessor currencies during the earlier period in the 1990s.[3] Among industrial country issuers that have launched large amounts of euro-denominated debt are Greece, Denmark and Canada. Among emerging market countries, the largest issuers include Argentina, Mexico, South Africa, Brazil. To borrowers, the attraction of the euro arises from the fact that it represents the world's second largest government bond market. The conversion of government debt in eleven national currencies into a single currency created a market that surpassed in size Japan's. At end-September 2000, the euro-area stock of government bonds denominated in euros amounted to euro 3.4 trillion.

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[2] This conclusion goes hand in hand with the anectodal evidence pointing to European companies issuing debt securities in euro, then converting those proceeds into US dollar funds to be subsequently invested in the US economy.

[3] Total international debt is measured here by the sum of euro and US dollar-denominated bond issues.

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The attraction of the euro has been even mightier for private sector borrowers. Between January 1999 and September 2000 euro-area private-sector borrowers issued 72 per cent of their debt in euro, compared with 10 per cent in national currencies in the pre-EMU period in the 1990s.[3] Borrowers residing outside the euro-area issued 21 per cent of their debt in euros, compared with 2 per cent in the previous period. [3]

Concerning banks and other deposit-taking and loan-making institutions, official ECB statistics [4] show that non-euro area residents' deposits in euros and loans extended to non-euro area residents in euros account for roughly 40 per cent of total, a slight increase from the pre-EMU levels.

From the standpoint of the use of the euro as an investment currency, statistical information is scant. Overall, the advent of the euro seems to have had modest effects on the currency composition of international investments so far, as both bank asset stocks and international portfolios of bonds and equities indicate. In mid-2000 the stock of international bank assets denominated in euro was roughly 20 per cent of the total as compared with a dollar share exceeding 50 per cent. In bond and equity holdings by major international investors, the euro ranks second to the dollar as the most widely used currency; while the dollar accounts for roughly 50 per cent of total holdings, the euro share ranges between 20 and 30 per cent according to the specific assets in question.

3.4 The euro as a pricing and invoicing currency

The US dollar retains its predominance as a currency of pricing/invoicing in homogeneous and standardized international markets, such as those of primary commodities, of which several Mediterranean countries are major exporters. An established international currency benefits from positive externalities, stemming from lower transaction and information costs and network effects. Over time the creation of a euro area whose share of world trade is larger than that of the United States will make the euro more attractive as a vehicle and invoicing currency. But the attraction of shifting to the euro is a function of how many other market actors also shift. There is little incentive to be first. This lends the international role of currencies a strong element of inertia.

Only modest shifts in producers' behaviour have lately been recorded: Iraq and Jordan switched to the euro in pricing and invoicing their petroleum exports.

[4] See ECB, Monthly Bulletin, various issues.

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4. EMU AND THE INTERNATIONAL MONETARY SYSTEM

While it is difficult to predict with any precision how rapidly, and to what extent, the euro will develop as a key international currency, it is clear that the euro area is a major player in the world economy, sharing with the United States and Japan a large part of the responsibility for managing world economic and monetary relations. Regardless of the extent to which the euro may rival the dollar as a key international currency, the euro's exchange rate vis-à-vis the dollar and the yen is at the core of the world monetary system.

A preliminary issue in this respect is whether the introduction of the euro will on balance have a stabilizing or a destabilizing effect on the functioning of the world monetary system. To address this issue, it may be useful to consider the following two closely related questions:

- are excessive external imbalances and exchange rate misalignments between the main currency areas be more or less likely to occur in the aftermath of the euro?
- how effective will the process of international policy coordination be in counteracting imbalances or misalignments if they arise?

Regarding the first question, it has been observed that, ceteris paribus, a large and relatively closed economic area like the euro area is more likely to gear its economic policies to domestic rather than external objectives. Therefore, the introduction of the euro can lead to an attitude of "benign neglect" by the countries of the euro area vis-à-vis external imbalances and exchange rate developments, since these would have a limited impact on euro area output and prices. Greater currency volatility and protracted misalignments of the exchange rate would result in this scenario.

However, this argument should not be overstated. First, the dollar-euro exchange rate is one of the main indicators the ECB watches, both in view of its potential effects on domestic prices and because of the information it may convey about market expectations. Second, the introduction of the euro has per se dramatically reduced the impact of movements of the dollar exchange rate on euro area countries, which was already limited given the large share of intra-European trade. The main effect of the euro is one of removing a potential source of intra-European exchange rate tensions and of attracting a larger number of countries whose exchange rate policy could gravitate on the euro, thus further reducing the relative weight of trade with other currency areas.

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Another concern is the possibility that, if the euro were to rival the dollar as a major international currency, the international monetary system may become vulnerable to large portfolio shifts between these two currencies, which would result in higher exchange rate instability. It is important to point out that, at least in the past, large portfolio shifts out of the US dollar have been mostly associated with situations of sharp uncertainty concerning the future orientation of monetary and fiscal policies or with episodes of tension in trade negotiations. Therefore, maintaining a steady and predictable policy orientation in the key currencies stands as the best way to avoid exchange rate volatility.

In this respect, the institutional framework established for EMU ensures that Europe provides a significant contribution to a sound international environment. The ECB gears monetary policy to the primary objective of price stability. Fiscal policies, whose responsibility remains with the national governments, are constrained by the Stability and Growth Pact, to ensure that excessive budgetary deficits be avoided. Taken together these elements, if correctly applied, make it unlikely that euro area policies become a source of international disequilibria. At the same time, the current efforts by European institutions to enact sounder structural policies in a variety of fields contribute to strengthen the ability of European economies to adjust to external shocks. Obviously, for a stable international monetary system, similar efforts are also needed in the other two main currency areas.

As regards the second question, i.e. how European monetary integration may affect international policy co-ordination, it has been argued that a multipolar, fragmented international monetary system may be inherently less stable than the previous one, characterized by the hegemony of the US dollar.[5] A historical parallel often used to support this argument is the comparison between systems characterized by a clear leader, such as the pre-World War I dominance of the British pound or the early post-World War II supremacy of the US dollar, and systems such as the one that prevailed in the interwar period, characterized by the competition between the pound and the dollar, that proved highly vulnerable to economic shocks and to the destabilizing behavior of some of its participants.

However, that historical parallel is only partly valid. First, the pre-EMU international monetary system no longer conformed to the model of a hegemon or a dominant leader with much smaller followers, since both the Deutsche Mark and the yen played a significant international role. Second, the much higher degree of economic and financial interdependence than in the past implies that the incentives for co-operation are much stronger, as no country

[5] See Giavazzi and Giovannini (1989).

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would be immune from the effects of a world economic crisis. Third, the institutions for multilateral surveillance and co-operation established after World War II provide the means to identify emerging crises and to co-ordinate policy responses. Although these institutions have occasionally proved to be not fully adequate and in the recent past the co-ordination of macro-economic policies among the main industrial countries has not always lived up to expectations, the existence of an established framework for international co-operation is an enormous improvement over the situation that, in the interwar period, led to conflict, disruption of trade and financial relations, and disastrous policy mistakes.

The future scope for co-operation will depend to a large extent on the ability of the key participants to find effective institutional mechanisms. Two main scenarios appear possible in this respect.

A pessimistic scenario postulates that the euro quickly erodes the dominant position of the US dollar and the ability and the willingness of the United States to act as a leader is reduced. At the same time, particularly in the early years of EMU, the euro area may be unable to take up that role, for a combination of reasons: because it is too absorbed by the need to sort out its own internal functioning; because the ECB is concerned primarily with establishing an anti-inflationary reputation; and because the existing EU decision making mechanisms are too cumbersome to allow the rapid actions needed of a leader.[6] The same reasons that would limit the ability of the two main economies to play a leading role could also make it difficult for them to co-operate and provide a joint leadership.

A more positive scenario, and one that I consider more likely, would see a gradual increase in the international role of the euro and in parallel of the responsibilities assigned to the euro area in the context of the existing framework for international policy co-ordination, based on the G7, the IMF and the BIS. The reduction in the number of players resulting from EMU could make this framework more effective, provided that the European members can find a common voice.[7] Over time, progress toward economic and political integration, well beyond the single currency, also implying more effective decision making, could enable Europe to take over a growing share of responsibility in managing international affairs.

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[6] See Henning (1997) and Bergsten (1997).

[7] See Commission of the European Communities (1990), Alogoskoufis and Portes (1991) and Kenen (1995).

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The experience of the past two years seems to run a middle course between the two alternative scenarios. The emergence of the euro as a competitor to the dominance of the US dollar is a slow process, stemmed by inertia. The biggest obstacle is, however, one of a politico-institutional nature, i.e. the quest for a "common voice" of the Europeans, or, as the European bureaucratic parlance has it, the issue of the "external representation" of the euro area. The issue is yet unresolved; so far, ad hoc arrangements have been put in place which follow from the fact that EMU is an entity with no equals: it is not yet a political union, rather a monetary union where monetary sovereignty is shared among national states that retain their membership unchanged in both informal groupings as the G-7 and formal institutions as the IMF.

The definition of a common European position on international matters is a difficult exercise, with the added complexity of reconciling the needs and views of the small, non G-7 members of the euro area and of the three big European G-7 members which cannot but reflect to some degree G-7 interests or requirements.

5. IMPLICATIONS OF THE EURO FOR DEVELOPING COUNTRIES

The extent to which the euro will be able to play an international role will depend in large part on its ability to become a pole of attraction for a wider economic area, in Europe and beyond. The pre-requisites for this already exist to a large extent and will become stronger over time.

On the real economic side, the euro area, given its large size, is a key trade partner of other economic areas. Particularly for the other European countries and for countries in neighboring regions (the Mediterranean, the Middle East and parts of Africa), the euro area represents by far the largest trade partner. Also with countries in other regions, in particular Latin America, trade relations are very significant and rapidly growing. On the financial side, the euro area has a large and efficient financial market, the degree of integration of which (and, therefore, its liquidity, diversification and efficiency) has increased rapidly after the introduction of the euro.

There are thus several trade and financial channels through which EMU affects economic activity and structure in neighbouring countries.

First, the GDP level in the euro area influences exports and GDP in such countries to a degree that depends on these countries' volume of exports to the euro area and the commodity composition of these exports.

Second, there is a financial channel of transmission through changes in interest rates: the size of these spillovers will depend on the relative size of private capital inflows to recipient countries, the nature of monetary and exchange rate policies and restrictions on capital flows.

Third, changes in euro interest rates influence other countries' balance of payments through their external debt service, depending on the share of their external debt denominated in euros and at variable interest rates.

Fourth, the euro's exchange rate vis-à-vis major currencies affects exports, GDP and external debt service in neighbouring countries.[8]

In addition, one should mention structural ramifications of EMU on trade and capital flows. On trade, the implementation of Association agreements by Mediterranean nations with the EU which provide for a sizeable reduction in these countries' trade protection, should induce a gradual transfer of resources to areas where these countries enjoy comparative advantage and lead to increased trade between these countries and the EU.

EMU may also enhance capital flows to emerging market economies. First, deeper and more liquid capital markets in Europe tend to lower borrowing costs for both countries in the euro area and for countries that raise funds in euro-denominated instruments. Second, EMU allows euro-area institutions such as insurance companies and pension funds to shift some of their portfolios into emerging market investments as constraints imposed by currency matching requirements on foreign-currency-denominates investments are eased. Third, emerging market economies could benefit from direct and portfolio capital inflows if the convergence of asset returns in Europe leads global investors to increase their emerging market holdings in order to diversify across countries with a wider range of risk and return characteristics or with different cyclical positions. In sum, EMU is likely to intensify a number of portfolio effects that should concur to fostering capital flows from the EU to emerging or developing economies. Among these, those that stand to benefit most from these portfolio shifts are those with more open capital accounts and developed domestic securities markets, with relatively low inflation rates and close links with the EU.

The extent to which the euro is important to neighbouring countries depends on the nature of their specific economic and political ties to the euro area. For the sake of simplicity, it is useful to distinguish two cases: **i)** European countries that are in the process of becoming EU members, the so-called

[8] For estimates of these effects, see Feldman R. at al. (1998).

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“accession” countries; **ii)** other countries with economic and historical ties to EU nations.

The countries that are in the process of becoming EU members or intend to do so in the future have a strong incentive to:

- strengthen their economic and financial ties with the euro area. Essential part of the process of joining the EU is the mutual elimination of trade barriers and the adaptation of the regulatory environment to that of the single European market;
- link their currencies to the euro. Integration with the EU also requires a stable macro-economic policy framework. To the extent that new entrants need to stabilize their economies and converge with the euro area with the aim of adopting the euro, they may find it useful to set their exchange rate policies with reference to the euro. The nature of the appropriate exchange rate regime would depend, for each country, on its specific situation, in particular the degree of convergence already achieved;
- hold official reserves in euro. To the extent that a country’s exchange rate policy is defined with reference to the euro, larger euro reserves would normally be needed for intervention purposes.

Other nations with close economic and historical ties to EU countries, for instance in the Mediterranean area, may also have incentives to increase their use of the euro and to strengthen ties with the euro area, although for partly different reasons. In particular:

- increasing trade and investment flows as a part of their process of integration in the world economy will be essential to their development strategy. Since trade with the euro area would represent a large share of their total trade, it would be normal that in the future much of it is invoiced in euro. To a growing extent, this may apply also to internationally-traded commodities;
- those countries can also be expected to have a strong interest in tapping euro financial markets, both to finance their trade relations with the euro area and because of the new opportunities for risk diversification that they would offer;
- some countries which until 1998 had been linking their currencies to the French franc or the Deutsche Mark naturally tend to continue to do so with the euro. Other countries may follow them, to varying degrees. For example, countries which had been pegging exchange rates to a basket including the US dollar and the Deutsche Mark may not only replace the latter with the euro but also give it a larger weight;

- regardless of whether countries decide to set their exchange rate policy with reference to the euro, they could be motivated to increase the share of euros in their official reserves in order to diversify their composition.

6. THE EURO AND THE MEDITERRANEAN COUNTRIES

In this section we deal with the economic, financial and currency relationships the Mediterranean partner countries[9] are likely to develop with EMU nations with the inception of the euro and as EMU progresses towards deeper integration.

6.1 Trade

Mediterranean countries' trade is strongly concentrated in Euroland and has been given further impetus by the adoption of a single currency. Euroland can be seen to represent the hub for a large area comprising the Mediterranean basin and Eastern Europe that tends to gravitate around it. EU countries' exports to the Mediterranean nations have increased at yearly rates of 6.3 per cent, at current prices, in the period from 1985 to 1992 and of 8 per cent in the period running from 1993 to 1998. EU countries' imports from the same nations have increased at rates of 6 and 4 per cent per annum in the same subperiods. The EU represents both a prominent export market and a leading supplier of imports: it accounts[10] for over 52 per cent of those countries' exports as compared with 12 per cent accounted for by the United States; the Mediterranean countries' import shares are roughly similar. In the Maghreb the share of the EU exceeds 60 per cent of the countries' external trade.

As a consequence, higher levels of activity in Europe brought about by EMU (by way of eliminating currency risk and reducing transaction costs) are bound to have beneficial spillover effects for the neighboring region. These are obviously difficult to quantify. According to IMF estimates, performed on a slightly different subset of countries, a 1 per cent increase in real GDP in Europe is associated with an increase of MENA[11] exports to the EU of about 2.7 per cent. Given the share of EU exports in the total trade of the region, this effect would boost MENA countries' exports by an average 1 per cent, ranging from

[9] 12 countries in the region: Algeria, Cyprus, Egypt, Israel, Jordan, Lebanon, Malta, Morocco, the Palestinian Authority, Syria, Tunisia, Turkey.
[10] Average 1995-97 data.
[11] The analysis is conducted in terms of the Middle East and North Africa (MENA) region. This includes Algeria, Egypt, Iran, Jordan, Kuwait, Lebanon, Libya, Morocco, Saudi Arabia, Syria and Tunisia. See Feldman R. et al. (1998).

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0.3 per cent (Algeria) to 1.9 per cent (Tunisia). This would contribute to an increase of about 0.2 per cent in MENA countries' output.

For countries that are prominent exporters of raw materials, agricultural commodities, and especially petroleum products, the dollar will remain the prevailing currency of denomination. But, as other countries increasingly diversify exports towards finished or semifinished industrial products, there will be a growing tendency to denominate trade in euro, reducing the current disparity between the share of the euro area in terms of direction of trade and the share of the euro with respect to invoicing. Accordingly, Mediterranean countries are expected to increase their demand for euros; in the longer run, the euro could also play an increasing role for intra-Mediterranean area trade as well as for transactions between the region and other non-EU neighboring countries. As concerns invisible transactions, such as migrants' remittances, the denomination of those will depend on the place of origin: migrants to Europe will remit in euros, while migrants to the Gulf countries will continue to remit in dollars or in local currency.

6.2 Currency composition of external debt

There is a noticeable mismatch between the Mediterranean countries' pattern of trade and the currency composition of their external liabilities. While the share of the EU in terms of these countries' direction of trade is very large, most of their financial liabilities are denominated in US dollars or other non-euro currencies (Table 5). Such mismatch will be only gradually corrected. Terms of contracts on the existing stock of debt have obviously not been altered by the adoption of the euro, but fresh external borrowing by Mediterranean countries has been attracted to the pan-European capital markets by the combination of lower transaction costs, lower interest spreads and the increased demand for financial assets in euros.

Table 5
Currency composition of long-term external debt, 1998
(in percent of total)

	EU currencies	US$	Yen	Other
Algeria	22,8	44,8	12,1	20,3
Egypt	30,6	37,2	12,5	19,7
Jordan	22,5	30,4	23,0	24,1
Iran	12,1	75,0	7,8	5,1
Lebanon	8,1	37,7	0,0	54,2
Morocco	26,7	37,9	2,7	32,7
Syria	3,5	84,4	3,1	9,0
Tunisia	16,4	40,2	15,2	28,2
Turkey	24,7	51,7	15,8	7,8

Source: World Bank, Global Development Finance, 2000

6.3 Foreign exchange reserves

Data on the currency composition of foreign exchange reserves is available only for few selected countries: in Egypt and Lebanon the US dollar is predominant, while in Morocco and Tunisia the euro prevails.

Conjectures can be made about future broad trends, at least in qualitative terms. A number of factors point to a process of diversification of reserves in favor of the euro. With growing economic integration between the EU and the countries that have entered into Association agreements with it and in view of the establishment of the Euro-Mediterranean free trade area the euro will play a more prominent role in external trade and the share of euro in foreign currency reserves will increase. Moreover, trade in euros should increase as trade invoicing more accurately reflects trade patterns and the share of euro-denominated liabilities will increase given the breadth and liquidity of European capital markets; these developments should result in larger holdings of reserves in euros.

6.4 Exchange rate regimes and policies

Currently, Mediterranean countries exhibit a multitude of exchange rate regimes (see Table 6). A first group that includes Turkey, Israel, Lebanon, Jordan displays market-determined exchange rates which are linked more or less rigidly through fixed pegs or crawling bands to a currency basket. Exchange restrictions or capital controls are nearly absent. In a second group of countries – Morocco, Tunisia, Saudi Arabia, Malta, Cyprus, Egypt and Algeria – foreign exchange markets are less developed and exchange rates are largely driven by central bank intervention, despite recent reforms which have introduced interbank currency

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markets where transactions are centered and exchange rates are freely determined by demands and supplies. Exchange rate regimes within this group range from fixed to crawling pegs to managed floats. Lastly, a third group comprises countries where administered regimes prevail regulating foreign exchange and capital movements. Exchange restrictions abound. In two cases – Iran and Syria – dual or multiple exchange rates prevail which entail an implicit system of subsidies and levies on currency relationships and the structure of relative prices.

Table 6
Exchange Rate Arrangements of Mediterranean Countries

COUNTRY	EXCHANGE RATE REGIME	PEGGING TO:	EXCHANGE RATE STRUCTURE
Turkey	MF	-	Unitary
Israel	CrB	Basket	Unitary
Lebanon (1)	CPA	-	Unitary
Jordan	CPA	SDR (2)	Unitary
Morocco	CPA	Basket	Unitary
Tunisia	CrP	-	Unitary
Saudi Arabia	PER	SDR(2)	Unitary
Malta	CPA	Basket	Unitary
Cyprus	PER	Euro	Unitary
Egypt	CPA	US $	Multiple
Algeria	MF	-	Unitary
Iran	CPA	-	Dual
Syrian Arab Republic	CPA	US $	Multiple
Libyan Arab Republic	PER	SDR	Dual

Source: IMF, Annual Report on Exchange Arrangements and Exchange Restrictions, 2000.

Acronyms: MF = Managed Floating with No Preannounced Path for the Exchange Rate; PER = Pegged Exchange Rate within Horizontal Bands; CPA= Conventional Pegged Arrangements; CrB = Crawling Band; CrP = Crawling Peg.

(1) The exchange rate is market determined but is *de facto* pegged to the US $.
(2) The currency is officially pegged to the SDR, in practice to the US $.

The choice of the degree of flexibility of an exchange rate regime depends on a number of structural characteristics of the economy, such as the size and degree of openness of the economy, the geographical concentration of trade, the degree

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of labour mobility, the nature of shocks to the economy. In theory, on the basis of the "optimum currency area" argument a fixed exchange rate regime is to be preferred, the smaller and more open the economy, the less diversified the production and export structure, the higher the geographic concentration of trade, the higher the degree of factor mobility and the more prevalent domestic nominal shocks. It would be obvious then to suggest that Mediterranean countries that largely share those features would be better off pegging their currencies to that of their main trading partner, the EU.

On the other hand the actual existence of a variety of exchange rate arrangements belies a diversity of policy preferences regarding exchange rate policy. Different exchange rate policies in turn imply divergent paths and performances of the real exchange rate. Countries that maintain strong links to currency baskets such as Morocco tend to move in step with the euro given its large weight in the basket. For countries with pegs or predominant links to the US dollar such as Lebanon, Egypt, Syria, Jordan, the exchange rate displays great variation relative to the euro.

For the countries that are linked to the euro through currency baskets the implementation of exchange rate policy to manage external competitiveness need not be changed in view of changes in the value of the euro. These countries depend on the EU market and will therefore wish to continue following the euro relatively closely so as to maintain competitiveness in European markets.

For the countries with currencies closely linked to the dollar, shifts in the valuation of the euro could be more worrisome, since such shifts could imply large changes in their competitiveness in European markets. In regard to exports, euro fluctuations would be primarily important for Syria and Egypt, where EU markets account for 56 and 44 per cent of total exports, respectively. For the oil exporting countries pegged to the dollar, export prices are determined in world markets, and competitiveness is relatively unaffected by exchange rate movements. In regard to imports, the depreciating trend of the euro since its inception has led to a loss of competitiveness against euro-area exporters. These effects have been important for most countries pegged to the dollar, where imports from the EU range from 34 per cent of total imports (Jordan) to 66 per cent (Libya).

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For the non-oil countries with currencies linked to the dollar and large trade shares with the EU countries, there may be merit in considering linking to a broader basket or switching to a more flexible exchange rate policy that might better preserve relative price stability against European markets. This decision will depend on a variety of factors including the effectiveness of exchange rate adjustment in bringing about relative price movements, the nature of the shocks affecting the region and EMU, and the currency composition of merchandise trade flows, trade in services, debt service and migrant workers' remittances.

Giorgio Gomel
Banca d'Italia

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