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COMMUNICATION FROM THE COMMISSION

THE IMPACT OF CURRENCY FLUCTUATIONS ON THE INTERNAL MARKET

The impact of currency fluctuations on the internal market

Communication from the Commission
to the European Council

Foreword

The European Union has seen considerable currency fluctuations since the summer of 1992. In three years, five currencies have depreciated by 20% or more against the most stable currencies in the EMS.

The scale and speed of these changes have justified this question being raised at the highest political level. At its meeting in Cannes in June, the European Council requested the Commission to "carry out a detailed examination of those problems and to report on its conclusions in the autumn".

In response to this request from the European Council, the Commission has attempted to identify the impact of intra-Community currency fluctuations on economic growth and on the internal market. It is also ready to present this report to the appropriate institutions of the Union.

I. Constraints

However detailed it may be, any study of this type comes up against a number of difficulties:

- some of the key data for the period after 1994 are not yet available;
- the effects of the fluctuations on investment decisions and employment are difficult to quantify;
- it is too early to draw definitive conclusions as to the ultimate consequences of these fluctuations, especially as relatively long periods can elapse before firms react;
- it has only been possible to analyze certain sectors in detail;

II. Findings

Despite these constraints, a number of phenomena can be identified:

- a deceleration of growth

According to the estimates of the Commission's services - confirmed by other international institutions - the currency turmoil and the sudden changes in current or anticipated profitability stemming from it have engendered uncertainty and a wait-and-see attitude among economic agents, leading to a **slowdown in growth** in 1995 of the order of 0.25 to 0.5 of a percentage point (dollar related effects included). Sustained growth in Europe is an essential precondition for reducing excessive unemployment.

- a variable effect on cost competitiveness

The effects of the currency fluctuations between 1992 and 1995 on long-term cost competitiveness vary. Of those Member States whose currencies have depreciated, some recorded appreciable gains in cost competitiveness between 1987[1] and 1995 (Italy, Sweden), while others experienced falls (Spain) and yet others recorded no change (United Kingdom). Of those Member States whose currencies have appreciated, some saw their cost competitiveness decline between 1987 and 1994 (Germany), while others remained stable (France).

- a secondary effect on trade balances...

Member States' trade balances seem to be less influenced by currency fluctuations than by structural factors and the growth differential between one country and its trading partners. Over a lengthy period (1987-94), France and Spain recorded an increase in market-shares in value terms for manufacturing industry, Germany a marked reduction, and Italy and the United Kingdom a slight fall.

... but an appreciable effect on profit-margins

One of the reasons why the visible macroeconomic effects seem to be limited is that exporters in countries whose currencies have depreciated have improved their margins since 1992 whereas exporters in the other countries have reduced their margins. The consequences of this profit-margin behaviour are difficult to foresee. On the one hand, firms in countries whose currencies have depreciated could be tempted in future to pursue more aggressive commercial policies. On the other, these variations in profitability may have an impact on corporate investment and development.

- a more visible impact at sectoral and regional levels

The impact of the currency fluctuations is more marked when individual branches of activity are analyzed. In the car and clothing industries, for example, an erosion of margins and a fall in exports in volume terms are noted in countries with stable currencies. Some frontier regions close to countries whose currencies have depreciated are also experiencing specific difficulties.

III. What conclusions should be drawn?

- difficulties for the Union economy

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1 January 1987 saw the last general realignment within the EMS and relative exchange-rate equilibrium. It therefore constitutes a logical reference date for studies of this type. The choice of another equivalent reference date (1983) does not alter the conclusions.

On the basis of these findings, the Commission concludes that currency fluctuations are creating certain difficulties for the Union economy, although these are in no way attributable to the elimination of trade barriers or to the internal market rules.

In general, the uncertainty arising from these changes may lead to a misallocation of resources and create difficulties in terms of the location of production activities. It is particularly clear that this uncertainty is having a negative effect on economic operators, is curbing **investment** and is slowing **growth.**

Furthermore, in those countries whose currencies have remained stable the speed and scale of the changes which have occurred since September 1992 are posing **difficult adjustment problems** for certain sectors and regions. Even where the currency fluctuations are merely compensating for earlier cost-competitiveness differentials, they are causing disruption which firms cannot easily absorb at a moment's notice.

At the same time, in those countries whose currencies have depreciated the fluctuations are causing a resurgence of **inflation** and a rise in **interest rates,** to the detriment of healthy and sustained growth. "Past experience with devaluations shows that they have not brought lasting success in economic-policy terms.

- the need to attack the causes of the fluctuations

Given these difficulties, new measures designed to correct the effects of the currency fluctuations on those sectors and regions affected might aggravate the problems: re-fragmentation of the single market, curbs on trade and a further slowdown in growth at the expense of employment.

In some cases, the currency fluctuations could have the effect of aggravating the problems of sectors or regions already affected by structural difficulties; these effects would then be examined -like the effects of any other cause- within the limits of the existing Community rules and mechanisms. In no circumstances shall this examination put into question either the allocation of structural funds between Member States or between objectives, or their programming rules.

Currency fluctuations are essentially a macroeconomic phenomenon, even if the effects are felt at sectoral or regional level. The solutions adopted cannot and should not tackle their consequences but should attack their causes. These causes are directly linked to the insufficient progress made towards convergence, particularly as regards the reduction of government deficits.

- single currency and convergence of economies

The definitive solution to this turmoil lies in the **convergence of economies** - this being necessary for the introduction of a strong and stable single currency - and particularly in durable compliance with the inflation and govermnent-deficit criteria set out in the Treaty. It should be pointed out in this connection that the single currency is destined to become the currency of the whole of the Union as soon as possible.

In both the short and the long term, reinforcement of the convergence process is thus essential for preserving and strengthening the internal market. Furthermore, with or without a single currency, a reduction in deficits is necessary if the sanction of the markets and higher interest rates are to be avoided. Progress on the convergence front will also serve to establish a **sound macroeconomic framework** for promoting growth and combating unemployment. This is one of the key points of the **European strategy for employment,** which also aims to enrich the employment content of growth through micro-economic and structural measures.

- strengthening of convergence

Within this framework, the Commission will ensure that the mechanisms provided for in the Treaty for strengthening convergence are rigorously applied. It will also ensure that effective means are used to achieve this objectif. It will finally ensure that the rules governing the operation of the internal market as a whole are strictly implemented.

This strengthening of convergence will also establish the foundations for reinforced monetary solidarity. These two points are indissociable, particularly in the context of the third stage of economic and monetary union, when a mechanism to replace the current EMS will have to be introduced for those Member States unable to adopt the single currency from the outset.

It is in this spirit that the Commission is now preparing, for the European Council meeting in Madrid, its contribution to the interim report in the context of the request from Cannes on the future exchange-rate relationship between the european currency and the currencies of the other countries in the Union.

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The conclusion of this report is that the Commission considers that the single currency is the **essential complement** to the single market. Economic and monetary Union is the appropriate response to the difficulties caused by monetary fluctuations to the European economy. Any other solution would risk being worse than the problems which it seeks to resolve.

All the efforts and progress being made in the convergence process ahead of monetary union are already helping to cushion the consequences of the currency fluctuations and to establish a sound macroeconomic framework that is conducive to growth and job creation.

I. INTRODUCTION

1. At its summit meeting in Cannes, the European Council emphasized that *"if the recent currency turmoil continues, it might affect the proper operation of the single market and put a brake on the process of harmonious and balanced growth"*. It requested the Commission to *"carry out a detailed examination of those problems and to report on its conclusions in the autumn"* (SI (95) 500, 27 June 1995). This request has to be placed in the context of Article 109m of the Treaty on European Union, which stipulates that *"each Member State shall treat its exchange-rate policy as a matter of common interest"*.

2. Since the crisis in the EMS exchange-rate mechanism in September 1992, a number of European currencies have depreciated sharply against the German mark. Such was the case between August 1992 and August 1995 with the Italian lira (31% depreciation), the Swedish krona (27%), the Spanish peseta (24%) and the pound sterling (18%). This period of turbulence on the foreign-exchange market has been marked by three important events: the departure of the pound sterling and the Italian lira from the EMS exchange-rate mechanism in September 1992, the decision in August 1993 to widen the mechanism's margins of fluctuation to 15%, and the sharp depreciation in the US dollar in February and March 1995, which contributed to the depreciation of a number of European currencies.

The depreciation of these European currencies is the result of pressures exerted by the financial markets. However, even if not determined politically, these depreciations represent a penalty imposed by the markets in response to insufficiently tight macroeconomic policies.

3. In theory, exchange-rate movements can affect trade within the EU in two different ways. Firstly, short-term movements may - because of the uncertainty they engender - lead to a fall in the volume of trade. Secondly, certain medium-term movements can also affect trade flows and international specialization on account of the changes in competitiveness that they engender.

4. Generally speaking, exchange-rate movements can also have major macroeconomic effects. Firstly, uncertainty can have a substantial negative impact on the growth prospects of the Community as a whole through its harmful effect on investment and consumption decisions. Secondly, exchange-rate changes can lead to a redistribution of economic growth and inflation between those countries whose currencies appreciate and those whose currencies depreciate, with the latter experiencing in the short run an increase in growth but an upsurge in inflation.

5. The Commission's departments have carried out an examination of the impact of recent exchange-rate movements on the operation of the internal market and on the economic growth of the Union and its Member States. In carrying out their examination, they encountered a number of difficulties of a methodological and empirical nature. On the methodological front, it is clearly a very complex task to isolate exchange-rate effects from other economic events occurring over the same period. The difficulty is accentuated by the fact that the available observation period is short, which makes it impossible to take account of all the effects. Moreover, a certain degree of caution is required particularly as the relatively long period of time that elapses between monetary fluctuations and the responses of enterprises to those fluctuations may be such that these responses are not captured owing to the shortness of the observation period. At the empirical level, the introduction of the single market has caused a break in the statistical series for trade and has delayed their publication. In effect, the introduction of a new system for data collection has affected the comparability of intra-Community trade statistics before and after 1993. Given these difficulties, the Commission's

departments have used a range of indicators the findings of which are set out below.

II. CURRENCY FLUCTUATIONS AND THEIR IMPACT ON GROWTH AND TRADE

Macroeconomic impact on growth

6. At the macroeconomic level, the recent exchange-rate movements between Union currencies are a cause for concern. Since the beginning of 1995, growth and investment in the Community as a whole has slowed somewhat, partly as a result of the purely economic consequences of these exchange-rate movements and partly as a result of a loss of confidence by economic agents in the face of currency uncertainties. This general statement masks divergent effects between those countries whose currencies have depreciated and those whose currencies have appreciated. In the case of the former, the benefits in terms of economic growth have been accompanied by a surge in prices and nominal interest rates, which has, to some extent, accentuated households' uncertainty. By contrast, in the case of the latter (whose weight in GNP terms within the Union easily exceeds 50%), the slowdown in growth has been accompanied by a reduction in inflation. It should be pointed out that, within both groups, the magnitude of the effects varies according to the degree to which the currencies have appreciated or depreciated.

On the basis of economic simulations and the latest information, the Commission's departments estimate that currency turbulence may reduce Community growth and investment by between 0.25 and 0.5 of a percentage point in 1995 (including the dollar effect). For Italy, the simulations indicate a further increase in prices of 1.5 percentage points and an increase in short-term nominal interest rates of 2 percentage points. For the countries with appreciating currencies, the simulations indicate a decline in inflation and in short-term nominal interest rates of between 0.5 and 1 percentage point (the simulations are based on the assumption that real short-term interest rates are constant). Generally speaking, these findings are confirmed by other international organizations, e.g. the OECD.

It must be stressed that the situation regarding exchange-rate changes between the European currencies is partly the result of movements in the dollar. In February and March 1995 the dollar fell sharply against Community currencies, and this has led to wider divergences between European currencies and to greater instability. Over the period from 1992 to 1995, for example, the movements in the DM/$ and the DM/LIT exchange-rate parities have been parallel (significant correlation). It is therefore very difficult to assess the effects of fluctuations between European currencies independently of the dollar effect.

Exchange-rate movements and cost competitiveness

7. On the trade front, the first problem is to establish to what extent the movements in nominal exchange rates have affected Member States' cost competitiveness. The concept of cost competitiveness traditionally used by international organizations should not be confused with the more general concept of competitiveness. The concept used here is a measure based purely on the unit cost of labour for a country relative to its trading partners. Cost-competitiveness indicators entail the arbitrary choice of a reference year. The Commission's departments have principally adopted the first quarter of 1987 as the reference period because it constituted a period of exchange-rate stability which ended with the September 1992 crisis. Choosing an alternative period (1983) does not alter the main conclusions drawn from the cost-competitiveness analyses.

8. The period from 1987 to 1992 was characterized both by relatively stable nominal exchange rates and by contrasting patterns of inflation and productivity the overall result of which was divergent cost-competitiveness trends among Member States. Over the period from the third quarter of 1992 to the third quarter of 1995, a number of countries saw their nominal effective exchange rates appreciate. Such was the case in Germany, Denmark, France, the Netherlands, Austria, Belgium and Finland, which recorded rates of appreciation ranging from 15% (Germany) to 7% (Finland). By contrast, Italy, Sweden, Spain, Greece, the United Kingdom, Portugal and Ireland saw their nominal effective exchange rates depreciate by amounts ranging from 26% (Italy) to 2% (Ireland).

9. These changes in nominal exchange rates have had differing effects on cost competitiveness, depending on the country in question. In some cases, they have offset the cost-competitiveness gains or losses recorded over the period from 1987 to 1992. In others, they have led to net gains or losses in cost competitiveness compared with the trends over that period.

10. In those countries whose cost competitiveness had deteriorated sharply between 1987 and 1992 the nominal changes which occurred over the period from the third quarter of 1992 to the third quarter of 1995 have more than compensated for the previously recorded losses in some cases (Sweden) and have partially compensated for the losses in others (Spain). For Greece and Portugal, these nominal changes have not led to any improvement in cost competitiveness, which has continued to worsen. This has not necessarily entailed a deterioration in their overall competitiveness since Portugal, for example, has seen an expansion in its intra-Community market shares.

For France and Austria, whose cost competitiveness improved appreciably between 1987 and 1992, the nominal changes occurring between 1992 and 1995 have eliminated to a great extent the previous gains.

Amongst those countries experiencing limited movements in cost competitiveness over the period from 1987 to 1992, the nominal changes from 1992 to 1995 have enabled Italy to record a major gain in cost competitiveness (24% over the period from the first quarter of 1987 to the third quarter of 1995). By contrast, those changes have led to a fairly considerable loss in cost competitiveness for Germany (20%) and, to a lesser extent, Denmark (9%) and the BLEU (7%). In the United Kingdom and the Netherlands, the changes in cost competitiveness have been relatively slight over the entire period from the first quarter of 1987 to the third quarter of 1995.

In conclusion, it should be emphasized that there is no strict relationship between variations in nominal exchange rates and variations in cost competitiveness. The former do not necessarily affect the latter as currency fluctuations are not the only factor causing variations in cost competitiveness. Improvements in unit wage costs denominated in national currency that stem from increased productivity changes and efforts to moderate wage increases can also influence cost competitiveness (Table 1).

Impact of exchange-rate movements on current-account and trade balances

11. The second question is to what extent these changes in cost competitiveness have affected current-account and trade balances. The figures so far available, covering the period up to the end of 1994, do not show major distortions in trade. Even though it is true that the current-account balances of countries whose currencies have depreciated have improved (except in the case of Portugal), the same applies to most countries whose currencies have appreciated,

the two exceptions being Austria and particularly Germany. In the latter case, the deterioration noted is due mainly to the effects of unification. It can therefore be concluded from these developments that current-account balances have not been influenced simply by the cost-competitiveness trend; cyclical and structural factors have also played an important part. To sum up, it transpires that exchange-rate fluctuations have not had a significant impact on current-account balances.

With regard to trade balances, although cost competitiveness may have had a real effect, this has to a large extent been cushioned by changes in profit margins. Furthermore, analysis shows that the relative growth of domestic demand is an important determinant of trade balances. The relative weakness of domestic demand in a number of countries whose currencies have depreciated (notably Italy and Sweden) has contributed to the improvement in their trade balances. Furthermore, trade balances have been influenced by such notable events over the last decade as the accession of Spain and Portugal to the European Union, German unification and the creation of the European single market.

Sectoral and regional effects of exchange-rate movements

12. The third and final question is whether certain Member States and/or sectors have been especially affected by the changes in exchange rates and cost competitiveness. In the case of manufacturing industry, changes in production prices expressed in ecus over the period from 1987 to 1994 broadly confirm the results obtained in terms of cost competitiveness. This new indicator (production prices), together with the cost-competitiveness indicators, therefore provides coherent results.

Over the whole period from 1987 to 1994, Portugal recorded the highest increase in manufacturing prices compared with the Community average (+39%). It was followed by Greece (+8%), Germany (+5%), the BLEU (+5%) and Denmark (+3%), all of which also recorded increases in production prices. By contrast, Italy (-13%) and, to a lesser extent, Spain (-4%) and France (-1%) saw a relative fall in their production prices. The other countries show trends similar to the Community average (Table 3)

13. The pattern of market shares in value terms for manufacturing industry shows that structural factors largely dominated exchange-rate effects over the period from 1987 to 1994. The analysis could not be extended to 1995 owing to the delay in data being made available.

Within the Union, France and Spain saw a steady improvement in their market shares over the period from 1987 to 1992 (+2.5 percentage points for France, +1.3 percentage points for Spain). By contrast, Germany recorded a loss of 3.3 percentage points and Italy one of 0.8 of a percentage point over the same period. Between 1992 and 1994 the situation in Germany showed a continual marked decline (-3.4 percentage points), whereas that in Spain continued to improve (+0.5 of a percentage point). In France there was some break in the trend after 1992, its market share having diminished by 0.6 of a percentage point. But this loss is still small compared with the gains over the previous period. In Italy, however, there was no real break in the tendency for its market shares to decline.

Outside the Union, the conclusions are not fundamentally different. However, Germany's market-share losses and Spain's gains have been more limited than those recorded within the Union. Over the period from 1987 to 1992, France's market-share gains outside the Union were slightly lower than within, but its losses over the period from 1992 to 1994 were greater outside the Union than within. In the case of Italy, market shares remained stable over the whole period from 1987 to 1994, with a slight improvement between 1992 and 1994 (Table 2).

14. The pattern of total exports of industrial products in volume terms over the period from 1987 to 1994 confirms that changes in production prices in a common currency are not the most important determining factor. Cyclical and structural factors also played a very important role. Compared with the Community average, Spain and Portugal enjoyed the highest levels of export-volume growth (+60% and +32% respectively), mainly as a result of the modernization of their economies and the removal of trade barriers within the Community. France (+12%) performed appreciably better than its European partners over the period from 1987 to 1994, although it did less well than its European partners over the period from 1992 to 1994. By contrast, German exports fell by 16% compared with the Community average, partly as a result of the unification process, which has reinforced a long-term trend. Italy's export-volume growth was systematically lower than the Community average (-2%) over the period from 1987 to 1994. The catching-up recorded between 1992 and 1994 failed to offset the relative losses suffered over the previous period (Table 3).

15. However, there are appreciable differences according to whether markets outside or inside the Community are considered. Over the period from 1987 to 1992, intra-Community exports of industrial products rose much more quickly in volume terms than exports to non-Community markets (+4.7% per year on average in volume terms compared with 1.5%). There was a reversal of this situation between 1992 and 1994 (+0.1% per year in the case of intra-Community markets as opposed to +9.2% in the case of non-Community markets). These trends are clearly explained by the stronger relative growth of demand in the EU compared with trading partners between 1987 and 1992, whereas the situation was reversed between 1992 and 1994. Some countries whose currencies depreciated between 1992 and 1994 benefited from this situation on markets outside the Community. This was particularly the case with Italy (+14.2%), Spain (+17.8%), Greece (+12.9%) and the United Kingdom (+12.3%), which recorded very sharp increases in their exports to markets outside the Community between 1992 and 1994 (Table 3).

16. One of the reasons why the impact of production-price changes on export volumes was relatively limited in the case of intra-EU trade is that exporters in countries whose currencies depreciated increased their profits instead of reducing their export prices. For industrial products generally, exporters in certain European countries whose currencies depreciated increased their export margins and did not take the opportunity to expand their market shares. This was particularly the case in Italy and Spain.

The observation period since the beginning of the currency turmoil has, of course, been short (a little more than two years), making it impossible to take account of all the effects. It is probable that not all the direct and indirect effects of the exchange-rate movements have yet been felt. In countries whose currencies have depreciated, exporters' strategies regarding export margins could change. Once their profit margins have been restored, they could adopt a more aggressive strategy in terms of market shares unless, as is often the case after a depreciation, production costs (import prices, wages) rose sharply. In countries whose currencies have appreciated, those exporters who have reduced their margins in order to hold on to market shares could rapidly encounter profitability difficulties. This could jeopardize their capacity to finance investment.

17. The situation varies according to the sector of activity and the degree of competition between producers. The Commission's departments have made an in-depth study of several sectors that were chosen because of their importance in intra-Community trade. It transpires that some of

these sectors are particularly sensitive to monetary fluctuations: cars, textiles and clothing (a sector in which SMEs play an important role) and certain agricultural products. In these three sectors, enterprises from countries whose currency has appreciated have expressed concern to the Commission about the falls in their export margins and the contraction in market shares.

For these sectors, it would seem that countries whose currencies have appreciated have had difficulty in penetrating the markets of Community countries whose currencies have depreciated. Conversely, the latter have generally not improved their positions on the markets of Community countries whose currencies have appreciated, even though some of them have improved their positions on markets outside the Union.

In the case of cars, exporters in those major countries whose currencies depreciated between 1992 and 1994 (Italy, the United Kingdom and Spain) have not increased their market shares to any appreciable extent in those EU countries whose currencies have appreciated. They have instead boosted their profits from the Community market. However, they have performed remarkably well in volume terms in non-member countries of the EU. This is partly explained by lower increases in export prices on markets outside the Community than on markets in the Union.

By contrast, exporters in countries whose currencies have appreciated have encountered difficulties in countries whose currencies have depreciated. This is particularly the case with German and French exports to Italy, where reductions in German mark and French franc prices, entailing an erosion of profit margins, have still not been sufficient to prevent a fall in exports in volume terms. However, the exchange-rate effect seems to be much more marked in France than in Germany, where other factors have affected exports. Unlike the Italian market, the United Kingdom market has remained very active (strong growth of domestic demand). This has enabled French and German exporters to increase their exports to the United Kingdom despite the depreciation of the pound sterling.

It should be pointed out, however, that some of the geographical reorientation of exports observed during the period 1992-94 constitutes a continuation of a trend already established during the period 1987-92 (for example, the decline in the importance of the Italian market for French exporters).

18. In the clothing sector, firms in some countries whose currencies have depreciated (Spain, the United Kingdom and Italy) saw their export volumes increase strongly between 1992 and 1994, particularly on markets outside the Union. By contrast, firms in most of the countries whose currencies have appreciated experienced an appreciable fall in export volumes between 1992 and 1994, particularly on the Community market (cases of France and Germany).

Trends in this sector over the period 1992-94 are at odds with those discernible during the period 1987-92. In the earlier period, France and Germany recorded higher rates of growth for clothing exports in volume terms than Spain, the United Kingdom and Italy.

19. In the case of agricultural products, the situation is significantly different from other economic sectors, owing to the existence of institutionally set prices and aid, fixed in ecus, and of "green" exchange rates used to convert these amounts into domestic currencies. In principle, movements in these "green" exchange rates follow market-determined exchange rates but, in view of the desirability of stable prices and aid, only with a certain lag.

The effect of exchange-rate movements depends, of course, on whether or not institutional prices exist. For products covered by intervention systems, exchange-rate movements affect the prices of products proportionally, sometimes with the aforementioned lag. Given that institutional prices are the same for all Member States, exchange-rate movements have little impact on trade flows, except sometimes in the short-term. For products not covered by intervention systems, the situation in price terms is comparable to that of non-agricultural products.

Exchange-rate movements affect farmers' incomes and therefore the long-term competitiveness of agricultural products. Besides their effect on prices, exchange rates have a direct impact on aid, which outpaces inflation when there is a strong depreciation or declines when the currency appreciates. However, farmers do benefit from mechanisms designed to protect them against certain shortfalls in aid denominated in national currency and are eligible for compensation for any falls in income consequent upon price reductions attributable to monetary factors.

20. The Commission's departments have examined the trend in trade in two products not covered by intervention systems: vegetables and pigmeat. The effects of exchange-rate movements are clearly dominated by structural factors (such as the growing economic stature of Spain) and by stochastic factors linked to climatic conditions. Thus, in the case of vegetables, Spanish exports to France and Germany had already increased well before the depreciation of the peseta, while the long-term decline in Italian exports to France and Germany was not checked to any significant degree by the depreciation of the lira.

21. In the case of certain services (construction and public works, distributive trades and tourism), surveys carried out at local level show that successive depreciations of the peseta and the lira seem to pose adjustment problems for the economies of certain frontier regions. This is particularly the case for France and Austria. Consumers in frontier regions of countries whose currencies have appreciated frequently cross the frontier to make purchases since the additional transport cost is offset by substantial savings due to price differences. Furthermore, construction firms in countries whose currencies have depreciated benefit from the relatively low cost of labour and are awarded contracts in frontier regions of countries whose currencies have appreciated. Finally, diversion effects occur when tourists in the same region choose to spend their holidays in the area with the lowest prices.

III. ECONOMIC-POLICY IMPLICATIONS

22. In contrast to the stability experienced in the period 1987-92, nominal exchange rates have undergone sharp and significant changes since September 1992. This has often been accompanied by changes of a similar nature in cost competitiveness.

This upheaval is at the root of a number of problems which have arisen, on the one hand, in respect of the operation of the internal market and, on the other hand, in the macroeconomic context. In the case of the internal market, the speed and scale of the changes which have occurred since September 1992 are posing difficult adjustment problems for certain sectors and regions (which had enjoyed cost-competitiveness advantages between 1987 and 1992). Furthermore, the uncertainty arising from these changes may have led to a misallocation of resources in terms of the location of production activities and investment decisions. As regards the macroeconomic context, economic agents have displayed an uncertainty and a wait-and-see attitude - particularly following the 1995 currency fluctuations - which have had a negative impact on investment and growth. In addition, the reduction in growth in countries whose currencies have appreciated is having a relatively major impact on the EU given their weight in the Union.

These problems affecting the operation of the internal market and growth have been made all the more difficult to handle by the fact that the Community economy was experiencing cyclical recession in 1993.

23. However, trade movements measured over the entire period 1987-94 show that the exchange-rate fluctuations recorded since 1992 have not hitherto been of major importance at the aggregate level. Over the long term, structural factors have played a clearly dominant role: accession of Spain and Portugal, decline in Germany's relative export weight accentuated by the unification process, increased export orientation of the French economy, etc.

24. However, the suddenness and scale of the exchange-rate movements since September 1992 entail - because of the adjustment problems they have created - a number of risks for the operation of the internal market. Some firms are tempted to erect barriers to trade, while the public authorities come under pressure to intervene to help sectors or regions particularly affected.

25. With regard to corporate behaviour, firms may be tempted to introduce trading restrictions to protect their margins. In the car industry, widening price differentials between Member States linked to exchange-rate movements have led consumers in frontier regions to cross frontiers to buy their cars. Since the beginning of 1995, the Commission's departments have received numerous complaints regarding alleged refusals to sell to non-national consumers or the possible rationing of such sales. These complaints will be analysed in the light of the Community rules in force, and in particular the Regulation on selective distribution. At the same time, the distributors' associations have drawn attention to the financial problems facing some of their members.

26. The public authorities in countries whose currencies have appreciated are coming under pressure from the sectors or regions most affected to rectify the situation. This applies particularly to textiles, clothing, shipbuilding, cars and frontier regions bordering Spain or Italy. Such pressure can only intensify if there are further devaluations.

Any policy designed to compensate for currency fluctuations through specific measures might lead first to an escalation of public expenditure, with each Member State reacting to the measures of others by providing new national support. Such an escalation would be particularly damaging to public finances and will, in the final analysis, serve only to aggravate the difficulties faced by the firms concerned. Furthermore, such fluctuations are essentially a temporary phenomenon in which winners and losers are constantly changing. Finally, even within a given sector, it is extremely difficult to determine the precise nature of the damage caused by a devaluation: while some market segments may be permanently affected, others may retain key comparative advantages.

For some time now, the Community and its Member States have implemented structural adjustment mechanisms to facilitate the transition of sectors or regions confronted with structural difficulties: for example, the Structural Funds and certain Community initiative programmes; ECSC funds for the conversion of certain industrial areas; state aid for rescuing or restructuring industries; regional aid, such as that subject to Commission frameworks or codes.

It cannot be ruled out that severe currency turmoil can make sectors or regions already affected by structural or cyclical crises even more fragile. However, monetary fluctuations cannot be used to justify any violation of Community mechanisms or rules. If these fluctuations were to aggravate the difficulties of a sector or region appreciably, their effects would be examined, like the effects of any other cause, within the limits of the existing Community rules and mechanisms. In no circumstances shall this examination put into question either the allocation of structural funds between Member States or between objectives, or their programming rules. At any event, the Commission will seek to ensure strict application of the rules governing the functioning of the internal market in its entirety and a regime of undistorted competition.

The introduction of anti-competitive practices in the form of limits on parallel imports or state aid linked to exchange-rate movements (except in the case mentioned at point 19[1]) would clearly contravene Community rules on competition and would not conform to internal-market rules. Such measures risk setting off a process of refragmentation of the internal market, a reduction in intra-Community trade and a slackening of growth in Europe. They would therefore jeopardize the efforts being made to complete the internal market. The internal market is the cornerstone of European construction. The Commission and the Member States must therefore consolidate the internal market and make every effort to prevent such refragmentation.

27. To this end, the Commission and the Member States must work together to establish an area of relative currency stability as an accompaniment to the harmonious development of the internal market. This calls for political will that must be reflected in action at internal and external levels.

28. Internally, currency stability requires Member States to exercise greater discipline. Past experience with devaluations shows that they have not brought lasting success in economic-policy terms. They have a cost in terms of inflation, risk premiums, high interest rates, and, more generally, credibility. The currency turmoil that the EU has recently experienced does not stem from a deliberate wish of certain Member States to make cost-competitiveness gains but from weaknesses in those economies, especially their macroeconomic management.

The solution to the problems posed by currency turmoil therefore lies primarily in the appropriate treatment of such weaknesses, particularly at the macroeconomic management level. In the context of EMU, the convergence process holds the key to preserving the internal market. Furthermore, progress towards convergence serves to recreate a healthy macroeconomic climate which benefits growth and the fight against unemployment. This is one of the pillars of European employment strategy, which also aims to increase the employment content of growth by microeconomic and structural means.

The margin for manoeuvre provided by the current upturn must therefore be exploited to reinforce efforts to consolidate public finances. In this connection, analyses indicate a link between exchange-rate stability and public-deficit levels, with countries whose currencies have depreciated generally showing the highest public deficits. Budgetary consolidation is essential if credibility is to be improved and a sound basis for growth re-established.

The conditions which would permit the introduction of a single currency represent the only

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[1] For the agricultural sector, see Article 42 of the Treaty.

permanent answer to the risks associated with currency turbulence within the single market. Moreover, as requested by the Cannes European Council, it is necessary to examine future exchange-rate relationships between the European currency and the currencies of the other Members of the Union. The Commission is preparing its contribution to the interim report for the Madrid European Council in the light of this request. In this respect, the Commission underlines the importance of ensuring that such relationships are based on reinforced convergence.

29. Externally, it is necessary to promote the coordination and monitoring of economic and monetary policies at international level. Currency turbulence is not simply an internal matter for the Community economies; weaknesses in the dollar tend to create great strains between European currencies. The dangers of the internal market refragmenting therefore increase the need for the Union to speak with one voice in international forums.

Table 1: Nominal effective exchange rates[1] and cost competitiveness[2]

CHANGE (%)	87q1/83q1		92q3/87q1		95q3/92q3		95q3/87q1	
	Nominal effective exchange rate	Cost Competitiveness	Nominal effective exchange rate	Cost Competitiveness	Nominal effective exchange rate	Cost Competitiveness	Nominal effective exchange rate	Cost Competitiveness
BLEU	6.4	3.5	2.7	-2.6	9.9	10.4	12.8	7.5
DK	6.2	21.4	0.4	-3.0	12.6	12.8	13.0	9.5
D	17.5	11.3	3.2	3.0	15.0	16.5	18.7	20.0
GR	-47.4	-15.3	-39.8	13.1	-14.2	12.7	-48.4	27.5
E	-12.0	-6.4	11.0	29.1	-15.9	-16.0	-6.7	8.5
F	-2.8	0.1	0.6	-10.4	11.9	8.7	12.6	-2.6
IRL	-6.7	-19.0	1.4	-23.2	-2.1	-9.0	-0.7	-30.1
I	-8.1	-4.7	-6.8	2.6	-26.4	-26.3	-31.4	-24.4
NL	10.0	-6.3	2.3	-8.4	10.7	4.0	13.3	-4.7
A	11.1	5.8	2.3	-10.4	10.7	9.6	13.2	-1.7
P	-42.8	-7.6	-9.2	18.6	-7.5	6.8	-16.0	26.6
FL	1.7	-1.8	-11.0	-17.3	6.8	0.3	-5.0	-17.1
S	-2.2	3.6	-0.8	13.0	-20.3	-24.1	-20.9	-14.2
UK	-14.9	-12.3	0.3	6.7	-11.2	-6.8	-10.9	-0.6

1 The nominal effective exchange rate allows comparison of the evolution of each Member State's exchange rate with those of other Member States.
2 Real effective exchange rate based on unit wage costs in the manufacturing industrial sector. The minus sign indicates an improvement in cost competitiveness.

Table 2: Export-market shares of EU countries[1]

INTRA-EU	1987	1988	1989	1990	1991	1992	1993	1994
BLEU	11.15	10.92	10.83	10.86	10.53	10.24	11.54	11.37
DK	1.70	1.61	1.53	1.60	1.71	1.82	1.87	1.72
D	30.95	29.82	29.42	28.10	27.51	27.62	24.89	24.26
GR	0.75	0.52	0.59	0.54	0.55	0.60	0.56	0.49
E	3.75	3.99	4.16	4.55	4.92	5.02	5.20	5.48
F	15.18	16.69	16.86	16.93	17.50	17.63	17.34	17.03
IRL	2.00	2.06	2.14	2.05	2.04	2.17	2.35	2.48
I	13.22	12.85	12.82	13.06	12.96	12.43	12.90	12.28
NL	10.06	9.92	10.05	9.78	9.23	9.81	9.73	11.21
P	1.38	1.37	1.49	1.61	1.62	1.70	1.67	1.55
UK	9.86	10.25	10.12	10.90	11.41	10.96	11.96	12.14
EUR-12	100	100	100	100	100	100	100	100

EXTRA-EU	1987	1988	1989	1990	1991	1992	1993	1994
BLEU	5.12	5.45	5.76	5.44	5.34	5.21	5.60	6.00
DK	2.99	2.74	2.56	2.67	2.57	2.66	2.45	2.50
D	38.37	36.57	35.98	36.40	36.99	36.30	35.01	35.16
GR	0.55	0.43	0.53	0.48	0.48	0.51	0.52	0.50
E	3.71	3.81	3.78	3.75	3.93	4.04	4.15	4.13
F	14.65	15.88	16.16	16.12	16.47	16.68	15.74	15.46
IRL	1.00	1.05	1.06	1.07	1.14	1.24	1.51	1.53
I	13.93	13.58	14.36	14.19	13.77	13.80	14.08	14.09
NL	4.81	4.96	4.79	4.68	4.80	5.50	5.60	5.53
P	0.73	0.71	0.81	0.84	0.79	0.82	0.67	0.64
UK	14.14	14.82	14.20	14.36	13.72	13.23	14.67	14.46
EUR-12	100	100	100	100	100	100	100	100

Source: COMEXT (EUROSTAT)

[1] No comparable information is available for the new Member States over this period.

Table 3: The impact of exchange-rate movements on EU manufacturing industry[1]

	PRODUCTION PRICES (in ecus)			TOTAL EXPORT VOLUME			EXPORT GROWTH[2] 1992-94	
	1987	1992	1994	1987	1992	1994	intra EU	extra EU
BLEU	100	99.1	105.1	100	100.9	113.5[3]	5.8	17.9[3]
DK	100	99.4	103.3	100	110.7	102.3	-4.8	7.3
D	100	98.8	104.7	100	91.4	84.3	-6.3	6.1
GR	100	103.8	108.1	100	117.6	98.3[3]	-11.5	12.9[3]
E	100	107.5	96.4	100	136.6	159.9	8.7	17.8
F	100	97.9	98.6	100	118.9	112.5	-2.5	3.6
IRL	100	100.9	100.2	100	134.4	144.9[3]	0.1	23.1[3]
I	100	97.6	87.4	100	89.7	97.9	2.2	14.2
NL	100	95.5	102.1	100	99.4	110.6	9.3	11.7
P	100	138.6	138.7	100	137.1	131.6	0.8	0.9
UK	100	102.7	102.9	100	95.4	96.1	3.6	12.3
EU	100	100	100	100	100	100	0.1	9.2

Source: European Commission

The data on production prices and total export volumes are indexed with base 1987 (= 100) and base the Community average (EU = 100). For example, the figure of 105.1 for production prices in 1994 in BLEU means, by comparison with 1987, that they have increased 5.1% more than the Community average.

[1] No comparable information is available for the new Member States over this period.
[2] Average annual growth rate.
[3] Estimate.