

Annual Edition

International *Economic Trends*



The Future of the Euro

On Jan. 1, 1999, 11 European countries will unite in the European Monetary Union (EMU). They will form an economic bloc with a common currency, the Euro, and a common monetary policy to be made by the European Central Bank (ECB). Undoubtedly, the EMU will be subject to economic (as well as political) pressures that raise doubts about its likely performance and, ultimately, its survival. At this point, however, market evidence in the form of government bond yields suggests the survival prospects of the EMU are good.

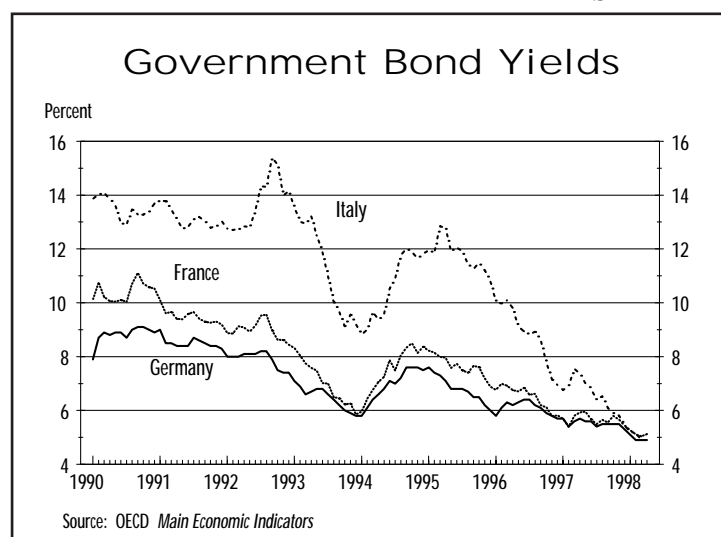
Price stability is the primary objective of the ECB. Conflict concerning this goal is likely to arise among the governments of the member countries in dealing with macroeconomic shocks that affect some countries more than others. Such shocks, which are often best handled by market adjustments, may create pressures for country-specific policies. With the formation of the EMU, however, the member countries give up the possibility of adjusting to shocks through changes in their own monetary policies or by adjusting their exchange rates. Consequently, fiscal policy is the primary interventionist tool available to carry out country-specific adjustments.

For most member countries, however, there is little room for an expansionary fiscal policy to fight a negative, country-specific shock. In 1997, only Finland, France and Luxembourg had a ratio of public debt to GDP of 60 percent or less, meeting one of the reference values for convergence set down in the Maastricht Treaty. The other eight members meet the Treaty's stipulation that the ratio of public debt to GDP be sufficiently diminishing and approaching the reference value at a satisfactory pace. As the Deutsche Bundesbank points out in its April 1998 Monthly Report, to achieve or maintain compliance with the Treaty in the long term, all EMU members, with the exception of Finland, Ireland and Luxembourg, will need

to enact further budgetary reforms, notably the high-debt countries, Belgium and Italy. It may be difficult to enact expansionary fiscal policy under such restraints.

Will the EMU overcome these challenges? Holders of government bonds believe it will. Most of the outstanding government debt of the EMU members will mature after Jan. 1, 1999. This means that coupon payments and redemption payments will be made in Euros, or, should the Euro fail, in national post-Euro currencies. If the expected inflation rates of these potential post-Euro currencies differ, the bonds of the countries with the higher expected inflation will have to offer higher yields. Based on historic differences in inflation rates among the EMU members, investors will demand a risk premium for holding government bonds of countries with high expected inflation if they think that the Euro is likely to fail. The government bond yields of three selected EMU member countries (France, Germany and Italy) show that they have converged considerably (see chart). This indicates that, based on the expectations of the market participants, the odds of the Euro's survival are good.

—Frank A. Schmid



Views expressed do not necessarily reflect official positions of the Federal Reserve System.

