

## The EMU and Sweden — an introduction

Harry Flam\* and Lars Calmfors\*\*

The seven articles in this issue all deal with various aspects of the EMU and of Swedish participation in it. They were written as background studies for the Swedish Government Commission on the EMU. The commission published its report—in Swedish—in November 1996 (*Sverige och EMU*). An updated and somewhat revised English-language edition was published in July of this year (Calmfors et al., 1997).

The commission's report draws heavily on various background studies (21 in total). Six of the studies made up the previous issue of the *Swedish Economic Policy Review*. The present seven studies deal with a variety of subjects: the history of international monetary systems and monetary unions, the overall costs and benefits of the EMU, the importance of symmetric versus asymmetric macroeconomic shocks in Europe, the endogeneity of optimum currency areas, the labor market and the EMU, and exchange rate uncertainty and the EMU.

**Michael Bordo** and **Lars Jonung** examine the development of macroeconomic variables (real GDP per capita, inflation, long-term interest rates and money supply) under the different international monetary systems that have been in operation since the 1880s. The gold standard of 1880-1914, with a credible commitment to maintain the value of national currencies in terms of gold, is found to be associated with a relatively high degree of nominal stability (stability of inflation, money-supply growth and the long-term interest rate) and a low degree of real stability (stability of real GDP). In contrast, the period after 1973, when major currencies have been floating without

\* *Member of the Economic Council of Sweden and of the Swedish Government Commission on the EMU. He is also Professor of International Economics and Deputy Director at the Institute for International Economic Studies, Stockholm University.*

\*\* *Chairman of the Economic Council of Sweden and of the Swedish Government Commission on the EMU. He is also Professor of International Economics and Director of the Institute for International Economic Studies, Stockholm University.*

a nominal anchor, is associated with a large amount of nominal instability. This is what one would expect from theory. However, the Bretton Woods system of fixed exchange rates, which was a dollar-gold standard but lacked a credible commitment mechanism, was characterized both by a high degree of real stability and a high degree of nominal stability.

One lesson that Bordo and Jonung draw from their study of the history of international monetary arrangements is that fixed but adjustable exchange-rate systems, such as Bretton Woods and the European exchange-rate mechanism (ERM), break down ultimately under conditions of free capital mobility. They present the standard argument that fixed exchange rates, free capital mobility, and monetary policy autonomy are incompatible. According to this view, the choice is between floating exchange rates, with the freedom to pursue an independent monetary policy, and irrevocably fixed exchange rates without monetary independence, as in a monetary union.

**Jacques Mélitz** reviews and assesses the empirical evidence about the overall benefits and costs of the EMU. According to the European Commission, switching from national currencies to a common currency will bring resource savings of about 0.4 per cent of GDP in the EU countries. Mélitz argues that this estimate is conservative, because the common currency is likely to open up new profit opportunities in the banking sector.

Mélitz also argues that the empirical finding that exchange-rate volatility has little or no effect on international trade and investment cannot be used as evidence that monetary union will not have substantial effects. Usually, the comparison has been made between floating rates and various kinds of fixed rates that have been propped up by capital controls. No such controls will exist in the monetary union. So the reduction in exchange-rate uncertainty may have a greater effect on trade and investment among union members and consequently bring social gains, besides the savings in currency-transactions costs.

The macroeconomic effects of losing monetary independence with a common currency are usually seen as largely negative. Mélitz does not agree with this assessment. He sees several reasons for why monetary independence is less important for stabilization than is commonly thought. Monetary union avoids the non-cooperative outcomes that national monetary policies may lead to. Furthermore, many of the shocks stemming from goods markets are too industry

specific to be dealt with by monetary policy. In cases where monetary policy can be useful, information problems stand in the way, and often policy mistakes are made. Automatic fiscal stabilizers will continue to play an important role in Europe.

Méltiz also sees several reasons for why monetary policy may be of limited usefulness in the case of adjustment to permanent shocks. The reason is that monetary policy may prevent or slow down necessary adjustment. Labor mobility is an important adjustment mechanism in Europe, contrary to the common perception, even though geographical mobility is lower than in the U.S.

Although the expected value of monetary policy independence may be negative, one cannot overlook that there is a small risk of large shocks, such as with German re-unification. In such situations, a nominal exchange-rate adjustment can be very useful. Méltiz therefore sees the possible need for some form of insurance among the members of the monetary union in the form of a system that allows inter-country transfers in the case of asymmetric shocks.

According to the theory of optimum currency areas, the appropriate size of an area with a common currency depends on the degree of synchronization of output fluctuations in different countries. **John Hassler** examines this issue and studies output behavior in the EU countries in 1975-95.

Hassler finds that business cycles and underlying macroeconomic shocks have been highly correlated in a core of EU countries, consisting of Austria, Belgium, France, Germany, and the Netherlands. Earlier, Sweden has exhibited quite a low correlation with other EU countries. A similar picture applies, for example, to Finland. Hassler also examines the extent to which output shocks in the various Swedish regions co-vary with shocks in other EU countries. He finds no major differences between regions.

Hassler is careful to point out that studies of historical business-cycle patterns may have little to say about future developments inside the monetary union. A common monetary policy and common fiscal rules may reduce the amount of country-specific shocks to the extent that in the past, these have been induced by policy. But clearly, the need for adjustment in this respect will be larger for Sweden than for many of the other EU countries.

**Per Jansson** analyzes the same issues as John Hassler, but tries to identify the relative importance for macroeconomic fluctuations of components that are common to several countries and components

that are country specific rather than to look at pairwise correlations of shocks between countries. He also surveys earlier studies on the relative importance of common and country-specific shocks.

Jansson's conclusions are similar to Hassler's. He identifies a similar core group of EU countries, where common shocks seem to be the relatively most important ones. According to his study, Denmark, Finland, Ireland, Sweden, and the UK do not seem to belong to this group. Jansson also finds some evidence that the country-specific shocks tend to be supply shocks rather than demand shocks. This could be taken to suggest that a significant amount of country-specific shocks will also remain in a monetary union. (Demand shocks will be eliminated to the extent that they have been caused by diverging national monetary policies, but a common monetary policy is not likely to reduce the amount of country-specific supply shocks.)

**Jeffrey Frankel** and **Andrew Rose** argue that the optimal currency-area criteria are endogenous. Countries that do not form an optimal currency area *ex ante* may do so *ex post*, after a common currency has been introduced. The reason is that the degree of symmetry of macroeconomic shocks and cycles among countries is a function of the extent of trade among them. One factor that determines the extent of international trade is trade barriers. Changing to a common currency means that barriers to trade in the form of transaction costs and exchange-rate uncertainty are reduced and consequently means that trade is likely to increase.

Frankel and Rose especially focus on the question of whether or not increased integration and trade is likely to cause macroeconomic shocks to become more synchronized. The Krugman (1993) hypothesis is that more integration will lead to more specialization and thus to less of synchronization among the countries in question. The alternative hypothesis is that trade links will transmit shocks from one country to another, and as a consequence, lead to more of synchronization. The empirical data examined in the paper clearly favor the latter hypothesis.

**Christopher Pissarides** studies the implications of the monetary union for labor markets. His starting point is that participation in the union requires more of labor-market flexibility, *viz.* more flexibility of nominal wages. The demand for more nominal-wage flexibility follows from the need to have a substitute both for exchange-rate changes in the case of country-specific shocks and for variability in

inflation as a means of achieving real-wage adjustments in the case of common shocks.

Pissarides finds similar patterns of asymmetric versus symmetric shocks as does Hassler and Jansson. He does not find strong evidence that exchange-rate restrictions lead to more nominal-wage flexibility. But low and stable inflation—as is to be expected in the monetary union—is likely to contribute to less nominal-wage flexibility, whereas more frequent macroeconomic shocks may work in the opposite direction.

Pissarides is skeptical about coordination of labor-market policies within the EU that goes beyond establishing common minimum levels for the social safety nets. He stresses the need to let different countries experiment with different policies and to let them adapt to their own particular conditions, but welcomes attempts at a coordinated evaluation of the diverse country experiences.

**Richard Friberg** and **Anders Vredin** review the argument that participation in a monetary union is beneficial because of lower exchange-rate uncertainty. They point out that the effects of exchange-rate uncertainty depend, in a complicated way, on the competitive situation of the firm, the market structure, the conduct of competitors, the degree to which exchange-rate changes are passed on to output and input prices in various currencies, and so on.

As already discussed, empirical research typically finds little or no effect on international trade and investment of exchange-rate volatility. Friberg and Vredin make the point that this is not surprising because in theory, firms may gain as well as lose from increased exchange-rate volatility: in general, it is not clear whether firms' profits are convex or concave functions of exchange rates. Also, exchange-rate uncertainty may not be independent of other types of macroeconomic uncertainty. For example, increased volatility of exchange rates may be linked to decreased uncertainty of other kinds and the net effect on profits may be positive. Ideally, the effect of exchange-rate uncertainty should be studied within a general equilibrium framework that takes all the various effects and interdependencies into account.

## References

- Calmfors, L., H. Flam, N. Gottfries, M. Jerneck, R. Lindahl, J. Haaland Matlary, C. Nordh Berntsson, E. Rabinowicz and A. Vredin (1997), *EMU — A Swedish Perspective* (Kluwer Academic Publishers, Amsterdam).
- Krugman, P. (1993), Lessons of Massachusetts for EMU, in: F. Giavazzi & F. Torres, eds., *The Transition to Economic and Monetary Union in Europe* (Cambridge University Press, New York), 241-261.
- Sverige och EMU, EMU-utredningens betänkande, SOU 1996:158 (Finansdepartementet, Stockholm).