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Comment on Hans Genberg: EMU and the changing structure of macro risks

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Hans Genberg defines macro risks as "fluctuations and unpredictability of output, employment, inflation, and similar variables". In research about business cycles, fluctuations in such variables are typically viewed as the result of shocks (unpredictable events) and transmission (or propagation) mechanisms. Due to the transmission mechanisms, the fluctuations are to some extent predictable, although the shocks are not. The types of shocks emphasised in recent theoretical business cycle models primarily stem from innovations in production technology, monetary policy and to a lesser extent, fiscal policy. Empirical work usually also allows for shocks to the private sector's "aggregate demand". These may be associated, for example, with innovations in financial markets or changes in preferences. Policy makers' objectives and reaction functions (or "rules") are of course among the important transmission mechanisms.

Genberg raises three questions about effects of the EMU. Will there be new sources of shocks? Will transmission mechanisms change? And will macroeconomic policy be made more difficult? I interpret his answers as "yes, yes, and perhaps". I think these conclusions are correct, but I reach them following somewhat different ways than Genberg.

Because the exact sources of business cycles cannot be identified (without strong theoretical restrictions), we really don't have much historical evidence to base our speculations about the future on. This must be kept in mind when reading Genberg's arguments—and my comments. Another important thing to note is that the discussion is concerned with macroeconomic stability, not efficiency. It is quite possible that a more unstable economy is also more efficient. The regulations of financial markets that characterised the OECD countries after World War II, until the 1980s, probably contributed to stability, but at a high cost in terms of lost efficiency. There is usually a trade-off between risk and return, and less risk is not always desirable.

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1. Will there be new sources of shocks?

It is very likely that the sources of shocks to production technology, monetary and fiscal policy, preferences for goods, services, assets, etc., will be different in the future from what (we think that) we have observed in the past. What is the role of the EMU? The EMU clearly involves profound changes in monetary policy and probably also in fiscal policy. Eleven (and later on maybe 15 or more) countries' different monetary policies are turned into one, single monetary policy. In this sense, there will be fewer monetary policy shocks than in the past. Fiscal policy is also supposed to be co-ordinated to a higher extent than before, but each country's fiscal policy will still be a potential, independent source of shocks. Private behaviour is much less likely to be affected by the EMU. Innovations in financial markets will surely lead to different shocks in the future than we have experienced hitherto. But first, this development is a global phenomenon; integration of world markets is associated with financial innovations, and these processes would continue even in the absence of a single, European monetary policy. Second, new financial technologies are often the result of private agents' attempts to handle risk and do not in themselves introduce additional sources of risk. Regarding technologies in the production of other services and goods, endogenous growth theory may lead us to expect that more market integration (and perhaps trade) in Europe can lead to more rapid growth in technology. But is not clear that this also means that there will be more or larger shocks or that the changes are due to the single monetary policy.

A common argument for the EMU is that a common monetary policy will lead to smaller policy shocks, on average, than if each country pursues its own monetary policy. Genberg argues that there is one effect that initially may go in the other direction, and it is associated with the ECB's lack of transparency. I feel less worried about this new source of risk than Genberg.[1] First, the 11 countries that have formed the currency union have not followed very transparent monetary policies in the past, so in that perspective, the EMU may actually contribute to less, rather than more uncertainty. Second, other countries (including Sweden and the UK) argue that they have benefited from increasing the transparency of their monetary policies, and it seems unlikely that the ECB (and the Fed in the U.S.) will

[1] But Buiter (1999) seems even more worried than Genberg.

not adopt similar policies if they have proven to be successful. After all, the ECB has similar objectives to more transparent central banks.

So I find it reasonable to assume that there will be new sources of shocks, but I find no convincing arguments that shocks, on average, will be more severe than in the past (at least not because of the EMU). It is equally plausible that the distributions, which the random events are drawn from, have the same or smaller variance in the future as in the past. But because we are speculating about unpredictable changes, such arguments must be taken with a large grain of salt.

2. Will transmission mechanisms change?

In contrast to the unpredictable shocks, the mechanisms through which the shocks are transmitted to macroeconomic variables, such as aggregate employment and inflation, reflect systematic behaviour of households, firms, and public authorities. I interpret Genberg's arguments as suggesting that there are two particularly important sources of changes in the transmission mechanisms.

Changes in the demand for money. The demand for the individual currencies in EMU countries will gradually decline, and the demand for euros will increase. If the euro becomes an important vehicle currency internationally, there may be a net increase in the total demand for the EMU countries' currency (and a correspondingly lower demand for the US dollar, yen, etc.). But there is a continuing increase in the demand for means of payments other than cash in all countries, and the introduction of the euro may speed up this process in Europe. So the demand for euros will be hard to predict, at least temporarily. In the longer run, it need not be harder to predict than money demand in the EMU countries earlier. Instabilities have been the rule rather than the exception, and it is quite possible that the demand for the larger euro aggregate will be more stable than the demand for the individual EMU countries' currencies.

Changes in monetary policy. A common argument against the formation of the EMU is that volatility in output and employment may go up as the member countries lose their ability to counteract country-specific shocks. The ECB will also put a larger weight on price stability than the member countries' central banks have done in the past, and this may also lead to more output and employment volatility.[2]

[2] See, e.g., Calmfors *et al.* (1997) for a presentation and discussion of these arguments.

Genberg suggests that the common monetary policy will make business cycles *within* the monetary union more synchronised than earlier. He points out that this may lead to larger fluctuations in European countries *outside* the monetary union. If the demand from these countries' export markets becomes more synchronised, the outsiders' exposure to world market fluctuations may increase.

Genberg also expects that the EMU countries will feel less need to have their common monetary policy affected by monetary policies in the rest of the world. Hence, the euro's external value might be quite volatile, and non-members may be more exposed to exchange-rate fluctuations than earlier. I find both of these arguments, which suggest that macroeconomic risk for countries outside the EMU may increase, very interesting. They deserve further study.

3. Will policy be made more difficult?

If transmission mechanisms change, policy will be made more difficult, because past experience will be of limited use. In particular, previous estimates of the transmission mechanisms may not be reliable when it comes to forecasting the future development of, e.g., inflation. So Genberg reminds us of the message in the *Lucas Critique*. Although I fully appreciate the logic of Genberg's argument, I suspect that it may not be very important for policymaking in practice. First, the formation of the monetary union, the Stability and Growth Pact, and similar developments in countries outside the EMU reflect a more pessimistic view on the possibilities of fine tuning stabilisation policies than earlier. The "more cautious approach to stabilisation" that Genberg thinks is warranted may thus be viewed as one of the causes of the EMU rather than as one of the troublesome consequences. Caution is warranted, but not primarily because of the EMU and the changes in transmission mechanisms that it leads to. Second, the forecasts of macroeconomic variables, which policy decisions are based on, typically do not rely on identified transmission mechanisms that have been estimated with a high degree of precision. Forecast errors are rather large and reduced form models and judgements are as important as structural models of the transmission mechanisms. Given this, the changes in such mechanisms that we can expect may only make policymaking marginally more difficult than it already is.

4. Risks in the transmission to the EMU

The section of Genberg's paper, which I find least convincing, is the one that discusses the consequences of currency substitution. Genberg believes that there are incentives for increased use of euros in a country that is expected to join the EMU in the near future, such as Sweden. I would rather consider an early currency substitution as a rather risky endeavour with low expected return. If Sweden joins the monetary union, no large exchange-rate changes between the crown and the euro should be expected. Exchange-rate stability is one of the convergence criteria for membership. Furthermore, nothing suggests that the crown/euro rate is presently very far from a long-run equilibrium rate. Hence, there is not much to win from an early substitution if Sweden will become a member of the monetary union. But if Sweden will stay outside, large swings in the crown/euro rate cannot be excluded (Genberg offers some arguments why), although one would expect that the current policies of the ECB and Sveriges Riksbank, if continued, would produce a rather stable crown/euro rate, on average. So on balance, it does not seem likely that Swedish firms and households would benefit from an extended use of the euro as a unit of account or transactions currency before the decision to join the EMU has been taken. Once the decision has been taken, which most likely will coincide with an announcement of the conversion rate and Swedish membership in the ERM, a rapid substitution should probably be expected. But that would then hardly create problems.

The discussion of the optimal currency denomination of contracts is complicated by the fact that we do not fully understand how price rigidities and exchange-rate fluctuations interact to produce risk. It is, for instance, hard—and maybe not very meaningful—to separate "exchange-rate risk" from other sources of risk.[3] It is also hard to believe that price rigidities, which serve a purpose under one exchange-rate policy regime, would also be optimal under another regime.[4] So Genberg's hypothesis that increased euro pricing would be associated with a larger degree of exchange-rate pass is not as self-evident as it may first seem. The choice of currency denomination and the degree of pass-through are both dependent on market

[3] See Friberg and Vredin (1997) for a review of these issues.
[4] See Friberg (1998) for a theoretical analysis of export pricing and its relation to exchange-rate changes.

structure and the nature of exchange-rate shocks. The effects of the EMU on these matters clearly deserve further study, but my feeling is that no clear predictions can be made at the current state of knowledge.

References

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