

ARE WE READY FOR THE EURO REVOLUTION?

m. dutta, professor of economics, rutgers university, New Brunswick, NJ 08901-1248

The inauguration of the euro on January 1, 1999, under the management of the European Central Bank (ECB) in Frankfurt, has been an epochal economic event warranting a reexamination of the general theory of employment, interest and money. The euro revolution invites students of economics to learn new macroeconomics in its supranational framework, instead of that of the traditional sovereign nation state economies. Indeed, the challenge is to unlearn the macroeconomics we learned earlier.

Much has been written about the fluctuations in the euro-dollar exchange rate. In January 1999 the euro rate was established at \$ 1.1667. In May 2000, the euro reached its recent low at \$0.8895, reversing the downward trend back to \$0.9649 in June, retreating again to \$0.9033 in early August. Thus, the euro is down some 23 percent from its initial value. The story of the euro-dollar rate fluctuations over the past eighteen months must be studied in its proper historical context. How does it compare with the rate of fluctuation of the dollar vis-à-vis other pre-euro Western European currencies, especially the pound sterling, the deutschemark, the frank, the guilder, the lira over the past twenty years? How about the history of the exchange rate fluctuation of the yen vis-à-vis the U.S. dollar? The real issue is not the euro-dollar exchange rate. It is the emergence of the supranational macroeconomic model which warrants a close study.

For the present, eleven EU member states of the European Union (EU) have voluntarily agreed to cease to have typical sovereign nation state economies. Denmark and Sweden have also recently voted to join the euro system, subject to a referendum in each case. The U.K. is the lone EU member continuing the debate “to be or not to be” a member of the euro system.

Monetary sovereignty of the member economies of the euro system has been voluntarily surrendered to the European Central Bank, the legally constituted authority under its independent Governing Council, to exercise monetary sovereignty for all its member economies both in terms of supply of aggregate stock of money and determination of the core rate(s) of interest. Political sovereignty continues to remain vested in nation states. However, many scholars in Western Europe point to institutions such as, ECOFIN, the European Parliament, EU Representation to WTO by one EU designee, Euro system's IMF status, the emerging concept of European defense system, as indicating that

even political sovereignty is in the process being merged into that of the European Union. To learn about the emerging single European political expression will be a complex and difficult process.

Two recent events merit special mention. First, President Chirac's lecture stressing the need for restructuring the EU at the German Parliament on June 27 this year is a milestone in this regard. Second, the constitution of the special committee to be headed by Alexandre Lamfalussy is expected to help expedite the process of organizing the political structure of a single Europe.

Indeed, in my view, the prime factor contributing to the fluctuation of euro-dollar exchange rate is the popular belief that one unified Western European monetary system in the absence of one unified political system is flawed. It is too novel an experiment. There is the issue of credibility and the market response to it is manifest in the recent euro-dollar exchange rate fluctuations. In the United States, the political union came some 150 years prior to the constitution of the Federal Reserve System in 1913 with the authority to manage the nation's monetary policy. In Western Europe, the process begins with the European Central Bank and one currency, the euro, while Western Europe only begins to evolve toward one European political entity.

One more specific factor has impacted on the euro-dollar exchange rate fluctuations. This is the recent appreciation of sterling exchange rate vis-à-vis the U.S. dollar and the euro. With the inauguration of the euro regime, the U.K., an important EU member with great historical significance in the world financial market, elected not to join the system. This decision was followed by a sizeable flow of funds to the sterling market from the dollar- and- yen markets, and possibly also from other oil-dollar rich economies.. The investors were concerned to earn access to the EU market through U.K.'s membership in the EU, while at the same time, retaining their competitive currency-risk edge vis-à-vis the euro. Further adding to the demand for sterling, was the inflow of funds from the euro regime to the sterling regime.

The above chain of events now became responsible for making the sterling exchange rate vis-à-vis the euro non-competitive. Unit cost of production in the sterling regime became higher and made their products in the world market increasingly less competitive. Recently many overseas corporations with sterling investments have experienced disadvantage in terms of cost/price competitiveness. Will these investors be forced by market to relocate their respective investments in the euro regime? Will that expose

the sterling to a depreciation vis-à-vis the euro? Will that lead to the appreciation of the value of the euro vis-à-vis the sterling and the yen? Will that influence the euro-dollar rate? These are issues which remain to be determined.. Will the U.K., plagued by the outflow of overseas funds and a consequent rise in the rate of unemployment and the possible threat of inflation then join the euro system? Will these events bring the euro and the dollar into a new market equilibrium? What impact will be felt on the international value of the yen? Truly, the EURO REVOLUTION raises many crucial questions.

It is important to recognize that in terms of their respective shares of world output and world trade, the EU and the Euro regime (even without the U.K.) and the U.S. and its Dollar regime continue to enjoy a competitive position in the global market. Japan, until recently the world's second largest economy both in terms of her shares of world output and world trade, has now become a distant third and remain exposed to possible risks. It will be a mistake to call the euro system a currency union or a monetary union of independent currencies of sovereign nation states . It is a new supra-national macro-economic framework with one currency and one monetary policy, managed by one supranational central bank. A great deal remains to be learned..

The author, a professor of economics at Rutgers University at its New Brunswick Campus, has recently been a Visiting Scholar with Japan's Ministry of Finance in Tokyo concurrently visiting Bank of Japan, Japan Bank for International Cooperation and several Japanese academic institutions inclusive of Hitotsubashi University in Kunitachi, and with De Nederlandsche Bank in Amsterdam, Der Deutsche Bundesbank in Frankfurt and the Banque de France in Paris, plus a visit with the ECB in Frankfurt.