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SPEECH

McDonough: A U.S. Perspective on Economic and Monetary Union in Europe

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Remarks by President William J. McDonough before the Association of German Mortgage Banks

Good evening ladies and gentlemen, Herr Dr. von K"ller. I am honored to be invited by the German Mortgage Banks to be the keynote speaker tonight at the Association's annual Pfandbrief Forum. It is a great pleasure to be here in Frankfurt among so many distinguished representatives of the German banking and financial community and members of the Bundesbank Council.

In my remarks to you this evening, I would like to offer a few thoughts on the implications of Economic and Monetary Union in Europe from my perspective as President of the Federal Reserve Bank of New York. Many in the United States today are following developments in Europe's move toward monetary union with considerable interest. I am certainly among them.

There can be no doubt about the magnitude and economic importance of the historic event that will take place on January 1, 1999, when the currencies of up to 15 member countries of the European Union are scheduled to be unified. It is a goal toward which Europe has been working ever since the Treaty of Rome was signed in 1957 creating the European Economic Community. While some might claim that this historic development will have little impact on the U.S. economy, nothing could be further from the truth.

The United States will be directly affected in several important ways by the start of Economic and Monetary Union in Europe, or EMU. I would like to review some of the main channels through which EMU is likely to affect American business and policymaking over the next several years. Further, I think it may be useful to highlight some of the important similarities and differences between the currency union that exists in the United States today and the currency union that you are in the process of creating in Europe.

The most obvious implication of the start of EMU for the United States--as well as for the world community--is the coming into existence of a new currency, the euro, which is intended to function as a major international currency alongside the U.S. dollar. I should make clear at the outset that it would be a mistake to think that the United States looks at this prospect with concern, as if the introduction of the euro could somehow compromise the ability of the United States to continue to conduct trade and financial transactions with the rest of the world.

As you well know, the dollar is currently used in roughly 50 percent of world trade transactions and in at least one side of 80 percent of world financial transactions. The introduction of another major international currency will neither harm the depth and liquidity of the dollar market nor hinder the ability of the United States to conduct its external transactions smoothly. On the contrary, to the extent that the birth of the euro fosters deeper trade and financial markets globally and a more efficient international monetary system, all countries stand to benefit, particularly an active participant such as the United States.

Let me be more specific. In my view, for the United States and the international monetary system, the implication of a growing international role for the euro over the foreseeable future will be most significant with respect to financial rather than trade transactions.

It is quite true that the euro may quickly become the currency of choice in the invoicing of trade between companies in the European Union and their foreign counterparts. Companies in regions with strong links to the European Union, such as those in eastern and central Europe, North Africa, and the CFA French franc zone, may also choose to invoice trade in euros. More generally, the euro may well expand its importance in world trade beyond the relative trade weight of the European Union countries, following a path similar to that taken by the U.S. dollar and--before that--by the pound sterling.

Nevertheless, I would argue that the economic effects of these potential changes in invoicing practices are likely to be limited. Why do I say this?

First, to a large extent, the re-denomination of a significant share of world trade into euros will mainly represent a shift in invoicing practices from the use of former European currencies to euros. Moreover, third-country effects are unlikely to be major, because the European currencies as a whole are already somewhat over-represented in their share of world trade transactions relative to their countries' weights in world trade--not as much so as the dollar, but certainly more so than the yen.

Finally, changes in trade invoicing practices have a direct economic impact only on the two parties involved in the transaction, and these effects are limited to determining who ultimately bears the exchange rate risk. In fact, because of the wide variety of risk-hedging instruments that are available to traders exposed to exchange rate fluctuations, the impact of exchange rate risk on trade patterns is likely to be secondary. This conjecture is confirmed by a substantial amount of empirical research.

In short, the economic impact of the euro in international trade transactions is likely to be limited. The same cannot be said of the euro's potential role in international financial transactions.

Partly because of their sheer magnitude--some estimates place the volume of international capital transactions at more than 40 times the volume of international trade transactions--growth in the use of the euro as the currency of choice in global capital markets will have much more significant repercussions for the United States than will increasing use of the euro in global product markets. To a large extent, these repercussions reflect the well-known gains that stem from increasing returns in the use of a currency as a store of value. As the market for a currency becomes more liquid, the costs of carrying wealth denominated in that currency fall, raising investors' preferences for denominating their portfolios in that currency. These increased preferences in turn lead to a further deepening and broadening of the market for that currency, costs of holdings are reduced further, and the process continues.

As in trade transactions, the dollar is the predominant means of exchange in international financial transactions. Its predominance is especially apparent with respect to large issues of international bonds--a clear reflection of the low cost of covering exchange rate and interest rate risk for long-term dollar instruments.

I would suggest, however, that the current role of the dollar should not be taken for granted. Once the euro comes into existence, the simple conversion of the EMU countries' outstanding securities into euros will contribute to the immediate creation of a major securities market.

This development alone will create a critical mass for a market in euro-denominated securities. It will give the market depth and liquidity, and, in so doing, bring down the costs of conducting transactions, issuing loans, and trading securities below those currently seen for European national currencies--possibly to levels comparable to those for dollars. The development of such a virtuous cycle could well feed upon itself and lead to the continuous growth of the market for euros.

In this context, I would like to suggest that the experience the United States has had with a large, unified capital market may point to ways in which a unified European capital market may evolve after the advent of EMU. If the U.S. experience is of any relevance, we may expect to see a decreasing use of bank loans in favor of a growing use of securities in Europe after 1999.

Repo markets would also likely grow, potentially along the lines we have seen in the United States, where institutional investors such as mutual funds and pension funds, state and local governments, and insurance companies have become the largest providers of capital under repo arrangements--in contrast with Europe's experience, where these types of investors tend to hold bank deposits. A growing role for repurchase arrangements is already apparent in Europe, and this growth may be expected to accelerate once the European central bank starts to operate in this market, accepting--and fostering--the use of a wide range of government paper as collateral.

It is useful to keep in mind that the move to a single-currency, highly securitized European capital market cannot be expected to be completely painless. Clearly, since banks are the main intermediaries of cross-border transactions, the banking sector will bear the brunt of the costs associated with the changeover to a common currency. For example, it will suffer losses from reduced foreign exchange trading and transfer revenues. It will also have to pay for the retooling of information management and delivery systems, as well as face increased uncertainties in its core deposits.

At the same time, however, the larger single market will create new opportunities for banks, particularly in the areas of investment banking and the cross-border sale of deposits, mutual funds, and other savings products. On balance, it seems fair to conclude that the commercial position and earnings of many European banks are likely to come under pressure. This may accelerate the ongoing restructuring of Europe's banking industry, a process that has been confined, to date, primarily to developments within each country.

More broadly, there can be no doubt that the implications of the growth of a more efficient and cost-effective market for euro-denominated capital would extend well beyond Europe. The availability of a new, low-cost channel for portfolio investment, for example, could help reverse the traditional reluctance of households and many institutional investors worldwide to invest internationally--a reluctance that has long puzzled academics and policymakers.

Moreover, a well-developed market for euro-denominated capital would encourage institutional investors from the United States and elsewhere to acquire diversified European portfolios offered in a single currency. In fact, this development could be accelerated if member governments chose to deepen the euro market by increasing the available range of bond maturities, which in some countries is somewhat limited at the short and long ends. In addition, capital might also flow in the opposite direction, as non-European firms and governments tap the euro-denominated capital market as an efficient source of funds, in the same way as European businesses and governments have chosen to borrow dollars in recent decades.

While the potential benefits of a more integrated European capital market in the long run are apparent, a number of observers have suggested that the economics of EMU--as well as its plain mechanics--may have unwelcome consequences for the dollar and world trade. More specifically, some have argued, EMU may cause a short-run glut of dollars in the international capital markets, leading the dollar to depreciate and the euro to appreciate, with resulting undesirable effects on trade flows.

The reason there could be a dollar glut, these observers maintain, is that EMU would eliminate the need for intra-European intervention, reduce the importance of exchange rate management, and allow national central banks to pool reserves for external intervention, thus generally reducing the European central bank's need for dollar reserves. Moreover, if the euro were to become an attractive reserve currency for non-European central banks, the dollar glut could become even more severe.

While some decline in the reserve role of the dollar is certainly plausible over time with the creation of EMU, I believe that the risk of a dramatic shift in official dollar reserve holdings both in and outside Europe in the wake of EMU has been exaggerated in terms of both its potential scope and effects.

I would suggest that it will take some time before the objectives and operating procedures of the European central bank become clearly understood by market participants. Although low inflation will be the ultimate objective of the new European central bank, markets will have to understand precisely how that objective will be pursued: What price aggregate will be the focus of monetary policy? How will intermediate instruments such as monetary aggregates be used to achieve the ultimate objective? What channels will the central bank choose to signal and implement changes in its policy stance?

As these longer term questions are addressed, the policy importance of the external value of the euro, particularly the euro/dollar exchange rate, will certainly be watched carefully. Both market participants and foreign central banks are likely to focus on the euro exchange rate as a high-frequency and widely available--if somewhat noisy--indicator of the current and likely future stance of European monetary policy. Given its need to instill confidence in the markets and to ensure the stability of the euro exchange rate, the European central bank is likely to want to be perceived as ready and able to operate effectively in the dollar market, for which substantial dollar reserves may be required.

In the short term, the response of non-European central banks to the introduction of the euro is also likely to be cautious. Ultimately, the desired euro holdings of these central banks will largely depend on the decisions they make about their exchange rate regime. A number of countries--including the central European countries that have applied for membership in the European Union and other countries in Africa--may decide to peg their currency to the euro. Yet these countries may well wait for the newly formed European central bank to establish its policy record and clarify its operating procedures before they commit their currencies to a euro peg. Indeed, history suggests that a currency's role as an international reserve, means of exchange, and store of value is slowly gained and slowly lost--as the examples of the dollar and pound sterling illustrate. The dollar, in particular, may have seemed on the way to losing much of its international prominence after the demise of the Bretton Woods system in 1973. After declining as a share of international reserves and a means for international transactions from 1974 to the mid-1980s, however, the dollar's relative use has not changed significantly during the past decade.

Indeed, as the U.S. economy has grown more efficient and internationally competitive in the past ten years, the dollar has retained its strong role in the international monetary system. In short, it seems safe to assume that significant changes in the international role of the dollar and the functioning of the international monetary system would occur only gradually, and surely in a manner that could be easily coped with, given the turnover in capital markets we observe today.

But should a different international monetary system ultimately emerge in which other currencies, such as the euro, play an increasingly important role alongside the dollar, there would be benefits for the United States as well. Such a development would, for example, impose greater market-led discipline on the United States and, in the process, help us address our chronic low-savings problem.

There is another indirect--although potentially more important--way in which EMU may affect U.S. business and policymaking. This implication of EMU has to do with the contribution a currency union is likely to make to increasing the efficiency and flexibility of the economies that join it. At least since the publication of the "One Market, One Money" study by the European Commission in 1990, observers and analysts of EMU have paid significant attention to the decline in transaction costs that can be achieved by unifying up to 15 different currencies, and to the resulting gains in efficiency for Europe's economies.

The experience of the United States is useful in this respect. The fact that 50 states in the United States share a common currency--and have done so for over 130 years--provides the critical foundation for an integrated and efficient capital market that extends from Maine to California and on to Alaska and Hawaii. In this market, capital flows smoothly from high-saving to high-investment areas, as required by changing business conditions, without any thought of exchange rate risk.

A common U.S. currency, it is important to note, has many advantages beyond simply reducing transaction costs. It also simplifies choices for households and corporate management, enhances the efficiency with which financial institutions and the payments system function, and promotes competition across the whole productive spectrum.

While a common currency in Europe can be expected to lead to similar efficiency gains, the economies of the United States and Europe differ in several important dimensions, so that a common currency is likely to work in substantially different ways in the two regions. The ways in which Europe and the United States differ most have to do with the degree of integration of their labor markets and their fiscal systems.

The United States enjoys a very mobile labor force--across sectors and states--which allows job losses arising during sector-specific or state-specific recessions to be rapidly absorbed where jobs are growing faster. This contributes to aggregate unemployment being kept reasonably in check. This willingness of American workers to move themselves and their family is a cultural characteristic of our people, no doubt based in the history of the United States as a nation of immigrants.

To complement its high degree of labor mobility, the United States also has in place a federal fiscal system that allows the federal government to channel large transfers from fast-growing regions to slow-growing regions. Progressive income taxation, a high elasticity of corporate tax profits to changes in income, and an integrated federal budget are the main components of this system.

In contrast to the United States, Europe is characterized by a more segmented labor market and very limited integration of its national fiscal systems. Both these characteristics limit the ability not only of Europe's private sector to shift resources in response to regional recessions but also of Europe's public sector to compensate for this rigidity. This lack of flexibility is widely acknowledged to be one of the root causes of the high unemployment rates that Europe has experienced during the last decade.

But, we may well ask, does it necessarily follow that because of the greater rigidity of its labor markets and the lack of a federal fiscal system, Europe cannot accommodate a common currency and instead needs to rely on periodic exchange rate adjustments as surrogates for productive flexibility? I do not think so. While less flexible labor markets and the absence of a federal fiscal system will certainly pose constant challenges for the management of a common European currency, a fluctuating exchange rate need not be the optimal way to respond to these shortcomings.

The argument that Europe--even a core component of Europe--can ill afford to renounce exchange rate flexibility rests crucially on the view that Europe is significantly more heterogeneous than the United States and, therefore, more vulnerable to country-specific shocks that can best be corrected by exchange rate changes. I do not support this view. Rather, I believe that in many respects differences among the European economies have been over-emphasized in the public debate.

It is possible to suggest, for example, that the economies of some European countries have more in common today than do those of some individual states in the United States, such as New York and Michigan or California and Idaho. Moreover, as a result of the convergence of economic policy objectives, the economic cycles among many European countries have become more synchronized over the last ten years, a trend that is likely to be reinforced by monetary unification. Furthermore, when shocks are mainly at the industry level--for instance, when a recession hits the automobile or steel industry in Germany and France--the German and French economies would hardly benefit from an exchange rate change. Such a change, in this case, simply would not affect the appropriate relative prices.

By contrast, American policymakers might have found it helpful to devalue the dollar in Texas when oil prices collapsed in the mid-1980s or the dollar in New England at the end of the defense-led growth of the late 1980s. These options, however, simply were not available. In retrospect, it was the discipline fostered by the absence of the opportunity to alter regional exchange rates that forced our firms, local governments, and workers to reorganize, become more efficient, and grow in what are now some of the most productive areas of the United States.

Similarly, if national labor markets in Europe become more flexible and efficient in the presence of a common currency and firms learn to count only on their own resources--with no help from an occasional exchange rate adjustment--European capital and labor markets may themselves become more integrated. And if greater integration of labor markets can only proceed slowly--given persistent and unavoidable cultural and language differences--this need not be the case for financial markets, where the disappearance of exchange rate risk will cause capital to move in response to interest rate differentials of only a very few percentage points.

In this context, I would like to make clear that I do not view as ideal the U.S. model where the burden of recessions tends to fall heavily on the shoulders of workers, who may be obliged to move across regions and industries in response to the business cycle. How to deal with the reality of the business cycle is an area where Europe--with its tradition of social safety nets--and the United States--with its tradition of flexible work arrangements--can perhaps learn something from each other. To date, neither of us seems yet to have found the optimal way to cope with the unavoidable reality of the business cycle to enable us to avoid both high unemployment rates and too skewed a distribution of income.

My last general observation about the implications of EMU for the United States has to do with the dramatic changes in macroeconomic policies that will accompany the creation of monetary union in Europe. Naturally, the main change will concern monetary policy, and it is in this area that the similarities between Europe and the United States will ultimately be the greatest.
The first similarity is that, with EMU, the formulation of monetary policy in both Europe and the United States will be highly centralized and the European central bank will enjoy, as the Federal Reserve does, a considerable degree of independence. These institutional features will reduce the scope for national governments to bend monetary policy to the needs of their country's business cycle and will help keep the focus of the European central bank on the objective of price stability.

The second similarity we may expect to see between Europe and the United States is that, with EMU, external considerations--such as the trade balance or the value of the exchange rate--will over time impinge less and less on the conduct of monetary policy, as now is the case in the United States. Once monetary union is in place for all 15 countries, the openness of Europe's unified economy--as measured, for example, by the share of exports in relation to GDP--is likely to be quite similar to that of the U.S. economy, on the order of 10 percent.

While the conduct of monetary policy in Europe may increasingly resemble that in the United States, the conduct of fiscal policy will continue to differ significantly in the two regions, largely reflecting the different paths Europe and the United States have taken to monetary unification. In the United States, political union came well ahead of a common monetary policy. The Federal Reserve was not created until 1913, when political unification had been long in place. The situation is, of course, quite different in Europe, where EMU member countries plan to retain substantial political and fiscal independence.

Despite this independence, EMU may well foster fiscal coordination among the member countries. This may happen in part because the EMU countries have chosen to subscribe to a set of common guidelines on the magnitude of their fiscal deficits, and in part because these countries will compete for a common pool of savings in an integrated capital market.

The prospect of market-based discipline on the fiscal policies pursued by the EMU countries is not so different from the situation faced by individual states and municipalities in the United States. The need for these entities to tap a common capital market to finance their deficits places their actions under a stricter market test than they would face if they could rely mainly on captive local savings. The municipal bond market in the United States is today a very active and competitive market, where yield differences on public debt reflect investors' perceptions of default risk, and inefficient state and local administrations are quickly penalized for fiscal profligacy.

Similar markets are likely to evolve in Europe after 1999. In fact, the major rating agencies are already planning for European issues of government debt following the creation of EMU. By all accounts, the agencies expect these ratings to mirror those currently assigned to countries' foreign currency debt, with fiscal factors driving rating changes once EMU is well under way.

As I hope I have made clear in my remarks this evening, we in the United States, as elsewhere, have been observing the progress toward monetary unification in Europe with great interest. In the process, I think we have learned to appreciate the complexity of this enormous undertaking. One conclusion I have drawn from my observations over the years is that many of the reforms Europe is pursuing on its path to monetary unification--including fiscal stabilization, tax harmonization, welfare and labor market reform, trade liberalization, and capital market integration--are goals that are worth pursuing in their own right and for which EMU provides a consistent frame of reference.

Continued progress toward furthering these broad-based goals is in the interest not only of Europe but also of the United States. There can be no question that the United States has benefited greatly in the past two decades from Europe's deepening integration. Europe has provided a steady opening of markets for American products and served as a source of an increasingly efficient supply of goods to U.S. households and firms. Europe's growing participation in international capital markets, which a successful EMU and a strong euro are intended to further, has also encouraged an increasing flow of savings between Europe and the United States in response to changing macroeconomic conditions in our two regions. We in the United States have much at stake in Europe's and EMU's future and we stand ready to work with you and support you in the furtherance of your historic efforts.

Thank you.