# ASPECTS CONCERNING THE MANAGEMENT OF THE MONETARY POLICY IN THE EUROPEAN UNION SPACE

Daniela GIURESCU, Lect., PhD.
University of Craiova

**Keywords:** exchange rate, monetary policy, coordination.

**Abstract**: The cooperative management of exchange rates through monetary policies has been the major focus of attempts at coordination and of much of the analytical literature since the collapse of the Bretton-Woods system of fixed exchange rates.

Exchange rate management is no longer seen as anathema, as the experience with the floating rates in the 1970s and the first part of the 1980s is not viewed as particularly successful (empirical evidence suggests, for example, that inflation persistence is greater in flexible exchange rate regimes).

In addition, since the exchange rate is a variable shared by at least two countries, it is a natural focus for coordination.

Coordinated exchange rate management had a high point in the late 1970s; thus, in November 1978 the Group of Three industrial countries intervened heavily to halt the depreciation of the dollar, while in 1979 and early 1980 the United States intervened to halt the dollar's appreciation, by selling dollars and acquiring substantial exchange rate reserves. Since then, the resolve of the Group of Three Industrial countries to stabilize exchange rates has been diluted. The consequences of events in Eastern Europe brought some of the worst failures in the coordination of monetary and exchange rate policies of recent years.

## 1. Exchange Rate Management in the European Monetary Union

Will European Monetary Union and the creation of the euro create more pressure for exchange rate management, or will it allow the maintenance of "benign neglect" about exchange rates?

Analytical models suggests that more symmetry may generate instability in the international monetary system. If one economy is much larger and more closed than others, it will be quite probable to act as a leader, using the money supply as its monetary policy instrument, without regard for its nominal exchange rate. It could be registered an equilibrium in which the large economy sets its money supply while the small economies intervene to affect their nominal exchange rates. If another major player were to emerge, however, in the absence of full cooperation, the greater symmetry could lead to instability. Both economies will have an incentive to try to use exchange rate policy, as their bilateral exchange rate vis-à-vis the other large country matters more, and in such a case instability will arise.

Thus, in the presence of large shocks we may see both economies trying to manipulate their exchange rates, that is, use beggar-thy-neighbor monetary policies, in which case there is a reversion to flexible exchange rates. When the size of the *N*the country is much larger than that of the other country (or countries), so that bilateral exchange-rate fluctuations do not significantly affect the *N*th country's output and real income, a regime of managed rates does not display the instability that characterizes the symmetric case. The results suggests that the greater symmetry that European Monetary Union will imply for the international monetary system may result in greater difficulty in managing exchange rates internationally.

It may well be that is not practical in today's circumstances to move away from fully flexible exchange rates. This has less to do with asymmetries and more with the technological and comunications advances that have speeded up capital mobility and created global financial markets.

What scope is there for monetary policy coordination then? There should be scope for monetary policy interventions that would help avoid the overshooting of the exchange rate of the euro, after the third stage of European Monetary Union starts.

This could be achieved through either monetary relaxation in Europe, following the start of the third stage, or monetary tightening in the United States. Such actions would slow down the appreciation of the euro vis-a-vis the dollar and could help avoid turbulence in the exchange markets. But such a policy would be a difficult task for the newly established European Central Bank to execute. If it went wrong it would risk its anti-inflationary credibility exactly at the time when there would be needed to build it up. On the other hand, the United States Federal Reserve would have less to fear in tightening monetary policy to avoid a sharp dollar depreciation.

In any case, it is difficult to envisage major monetary policy switches in response to the appreciation of the euro after the start of the European Monetary Union.

Such a response would come only if Europe were to face a worsening unemployment problem that would deepen still further following the appreciation of the euro, or if the US economy were expanding too vigorously.

Thus, the introduction of the euro brought about potentially important changes in the international monetary scene, as the euro substitued to a large extent for the dollar as an international means of payment, unit of account, and store of value. Such changes in the fundamentals brought about an increased demand for euros shortly after the introduction of the new currency in international market.

It could be afirm that in the long run it is in the European Union's interest to maximise the size of the „currency region" of the euro, of its international use; in the medium run, it is in the EU's interest to pursue a policy oriented towards the stabilisation of the euro's exchange rate.

The euro's introduction highlights a twofold problem. One the one hand, EU policy-makers face the issue of which „exchange rate policy" to follow vis-a-vis other currencies, especially the dollar; on the other hand, both the European Union and the United States of America have to face the issue of the management of the new international monetary system in a manner quite unlike that of the past.

In the long run, the relevant question is whether the euro will be capable of attaining, as international currency, a weight proportional to that of the European Union in world trade and production.

In this respect and from this point of view, the crucial issue is the management of a bipolar (or tripolar) monetary system where it is no longer evident which currency assumes the „residual" role.

The main problem is whether, and to what degree, the international system provides incentives for cooperation between the United States of America and the European Union. A definitive answer to this question appears complex to say the least, considering the post-war relations in monetary issues between the two largest economies of the international system; this interdependence raises the costs of a macroeconomic conflict which, based on historical experience, could quickly spread from monetary to trade relations.

The „medium run" aspects are, to some extent, less problematic. They are dominated by path-dependency phenomena owing to the presence of multiple equilibria in the relations between key currencies. This implies that it is the medium-run evolution of the euro's external dimension that will, most probably, determine the long-term configuratin of monetary relations, whether the euro succeeds in taking on a global dimension or whether it will be relegated to a regional role.

In the medium run it is in the European Union's interest to pursue a policy aiming at the stability of its currency's exchange rate. This is a desirable objective not only because it would stabilize European interest rates, but also because an „activist" policy, targeted to support the European Union's export competitiveness, would most probably be counterproductive.

The ongoing adjustment of the European Union's public finances underlines dramatically the lack of private investment with respect to savings. A stable external value of the euro in a framework of contained or negligible inflation would allow interest rates to be maintained at low levels, supporting a monetary environment favouring investment and growth; quite the opposite of what occurred during the 1980s and part of the 1990s, when tight monetary policies targeted at containing inflation, in the face of growing public finance deficits and sluggish – if declining – price dynamics, had caused a sharp rise in real interest rates. The new macroeconomic environment would thus be completed by a stable exchange rate for the euro as a necessary condition for a stable interest-rate policy.

It can, of course, be argued that the euro's exchange rate – against the dollar – would depend in part on the behaviour of Europe, and in part on that of the USA. This brings us back to the question of the role of monetary cooperation between the two economies. A preliminary point in this respect is that a policy of stable exchange rate – understood as a „non-aggressive" EU policy – is an important initial condition for a strengthened transatlantic cooperation. Second, it remains to be seen whether forms of managed exchange rates – like target zones – would improve the operation of the international monetary system.

Notwithstanding a „more managed" international monetary system, nontheless, the introduction of the euro does raise the options for EMU's external monetary policies.

Thus, the expansion of the European money market following the introduction of the euro could weaken the impact of US monetary policy on European interest rates.

On the other hand, a stable exchange rate does not – as is sometimes argued – clash with the need to sustain the EU's growth through exports. In the first place, the inclusion in the European Monetary Union of the „peripheral" countries – Italy, Portugal and Spain – does not result in any greater pressure towards real devaluation.

In the second hand, it is the large intra-EU market, rather than exchange rate competitiveness in extra-EU markets, that supports EU countries' exports. This result confirm the intra-industry nature of intra-EU trade and highlights the non-price factors in competitiveness. It follows that intra-EU trade will benefit from the growing integration of European markets as a result of the completion of the single market, of its enlargement and of the introduction of the euro itself.

Also, the independence of European monetary policy will be increasingly strengthened by the process of integration of the euro's financial markets. The introduction of a single currency favours the development of extensive and thick financial markets, even if the (initial) non-participation of the UK were to slow the process down.

The expanded financial market led to greater diversification of financial instruments and greater competitive pressure on the banks from other intermediaries as well as within the banking system. This, in turn, led to greater efficiency of the banking system, lower cost of financing and greater efectiveness of the transmission of monetary policy, even though there will continue to be differences among the EMU's member countries owing to differences among national financial structures.

A summary of the macroeconomic issues implied could lead to a relatively optimistic conclusion. To the extent that a stability oriented macroeconomic policy favours investment and output growth it also favours employment creation. A „simple" macroeconomic approach, however, leaves out many of the elements needed to identify the appropriate policy options for the euro, especially in relation to the issue of unemployment.

It remains to be seen to what extent such a policy is feasible given the underlying structural characteristics of the European Monetary Union.

2. An Integrated Monetary Space – Costs and Benefits

In order to determine this extent, *the benefits* and *costs of a monetary union* should be underline.

The *benefits* from a monetary union increase with the extension of the union, as expressed in terms of either the number of participating countries or of economic size.

The *costs* increase with an increasing diversity of the preferences of the area's policy-makers regarding stabilisation policies.

The costs of Union membership for a country with a high preference for containing inflation increase if other union member share the same preference for output stabilisation oriented monetary policies. In general, the higher the convergence of the member countries' preference for low inflation and stability-oriented monetary policy, the lower the costs.

From this point of view, EMU's composition becomes crucial, but it is equally evident that the process of financial convergence suggests that the costs of the EMU will be quite moderate as even the least disciplined among the Union's members have implemented rigorous anti-inflationary and fiscal reform policies and to the extent that the stability pact will be in force.

It could be concluded that the success of a monetary union depends on the following variables: *the intensity of integration; the convergence of policy preferences towards stability.*

The net benefits will be a function of both the structural and microeconomic features of the Euroland economy as well as of the definition of common or at least mutually consitent economic policies.

## REFERENCES


1. De Grauwe P., (2003) – *Economics of Monetary Union*, Oxford University Press, Forth Edition;

2. Eggertsson G., Woodford M., (2003) – *Optimal Monetary Policy in a Liquidity Trap*, National Bureau for Economic Research, Cambridge;

3. European Central Bank (2005) – *The Implementation of a Monetary Policy in the Euro Area*;

4. European Central Bank (2004) – *The Monetary Policy of ECB.*