



V

Economic Policy Challenges Facing the Euro Area and the External Implications of EMU

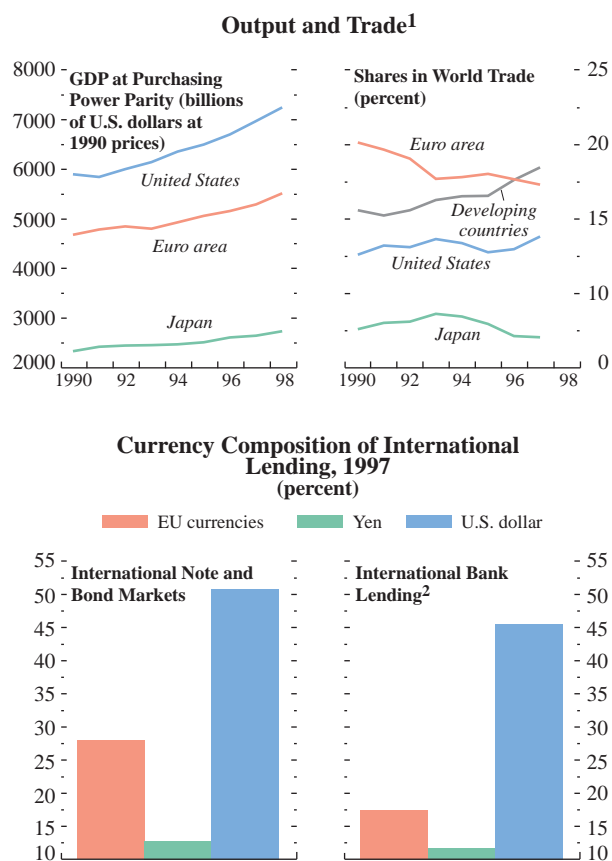
On January 1, 1999, the third and final stage of European Economic and Monetary Union (EMU) will begin with the establishment of a currency union encompassing 11 of the 15 member countries of the European Union (EU)—Austria, Belgium, Finland, France, Germany, Ireland, Italy, Luxembourg, the Netherlands, Portugal, and Spain. On that date, these countries will lock their exchange rates and adopt the euro as their common currency, with monetary and exchange rate policy determined by area-wide institutions. Thus, each country will give up the possibility of independent monetary and exchange rate policy.

EMU does not change the locus of responsibility for policies other than monetary and exchange rate policies. Policies affecting external trade and the integration of internal markets are already a matter of EU competence. Fiscal and labor market policies will continue to be decided mostly at the national level, albeit subject to closer surveillance by EU institutions (see the appendix to this chapter). In this regard, the Stability and Growth Pact (SGP), agreed in June 1997, set out the procedures for surveillance of national fiscal policies, strengthening the framework provided in the Maastricht Treaty. Also, the Treaty of Amsterdam, signed in October 1997, explicitly recognized labor market policies as a matter of common concern and set out procedures for their surveillance. Except for monetary and exchange rate policies, area-wide decision making and surveillance are the responsibility of institutions of the EU as a whole. It has been agreed that ministers of euro-area countries can meet (as the Euro-11 Group) to discuss issues related to the single currency, but that formal surveillance and coordination decisions will be the prerogative of the full EU Council of Ministers (ECOFIN).

The monetary and exchange rate policies conducted at the euro-area level will be of considerable global importance. The prospective euro area rivals the United States in terms of output and trade, and the role of the euro in financial transactions eventually may challenge that of the U.S. dollar (Figure 5.1). EMU will be particularly important for countries with close trade and financial ties with the euro area, notably countries in central and eastern Europe and in the Mediterranean basin, and many countries in Africa. And with EMU, policies conducted at the national level will have an important influence on the exchange

Figure 5.1. Euro Area and the World Economy: Indicators of Relative Size

The euro area is somewhat smaller than the United States in terms of output but accounts for a larger share of world trade, while European currencies are currently underrepresented in global financial markets.



Sources: IMF (upper panel); and Bank for International Settlements, *68th Annual Report* (Basle: Bank for International Settlements, June 1998).

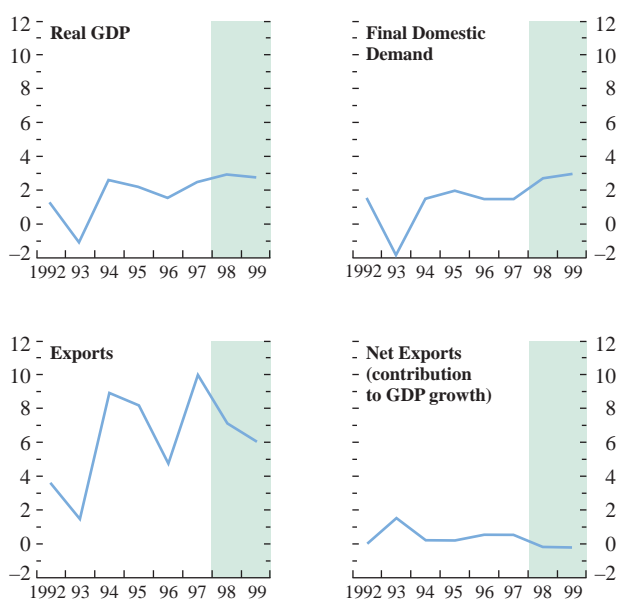
¹For 1998, IMF staff projections. Trade shares are calculated through 1997 only.

²Cross-border claims and local claims in foreign currency of banks located in industrial reporting countries. European Union currencies comprise the deutsche mark and French franc only.

Figure 5.2. Euro Area: GDP Growth and Components of Demand¹

(Percent change unless otherwise noted)

Exports led the recent revival of euro-area growth, but domestic demand is projected to play the leading role in 1998–99.



¹Shaded areas indicate IMF staff projections.

rate of the euro and on the ease with which monetary policy is able to achieve its goals.

The delineation of monetary, fiscal, and structural policy responsibilities between the euro-area institutions and national governments helps assign responsibility for these policies, but it also complicates their coordination. Monetary policy in the euro area will concentrate on economic conditions in the area as a whole. At the same time, structural and fiscal policies at the national level will need to take account of the fact that independent movements in interest rates and exchange rates are no longer possible. This allocation of responsibilities will make the task of achieving an appropriate mix of policies at the euro-area level more complex than in most national monetary areas.

The October 1997 *World Economic Outlook* (Chapter III) examined the new policy regime entailed in EMU, the policy requirements of a successful EMU, and the implications of EMU for the rest of the world economy. A year later, and in the context of the economic conjuncture a few months before the single currency's inauguration, this chapter examines economic policies in the euro area from national, regional, and global perspectives. One aim is to highlight the policy challenges facing the euro area and its member countries in light of the interrelationships between policies at the national and regional levels. The desirability of promoting compatibility between policies set at the two levels while at the same time recognizing the separate policy mandates was stressed by the European Council in December 1997, when it emphasized the need for enhanced coordination for a proper functioning of EMU. Another aim of the chapter is to draw out further some of the implications of EMU for the global economy and especially for those countries with close economic ties to the euro area.

Economic Policies in the Euro Area

The fiscal, monetary, and structural policy requirements of the euro area, and their implications for the overall policy mix, have to be considered in the context of recent economic developments and current prospects.

Economic Developments and Prospects

The birth of EMU is being facilitated by a macroeconomic environment in the euro area that has improved considerably from the early and mid-1990s. For the area as a whole, a slack-absorbing recovery has been gathering momentum since early 1997, and the strengthening of fiscal and inflation performance associated with meeting the convergence criteria for EMU has provided the basis for what could become an extended period of generalized, sustained, noninflationary growth (Figures 5.2 and 5.3). The initial impe-

tus to the recent renewal of growth came from exports, which surged in response to a strengthening of global demand and a real depreciation of euro-area currencies (Figure 5.4). A sharp rebound in business and consumer sentiment followed quickly. This was supported by a stabilization of conditions in the labor market and reinforced in late 1997 and into 1998 by a decline in unemployment, which is expected to average $11\frac{3}{4}$ percent of the labor force in 1998 compared with $12\frac{1}{2}$ percent in 1997. These domestic factors, combined with some moderation in external demand, were reflected in a shift in the composition of growth moving into 1998 to one largely based on domestic demand. Overall, growth in the euro area rose from an annual rate of under $1\frac{1}{2}$ percent in the course of 1995 (fourth quarter to fourth quarter) to almost 3 percent in the course of 1997.

Within this overall picture, notable differences in cyclical positions have emerged in the euro area, with countries falling into two broad groupings, albeit with considerable intragroup variation. For the more cyclically advanced countries (Austria, Finland, Ireland, the Netherlands, Portugal, and Spain), which account for about one-fourth of euro-area GDP, output gaps in 1998 are estimated to be negligible on average, while for the other, less cyclically advanced economies (Belgium, France, Germany, and Italy), gaps are estimated to average close to 2 percent (Figure 5.5).

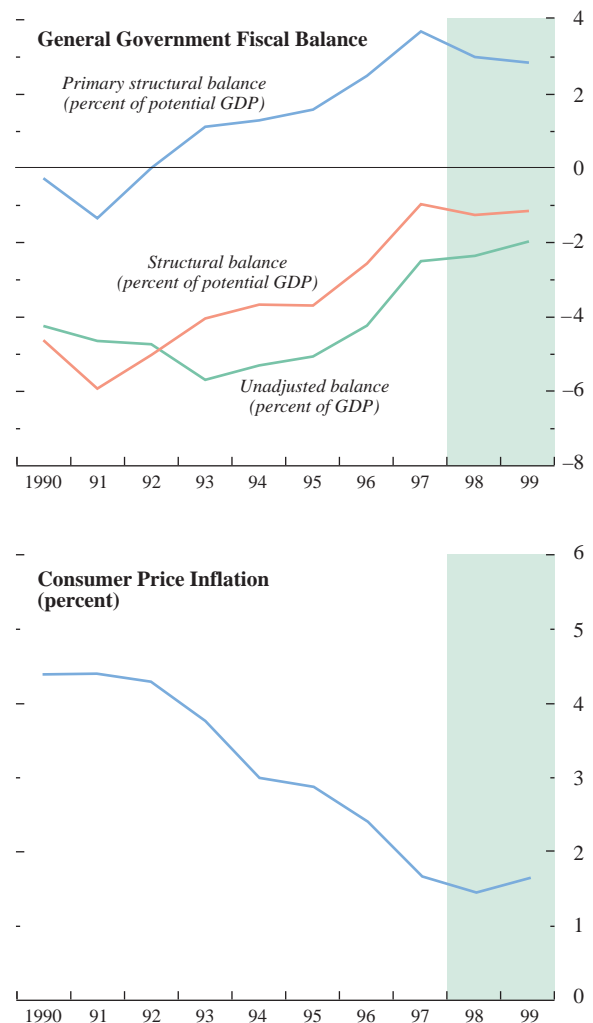
These differences in cyclical positions reflect recent variations across countries in growth performance. While no single explanation fits all countries, exports in a number of the more cyclically advanced countries (notably Finland, Ireland, and Spain) were spurred by marked real exchange rate depreciation between 1992 and 1995, while the less cyclically advanced countries as a group experienced real appreciation over this period.¹ Labor market performance has also been stronger in the more cyclically advanced economies, helping to boost confidence. While differences in this respect between the groups are of course closely related to growth performance, employment in a number of the more cyclically advanced economies (notably Ireland, the Netherlands, and Spain) has also been boosted by structural reforms.

Consumer price inflation, while still low by most historical standards, is somewhat stronger in the more cyclically advanced economies, running at an annual rate of close to 2 percent in the summer of 1998, com-

¹Within the group of less cyclically advanced economies, Italy experienced a substantial real depreciation between 1991 and 1995, which was reversed in part in 1996–97. Italy's position in the less cyclically advanced group reflects its particularly large fiscal retrenchment. Among the more cyclically advanced economies, the Netherlands and Austria also experienced real appreciations. The relatively cyclically advanced position of the Netherlands reflects the benefits of many years of structural reform, while in the case of Austria there was a relatively narrow output gap after the 1992–93 recession.

Figure 5.3. Euro Area: General Government Fiscal Balance and Inflation¹

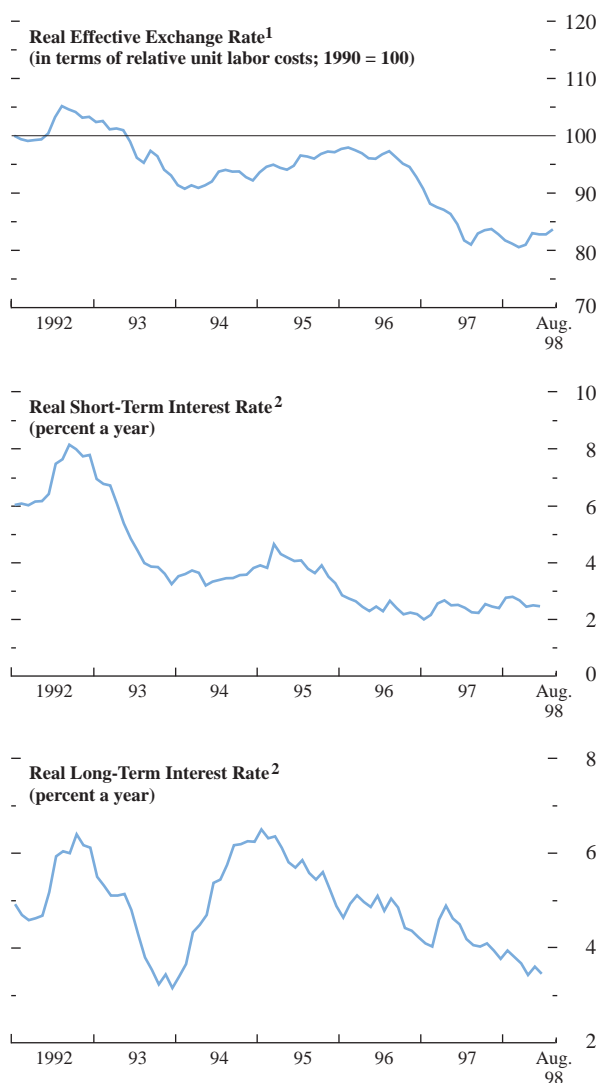
Preparations for EMU have led to large reductions in fiscal imbalances and inflation.



¹Shaded areas indicate IMF staff projections.

Figure 5.4. Euro Area: Real Exchange Rates and Interest Rates

A real depreciation has eased monetary conditions since 1996.



¹See Box 5.5 for details of the euro effective exchange rate.

²Deflated by the 12-month change in consumer prices.

pared with less than 1½ percent in the euro area as a whole (Figure 5.6). The potential for increased price pressures in the more cyclically advanced countries is suggested not only by the high rates of resource utilization, but also by faster increases in equity and real estate prices (Figure 5.7) and strong growth of credit. However, inflation developments in the less cyclically advanced economies are likely to dominate the picture for the euro area as this group includes the three largest economies (France, Germany, and Italy).

Looking forward, and despite the weakening in the external environment, the recovery in the euro area is projected to maintain its recent momentum—with growth of 2¾–3 percent a year in 1998–99—as the earlier rebound in confidence is being reinforced by an accommodative policy stance, reflecting relatively low real short-term interest rates, a further decline in long-term rates, and a shift in fiscal policy from markedly restrictive in 1997 to slightly expansionary in 1998 (see Chapter II). Consumer price inflation is projected to remain at around 1½ percent in 1999 for the area as a whole and to rise to about 2¼ percent in the more cyclically advanced economies. While unemployment is expected to decline further as a result of above-potential growth, it is projected still to be above 11 percent of the labor force at the end of 1999.

Uncertainty about the degree of economic slack complicates the assessment of medium-term prospects, but the IMF staff's estimates (which show an output gap of 1¾ percent for the euro area as a whole in 1998) seem to be consistent with the absence of all but localized symptoms of inflationary pressures. Taking into account also the likelihood that the non-accelerating inflation rate of unemployment (NAIRU) will decline in a sustained recovery, as hysteresis effects are reversed, there would appear to be considerable scope for a reasonably paced expansion, perhaps with euro-area output growing for a number of years by around ½–¾ of 1 percentage point faster than its recent trend. Early structural reforms would reduce further the risk that supply bottlenecks emerge as the recovery matures.

As discussed in Chapter I, global economic conditions have deteriorated significantly in the course of 1998 as a result of severe financial and economic difficulties in Asia and Russia and spillover effects elsewhere. Exports to Japan, Russia, Korea, and the ASEAN-4 countries taken together account for 11 percent of euro-area exports and 1½ percent of GDP, but the risks clearly extend beyond direct trade linkages with these countries to include the impact on the global economic environment and on confidence in the euro area. In addition, there are important uncertainties surrounding the exchange rate of the euro. While the euro appears to be only moderately undervalued in effective terms relative to medium-term fundamentals, the implied correction that may be in prospect would comprise larger, but to a significant extent offsetting,

medium-term shifts upward against the U.S. dollar and downward against the Japanese yen. Should these movements not occur in tandem or should overshooting occur—not inconsequential risks given the current international circumstances—there could be significant shifts in the real effective exchange rate of the euro that would materially affect prospects for the area.

General Policy Considerations

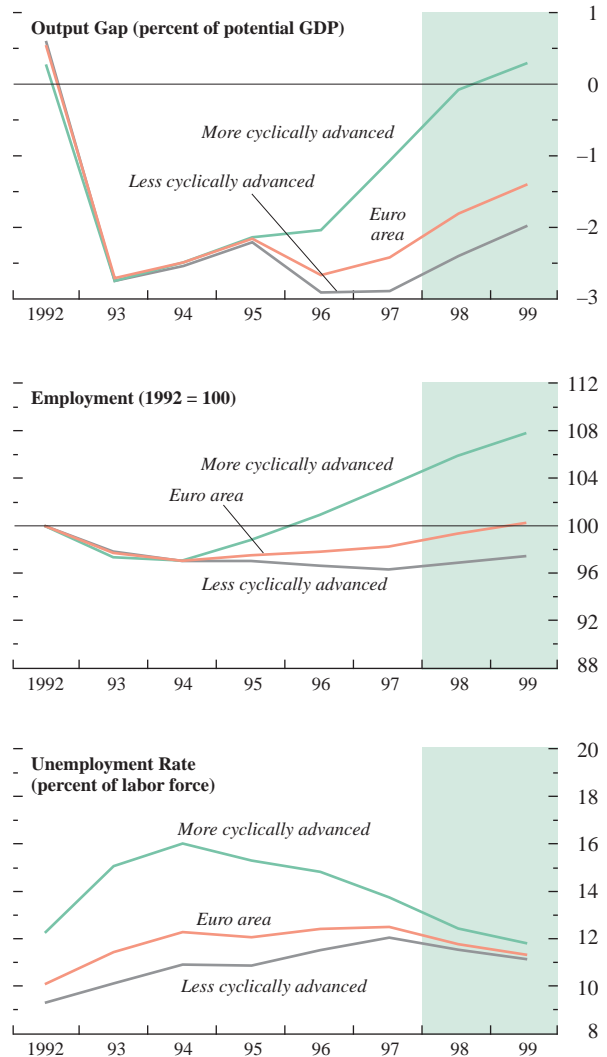
In addition to consolidating the convergence achievements to date, euro-area policymakers need to focus increasingly on how to capitalize on them. In particular, these achievements provide a strong foundation for tackling the structural rigidities that are at the root of high unemployment while, in a shorter-run context, they afford greater room for maneuver in addressing the uncertainties in the economic outlook. Greater cyclical convergence would have facilitated the smooth launch of EMU, and of the single monetary policy in particular. Fortunately, differences in cyclical positions among the three largest countries are not large. But the differences between them and the more cyclically advanced economies, which are being exacerbated by expansionary policies in many of the latter, could, if not properly handled, cause strains that would impede the recovery in the area as a whole.

Two aspects of the EMU policy framework will help the euro area to meet these challenges. The first is the clear commitment to price stability—widely taken to mean inflation of 2 percent or below—for the euro area as whole, with the European Central Bank (ECB) charged to make this its overriding priority. This strong commitment to preserving the nominal stability that has been established—which should allow a more neutral stance of monetary policy over the cycle than has been the case—bodes well for the longer-term growth performance of the euro area. The second positive feature of the framework is the SGP, specifically the commitment by each member to achieving medium-term budgetary positions that are close to balance or in surplus. On one level, this is simply the fiscal analogue of the dedication of monetary policy to price stability. On another, however, the SGP can help the euro area cope with and dampen the transmission of shocks and imbalances, be they regionwide or country-specific, by promoting the establishment of medium-term fiscal positions that allow countries to deal with normal cyclical fluctuations and still respect the deficit ceiling of 3 percent of GDP.² This medium-term orientation is essential if the procyclical and consequently destabilizing fiscal policies common in continental Europe over the past two decades are to end. Such policies

²As discussed in Chapter III of the October 1997 *World Economic Outlook*, observance of the SGP should allow a degree of fiscal stabilization in the euro area at least as powerful as that observed in other monetary areas, even without a central fiscal authority.

Figure 5.5. Euro Area: Output Gaps, Employment, and Unemployment¹

Notable cyclical differences have emerged between two groups of countries since 1995.

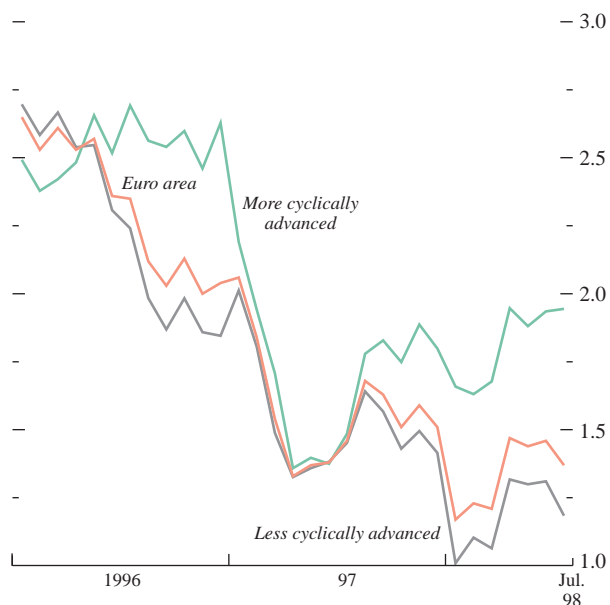


Sources: IMF, *World Economic Outlook*; and OECD.

¹More cyclically advanced countries are Austria, Finland, Ireland, the Netherlands, Portugal, and Spain. Less cyclically advanced countries are Belgium, France, Germany, and Italy. Shaded areas indicate IMF staff projections.

Figure 5.6. Euro Area: Inflation¹*(Percent change in consumer prices from a year earlier)*

Inflation in the more cyclically advanced countries is above the euro-area average.



¹More cyclically advanced countries are Austria, Finland, Ireland, the Netherlands, Portugal, and Spain. Less cyclically advanced countries are Belgium, France, Germany, and Italy.

have reflected the tendency of policymakers to focus on actual rather than cyclically adjusted fiscal balances and thus to implement expansionary measures during periods of buoyant economic activity, with the consequence that corrective action has often needed to be taken when economies have been in a downturn.

However, when it comes to addressing real imbalances and divergences, the EMU policy framework is not yet sufficiently elaborated in two key areas. First, while maintaining primary responsibility for fiscal and structural policymaking at the national level provides scope to adapt these policies to country-specific circumstances, this will pose a challenge for policy coordination. National policies will have inevitable—and often pervasive—spillover effects on other member countries via their implications for the single monetary policy and the exchange rate of the euro. How countries use fiscal policy to tackle their divergent cyclical situations is a clear example. But structural policies also are relevant in this regard both because inflexible markets impede the ability of countries to adapt to contractionary forces and because of their longer-term effects on economic performance. While surveillance mechanisms are in place to facilitate coordination, it remains to be seen how effective these will be in ensuring a sound overall development. Second, while there has been some progress in reducing structural rigidities, policies in place are inadequate, and political opposition to reform is still strong. It remains to be seen how effectively the new EU arrangements for labor market surveillance will help policymakers tackle these issues. In addition to its role in addressing the euro area's high unemployment, greater flexibility in labor and product markets will be needed to deal with asymmetric shocks, given that exchange rate adjustments will no longer be an option within the euro area. Moreover, as the process of getting to EMU has been associated with rising unemployment, many may question whether EMU was worth the effort if it does not set the stage for a lasting and marked reduction in euro-area joblessness.

The various authorities therefore need to put in place clear and credible strategies that both make the most of the positive aspects of the framework for EMU and address its limitations. With the monetary conditions resulting from the single monetary policy unlikely to fit well the circumstances of all countries at all times, the strategies for fiscal and structural policies need to ensure that countries are well positioned to deal with country-specific problems. By the same token, there is need for effective coordination to ensure that the combined effect of national policies fits well the overall macroeconomic dynamics of the euro area. This is especially important in the early days of EMU when financial markets will be assessing how well the institutional framework is coping with interactions and interdependencies of national and region-wide policies. Against this background, the require-

ments for monetary, fiscal, and structural policies are assessed below.

Monetary Policy

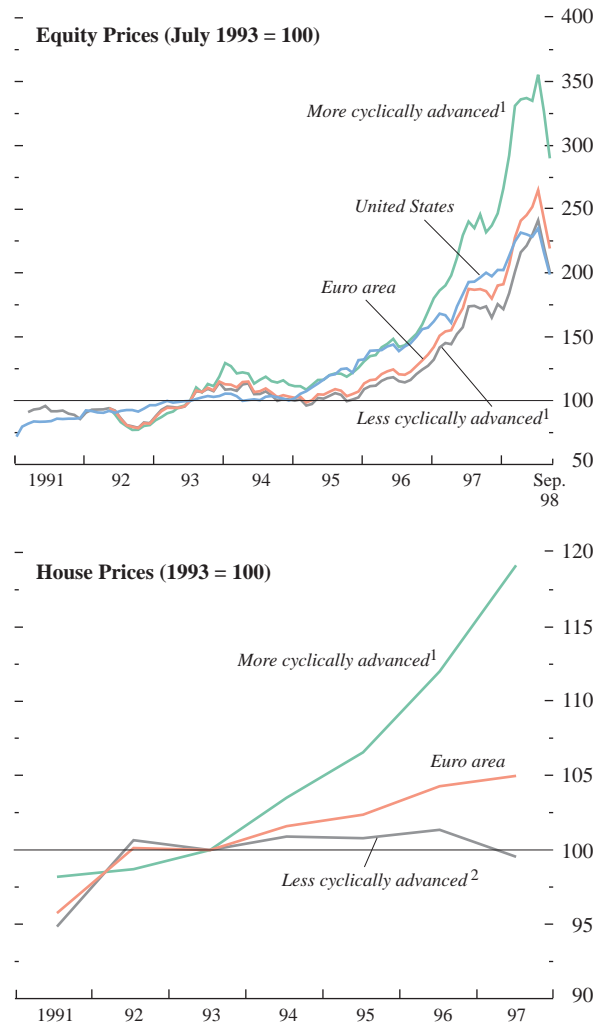
The convergence to low inflation in the euro area eases the challenge that the ECB will confront as it takes over the reins of monetary policy on January 1, 1999, as well as that facing the Bundesbank and other European central banks as they seek to ensure a smooth transition to the new regime over the coming months. Earlier in 1998, it seemed that the benign inflation outlook would provide room for maneuver in phasing the tightening of monetary conditions in the euro area that would be needed to ensure a less accommodative stance as the cyclical expansion matured. The focus has shifted considerably in the course of 1998, however, because of the deterioration in the external environment and the associated increased downside risks to growth and further dampening of commodity price expectations. By late summer, financial markets no longer expected interest rates to rise in the euro area over the next year: rather they anticipated that rates would by the end of 1998 converge downward to the level of around 3½ percent currently prevailing in the ERM core and remain around this level through 1999 (Figure 5.8). Moreover, there has been increasing attention to the questions of whether and under what circumstances a lowering of interest rates from this level would be warranted.

As it seeks to come to grips with the monetary policy needed in an evolving environment, the ECB will need to pay due regard to establishing its credibility quickly in the face of some unique start-up challenges. Some of these, such as putting in place the requisite information and operational systems, and compiling consolidated area-wide monetary statistics, are comparatively straightforward. Others are more imponderable, such as assessing the effects of the regime change involved in EMU on behavior not only in financial markets but in product and labor markets as well; the acclimatization of ECB Council members—conditioned by years of policy formation and implementation on the basis of national considerations and operating strategies predominantly oriented to maintaining a stable exchange rate against the deutsche mark—to the need to act and to be perceived to act from a pan-European perspective, as required by the ECB's mandate; and within such a perspective, giving appropriate weight to the euro's importance in the world economy.

A further challenge is to elaborate a workable monetary framework. Regime-shift considerations, particularly given the pronounced changes in European financial markets that are in prospect, suggest that approaches based on the behavioral relationships of economic models—such as monetary targeting or inflation targeting—are likely to be difficult to imple-

Figure 5.7. Euro Area and the United States: Asset Prices

Since 1996, asset prices have risen particularly sharply in the more cyclically advanced euro-area countries.



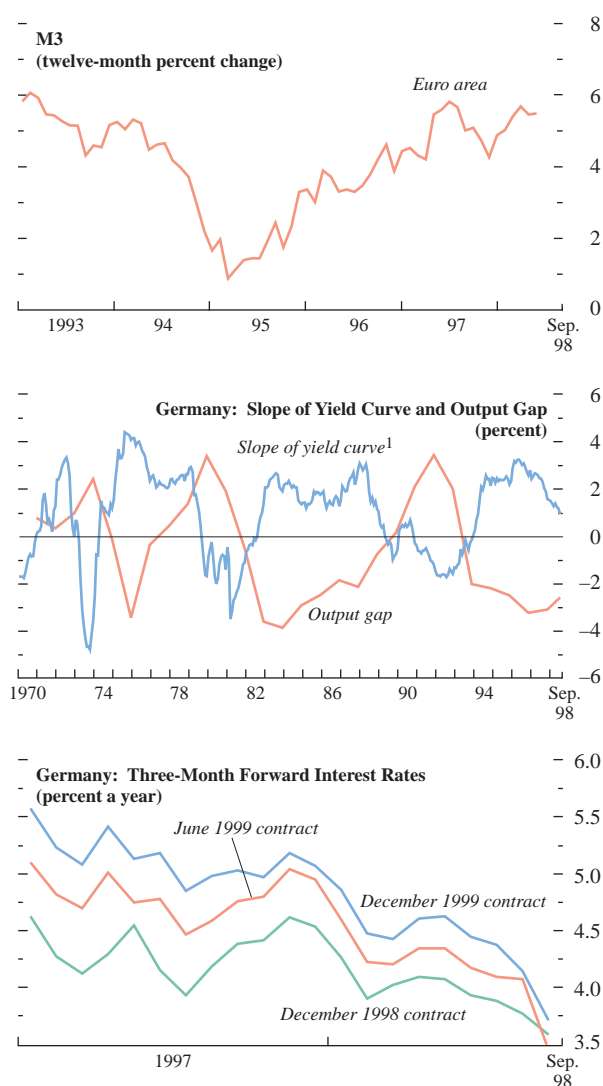
Sources: WEFA, Inc.; and Bank for International Settlements.

¹More cyclically advanced countries are Austria, Finland, Ireland, the Netherlands, Portugal, and Spain. Less cyclically advanced countries are Belgium, France, Germany, and Italy.

²Less cyclically advanced countries as above except for the exclusion of Italy, for which data are unavailable.

Figure 5.8. Euro-Area Broad Money Stock, Slope of German Yield Curve, and Forward Interest Rates for Germany

Signs of inflationary pressure are generally absent from monetary indicators.



Sources: WEFA, Inc.; and IMF staff estimates.

¹Ten-year bond yield minus three-month money market rate, in percent a year.

ment at the outset of EMU, even though they would be helpful in underlining the pan-European nature of policy since they would be explicitly formulated in euro-area terms. A flexibly implemented monetary target could boost the ECB's credibility because it would follow the Bundesbank's practice. But, with the relationships between instruments and inflation apt to be unstable, or at least uncertain, for a considerable period, the ECB is more likely to be able to assert an effective pan-European approach by adapting the instruments of monetary policy pragmatically with a view to maintaining low inflation. In doing so, however, it will have to explain clearly and frequently, especially at the outset, its monetary policy strategy and the factors influencing its deliberations and actions.

As of September 1998, the key data pertaining to an assessment of inflation prospects in the euro area are:

- Euro-area price inflation has been subdued, and there are no imminent dangers either on the cost side or from output bottlenecks. Recent wage increases have remained moderate, primary commodity prices have been weak, and the effective exchange rate of the euro area has appreciated over the past year. The sizable output gap and the moderate speed at which it is expected to close suggest that bottlenecks are unlikely to pose problems during the next year to 18 months.
- Developments in the monetary aggregates also suggest the absence of inflationary dangers (see Figure 5.8). Over the past year, the 12-month growth of M3 in the euro area has hovered in the 4–6 percent range, which would appear broadly in line with medium-term requirements.³ Moreover, the moderate growth of M3 over the past four years would seem to imply that the supply of money does not at present pose an inflation danger.
- Concerns about inflation appear absent in the financial markets. The relatively flat yield curve for this stage of the cycle implies that monetary conditions are not overly easy (see Figure 5.8), and the continued downward trend in long-term interest rates over the past year suggests a further decline in inflation expectations, although it probably also reflects declines in real interest rates. Long-term deutsche mark interest rates are now at historical lows.

In assessing what these factors imply for interest rate policy, one perspective is provided by policy rules

³Assuming inflation of 2 percent, together with a euro-area potential growth rate of 2.4 percent and the trend decline in velocity of 0.35 percent a year since 1990, would imply a "neutral" growth rate of 4¾ percent a year for broad money. Available data at the time of writing refer to aggregations of national monetary statistics rather than consolidated euro-area statistics; consolidated data are expected to become available later in 1998.

based on the past behavior of central banks such as the U.S. Federal Reserve and the Bundesbank. In this context, the literature provides a number of Taylor rules estimated for the Bundesbank, which suggest on the basis of current projections for output and inflation that short-term interest rates in the euro area should rise in 1999 by $\frac{1}{3}$ of 1 percentage point from their average level in 1998 (see Box 5.1, on page 134). Such rules also highlight the tensions emanating from cyclical divergences that will become more apparent as short-term interest rates in the euro area converge over the coming months. For France and Germany on their own, they indicate for the year ahead an interest rate about $\frac{1}{2}$ of 1 percentage point lower than for the euro area as a whole, while for the more cyclically advanced economies, they point to the need for short-term interest rates that in some cases are well above average.

Policy rules based on past behavior have, however, a number of important limitations in the current circumstances.

- Taylor rules capture only the average past response of central banks and do not take account of all the factors that typically influence monetary policy such as external factors and the balancing of risks in particular circumstances. These last two considerations are both pertinent in the current context, since there are risks that the global environment could deteriorate further, while the policy problems that would arise from growth being slower than projected are likely to be greater than those that would emerge should growth be faster than expected. Moreover, the monetary authorities of the euro area will also need to weigh any implications of a change in rates for the global economy.
- The marked decline in long-term interest rates in recent months, which has followed a steady downward trend over several years, combined with the relatively flat yield curve currently, raises questions whether there may have been a downward shift in the neutral real interest rate—that is, the interest rate that is compatible with output at potential and stable inflation. Portfolio reallocations in the wake of the Asian crisis have favored the mature financial markets of North America and Europe, suggesting some influences on long-term interest rates that may be temporary in nature. However, convergence around low inflation and reduced fiscal deficits may have contributed to a more permanent moderation of real interest rates in the EU and a number of industrial countries elsewhere. In the euro area, this consideration is reinforced by the strengthened policy framework for fiscal discipline.
- The regime change associated with EMU is likely to influence other key behavioral relationships. For instance, wage behavior in countries that have

in the past used the exchange rate as a means of adjustment could become much more conditioned by the need to maintain competitiveness when there is no longer the escape route of devaluation. A narrowing of output gaps in such countries may thus entail less wage pressure than previously.

The above considerations, together with the absence of inflationary dangers, would suggest that a path for short-term interest rates in line with current market expectations is appropriate at the present juncture, with short-term interest rates converging on those in the core of the ERM. While this would entail a reduction in the average euro-area short-term interest rate in the coming months of about $\frac{1}{2}$ of 1 percentage point from its level in the summer of 1998, the fact that medium- and long-term rates have already effectively converged in the euro area will limit the expansionary implications. If the downside risks to growth materialize or intensify, a more definite easing—entailing a reduction of euro-area short-term rates below those presently prevailing in the ERM core—may be needed. A resumption of fiscal deficit reduction in 1999, particularly if it entailed determined action to restrain demand and avoid overheating in the more cyclically advanced economies, would allow the monetary authorities greater room for maneuver in easing monetary conditions. If, on the other hand, there is unfavorable news about the prospects for fiscal adjustment in 1999, and especially if continued fiscal stimulus seems likely, it will become more difficult for monetary authorities in the euro area to ease their policy stance.

Fiscal Policy

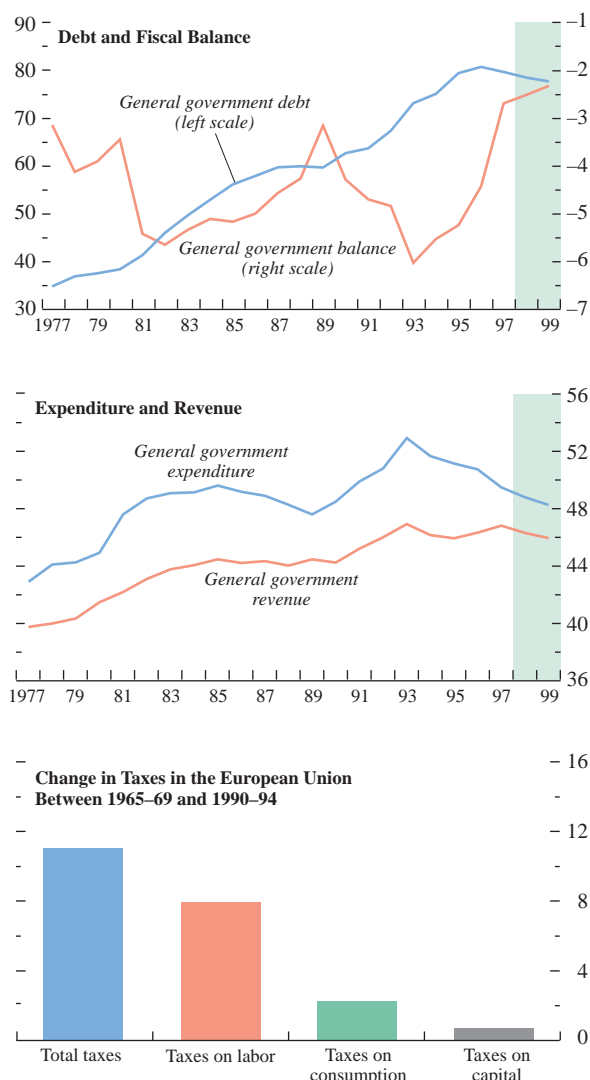
Fiscal policy requirements are conditioned by the large fiscal imbalances and the significant growth of public sector budgets since the 1970s. Increased debt ratios cast a shadow over longer-term economic prospects and, together with large deficits, have limited the scope for fiscal policy to act as a stabilizing instrument, a weakness all too evident in the 1990s. The substantial increases in transfers to households and interest spending have resulted in a heavy tax burden on the economy, particularly on labor, and the design and interaction of social benefits and tax systems have further distorted incentives to work (Figure 5.9).

Owing in large part to the Maastricht criteria, the 1990s have witnessed considerable progress in reducing structural deficits and in stabilizing debt ratios. In contrast, the recent record on spending and tax reform has been decidedly mixed; the cyclically adjusted revenue burden actually rose as a share of potential output in the early 1990s, and it has only leveled out more recently. Moreover, while adjustment since 1993 has, for the euro area as a whole, emphasized spending cuts, it has relied too much on ad hoc adjustments such

Figure 5.9. Euro Area: Fiscal Trends¹

(Percent of GDP)

The growth of government debt has been curbed in recent years, but the tax burden is significantly larger than in the late 1960s.



Sources: OECD; and European Commission.
¹OECD projections.

as across-the-board spending limits, government investment cutbacks, and sometimes even temporary measures, rather than on fundamental reform of government programs.⁴

The SGP provides a framework for protecting and building on recent progress in strengthening the financial positions of governments. In part, it does this by establishing more clearly the principle that countries that fail to correct excessive deficits will be subject to sanctions. But equally important, it strengthens procedures for the surveillance of fiscal policies. While this surveillance will be conducted in the context of the SGP's medium-term goal of budgetary positions close to balance or in surplus, and while the conditions that would trigger sanctions are both expressed in terms of actual budgetary positions, countries will need to focus on underlying fiscal positions to make the pact work as intended.

There has been considerable discussion as to whether structural balance is needed to provide countries adequate room to deal with normal cyclical fluctuations. Using the largest output gaps in the past as a guide, a structural deficit averaging 1 percent of GDP for the area as a whole would allow the operation of automatic stabilizers while keeping the general government deficit within 3 percent of GDP. However, a range of additional considerations—including uncertainties regarding potential output and output volatility, the advisability of providing some extra room for discretionary measures, and high debt ratios in some countries—argue for a more prudent stance (see Box 5.2, on page 136). Moreover, the future pressure on pension and health spending associated with the aging of populations underlines the case for substantially reducing the debt-to-GDP ratio, and thereby the interest burden; while there are considerable uncertainties in the estimation of these demographic effects, they could on present policies add 7 percentage points of GDP to spending over the next 30 years, with a further, albeit relatively moderate, increase over the following decade.

The objective of structural balance or small surplus implied in the SGP thus appears to be a reasonable first approximation to the medium-term fiscal needs of the area as a whole. This objective seems readily achievable since the structural deficit of the area as a whole is projected at 1¼ percent of GDP in 1998. Moreover, that figure overstates the primary adjustment required to reach the SGP goal, as interest spending is projected to decline by ¾ of 1 percentage point of GDP between 1998 and 2001. Thus, in the euro area as a whole, a primary structural adjustment of about ½ of 1 percentage point of GDP should be sufficient to achieve a balanced structural position by 2001, assuming no adverse interest rate shocks.

⁴Estimates by the European Monetary Institute (EMI) indicate that temporary measures reduced the euro-area fiscal deficit by almost ½ of 1 percent of GDP in 1997.

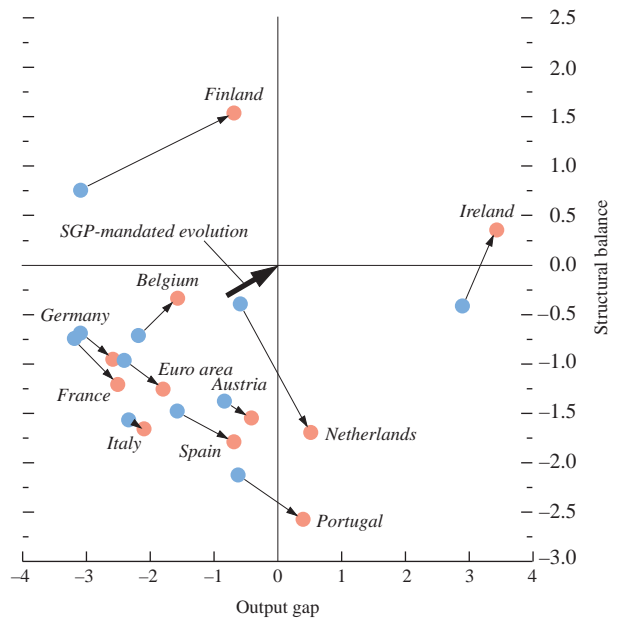
The requirements vary somewhat by country. In most cases, an underlying budgetary position of around balance would be satisfactory, but surpluses of 1–2 percent of GDP appear to be warranted for Finland and Ireland.⁵ On this basis, five of the euro-area countries (Belgium, Finland, Ireland, Italy, and Luxembourg) already have a satisfactory primary budgetary position or need at most a small primary structural adjustment. Of the other countries, Austria, France, Germany, the Netherlands, and Spain require primary structural adjustment of $\frac{1}{2}$ of 1 percent to 1 percent of GDP, with an adjustment of $1\frac{3}{4}$ percent needed in the case of Portugal. Countries may in due course need to go further, depending on how their individual circumstances evolve, including progress with labor market and spending reforms, and also taking into account the need in some countries to reduce the high level of government debt.

The improvements warranted in primary structural balances understate the extent of spending reform required, in view of the need to address the distortions associated with the large tax wedges built up over the past three decades and in particular those affecting low-income workers.⁶ To make significant headway in reducing tax burdens while also reducing structural deficits, countries will need to restrain the real growth of primary spending well below that of GDP.

Political resistance to both slowing primary spending and broader structural reforms could imply a short-run trade-off between structural reform and deficit reduction.⁷ In this light, a gradual move to underlying fiscal balance in the euro area by 2001 would be reasonable, provided that it is combined with substantial structural reforms, including spending reforms that would make way for significant tax reduction. Ultimately, strengthening fiscal positions and structural reform are complementary in that a decline in structural unemployment, based on a broad reform strategy (not just reduced taxes) can facilitate improvements in

Figure 5.10. Euro Area: Structural Fiscal Balances and Output Gaps, 1997 and 1998¹
(Percent of potential GDP)

In 1998, structural balances in most euro-area countries are projected to deteriorate, contrary to the requirement of the SGP.



¹The large arrow indicates the direction in which countries need to move in order to satisfy the Stability and Growth Pact (SGP). The lighter arrows, which show movements in output gaps and structural balances from 1997 (blue) to 1998 (red), indicate that many countries will move away from the objective of structural balance in 1998.

⁵In Finland, a significant structural surplus (about $1\frac{1}{2}$ percent of GDP) is projected for 1998. Such a surplus is warranted in light of the large cyclical effects on the budget in the past and the relatively early onset of problems associated with an aging population. In Ireland, the considerations include the less synchronized business cycle, a greater vulnerability to asymmetric shocks, and the expected reduction in EU structural funds in the next decade.

⁶Market pressures for tax harmonization may also intensify, putting additional pressure on countries to lower relatively high tax rates. The move to monetary union has reinvigorated EU efforts to foster greater tax harmonization and coordination, especially with regard to capital income, but progress remains difficult owing in large part to the requirement that decisions be unanimous. It should be noted in this context, however, that the OECD, based on analysis of Canada and Switzerland, infers that significant differences in tax rates can exist over time, even within countries (see OECD, *Economic Outlook*, June 1998, Chapter IV).

⁷See Barry Eichengreen and Charles Wyplosz, "The Stability Pact: More Than a Minor Nuisance?" in David Begg and others, *EMU: Prospects and Challenges for the Euro* (Oxford, U.K.: Blackwell, 1998).

Box 5.1. How Useful Are Taylor Rules as a Guide to ECB Monetary Policies?

Taylor rules are one way of characterizing how central banks adjust short-term interest rates in response to deviations of inflation from target or of output from potential.¹ Such rules have received considerable attention, including from market analysts, as a basis for assessing what policies the European Central Bank (ECB) might follow. This box considers to what extent a Taylor rule based on the past behavior of the Bundesbank might be useful from this perspective.

Although the original Taylor (1993) rule was based on actual inflation data,² it can easily be given a forward-looking perspective, as was done by various authors that have recently estimated feedback rules for the Bundesbank experience since the mid-1970s.³ The estimates indicate that the Bundesbank has typically pushed up the nominal short-term interest rates by about 130 to 160 basis points (and thus the real rate by some 30 to 60 basis points) for every 1 percentage point rise in expected inflation one year ahead, holding the output gap constant, and that it has reduced the nominal (and real) short rate by about 25 to 50 basis points for every 1 percentage point shortfall in output relative to potential, holding ex-

pected inflation constant. These ranges of estimates encompass the parameters used in the original Taylor rule, characterizing the behavior of the U.S. Federal Reserve Bank.⁴ There are significant differences, however, between the rules based on Bundesbank behavior and the original Taylor rule with respect to the neutral real short-term interest rate, which is the real interest rate compatible with output at potential and inflation at the central bank's target. In the studies of Clarida, Gali, and Gertler, for instance, this was set at the ex-post average of the real short-term rate in Germany over the estimation period—varying from 3¼ to 3¾ percent, depending on the specific sample period chosen—while in the original Taylor rule the neutral rate was assumed to be 2 percent.

On the basis of the rules estimated for the Bundesbank, the narrowing of the euro-area output gap and the small increase in inflation that are projected for 1999 would warrant an increase in short-term interest rates by perhaps ½ of 1 percentage point in 1999 from the 1998 average. Two of these rules—those produced by Clarida, Gali, and Gertler (1997) and Peersman and Smets (1998)—produce an interest rate in 1998 that is broadly the same as the actual euro-area average in the summer of 1998, but the 1998 rate implied by Clarida, Gali, and Gertler (1998) is significantly higher, mainly reflecting its larger estimate for the neutral rate. This latter estimate of the neutral rate would, however, seem particularly susceptible to upward bias, as it is based on the simple average of real interest rates in a sample period in which disinflation efforts were particularly prominent.

A number of factors need to be considered in assessing whether such rules are relevant in the context of EMU.

The ECB's objective function. The constitution of the ECB, and in particular the primacy it accords to price stability, is similar to that of the Bundesbank. Thus, it would

¹The presence of the output gap in such rules can reflect that minimizing the output gap (or achieving full employment) is a key objective of the central bank along with low inflation, or alternatively that it provides the central bank with additional information on the inflation outlook as well perhaps as carrying some weight as a secondary monetary policy objective.

²J.B. Taylor, "Discretion Versus Policy Rules in Practice," *Carnegie-Rochester Conference Series on Public Policy*, No. 39 (1993), pp. 195–214.

³See, for instance, R. Clarida, J. Gali, and M. Gertler, "Monetary Policy Rules in Practice: Some International Evidence," *European Economic Review*, Vol. 42 (1998), pp. 1033–68; R. Clarida, J. Gali, and M. Gertler, "Has the Bundesbank Followed a Taylor Rule? A New Test and Some Implications," IMF Seminar Series 1997–10A (Washington, 1997); and G. Peersman and F. Smets, "The Taylor Rule: A Useful Monetary Policy Guide for the ECB?," paper presented at the conference on "Monetary Policy of the ESCB: Strategic and Implementation Issues," Università Bocconi, July 6–7, 1998.

⁴The original Taylor rule assumed that nominal interest rates are increased by 150 basis points for every one percentage point increase in expected inflation and are reduced by 50 basis points for every 1 percentage point shortfall in output relative to potential.

a government's financial position, while the durability of improvements in government finances in the face of continued high unemployment will inevitably be open to question.

While the improvement needed in primary structural balances over the next few years seems quite moderate, there are serious risks that countries will not achieve it, exemplified by the projected weakening of euro-area structural fiscal positions in 1998 (Figure 5.10; see preceding page). Admittedly, fiscal performance in 1998 should be seen in the context of the very large adjustments in 1996–97, and the need in some countries to replace temporary measures adopted in 1997 with more permanent ones. However, the outlook for 1999, based on policies now in place, height-

ens concern that the procyclical bias in fiscal policy remains. Primary structural balances are projected to deteriorate further, with the improvement in actual fiscal balances reflecting the cyclical recovery and declining interest spending (see Figure 5.3).

The fiscal risks just outlined are all too reminiscent of the historical proclivity of governments to loosen their belts during cyclical upswings. Thus, between 1988 and 1990, as the last cyclical peak was reached, the structural fiscal balance in the euro area deteriorated by over 1 percentage point of GDP. Similar procyclical tendencies in the period ahead would inevitably bring tension between fiscal policy and the SGP during the next cyclical downturn. In this connection, a key challenge facing governments is to accept

seem reasonable to assume, as a working hypothesis, that the ECB's objective function in terms of desired euro area performance will be broadly similar to that of the Bundesbank in terms of German economic performance. It should be noted, however, that the arguments typically used in Taylor rules do not include the full range of influences on central bank behavior, notably in the present context external factors and the assessment of risks in the outlook.

The implications of output gaps for future inflation. The regime change that EMU brings could induce important behavioral changes, especially in labor market negotiations, which would affect the interpretation of what output gaps portend for future inflationary pressures. For example, in countries that in the past have relied on exchange rate changes to correct competitiveness problems, wage claims may be more moderate for a given level of demand pressures, as the exchange rate escape hatch will no longer be available. More generally, it might be argued that monetary union will foster increased awareness in wage negotiations of competitive positions relative to other parts of the euro area. On the other hand, where monetary policy has in the past had an effective role in moderating wage pressures, the shift to EMU may weaken the perceived constraints on wage demands. Thus, it has been argued that wage demands could intensify in Germany, as wage agreements in Germany will weigh less in the considerations of the ECB than they had in those of the Bundesbank.⁵

The transmission of monetary policy. The calibration of the rise in official interest rates needed to address a specific increase in future inflationary pressures will depend on the transmission of changes in official rates to interest rates in the economy more generally and from there to the behavior of consumers and investors. In judging the applicability of a rule based on Bundesbank behavior, a key

⁵Rudiger Dornbusch, C.A. Favero, and F. Giavazzi, "The Immediate Challenges for the European Central Bank," *Economic Policy*, Vol. 26 (1998), pp. 15–64.

question is the extent to which the effects of interest rate changes on output and inflation that have pertained to Germany will be similar for the euro area as a whole. It is clear that there are differences across countries in the transmission of policy, but the general conclusion has been that these do not appear to be so large as to create major problems for the ECB. For example, simulations with the IMF's MULTIMOD model indicate that after a year, the impact of a change in monetary policy (modeled as a change in the monetary target) on output and inflation is broadly similar for the euro area as a whole and for Germany. Again, however, past estimates are subject to the usual caveat that behavior may change in EMU.

The neutral real interest rate. The neutral real interest rate that prevailed in Germany in the past seems more relevant than the average for the euro area as a whole, given that interest rates in many of the euro area countries included significant currency risk premia. There are reasons to believe, however, that historical experience may overestimate the current neutral real interest rate for both Germany and the euro area as a whole. Relevant considerations include that monetary policies over the past two decades were engaged in an effort to bring inflation down, and the significant adjustments in fiscal positions that have recently taken place across the euro area. Matters are complicated further by the sharp fall in long-term interest rates in Europe over the past two years to levels that are unprecedented in post-war experience. It is unclear to which extent these declines reflect changes in inflationary expectations, temporary effects stemming from the "flight to quality" in the wake of the Asian crisis, or more permanent changes in the real rate. Taken all together, these considerations would indicate not only that the equilibrium real interest rate may have fallen but also that there are very large confidence intervals around even the "best" estimate of the equilibrium real interest rate.

In conclusion, a Taylor rule based on parameters estimated for Germany may provide a useful benchmark against which to monitor the policies of the ECB. However, owing to the various factors outlined above, such calculations need to be interpreted with a great deal of caution.

that they will need to achieve sizable budget surpluses as output moves above trend. In the past, it has been fairly common for output to exceed its trend or potential level by 3–4 percent at cyclical peaks; at such levels of resource utilization, actual budget surpluses of around 2 percent of GDP would be needed in most countries to be consistent with underlying balance.

The weakening of euro-area structural fiscal positions projected for 1998–99 is for the most part due to projected declines in revenue relative to GDP. This is in a sense good news: it would be far worse if the stickiness of deficits was due to increases in spending. Tax wedges in Europe are too large and need to be reduced for structural reasons. However, in some cases the revenue declines reflect reversals of temporary in-

creases in 1997 while in others they are insufficiently oriented toward attacking the most severe labor-market distortions, especially the high marginal taxes facing low-income workers. More fundamentally, financing these revenue declines through slower deficit reductions rather than spending cuts risks weakening the foundations of the recovery and mortgaging the area's ability to weather future downturns. In particular, weaker government fiscal positions could result in tighter monetary policy and force governments to resort to policies that would exacerbate the next cyclical downturn as they try to keep deficits within 3 percent of GDP.

Against this background, governments should provide convincing evidence in their budgets for 1999

Box 5.2. Orienting Fiscal Policy in the Medium Term in Light of the Stability and Growth Pact and Longer-Term Fiscal Needs

This box considers how fiscal policy should be oriented in the medium term in light of the goal established in the Stability and Growth Pact (SGP) and longer-term fiscal policy needs.

In the SGP, EU member states commit themselves to medium-term budgetary positions that are close to balance or in surplus so as to allow them to deal with normal cyclical fluctuations while keeping the general government deficit at or below 3 percent of GDP. Based on the largest negative output gaps experienced by individual countries over the past 30 years, a more modest fiscal goal—a deficit ranging from ½ of 1 to 1½ percentage point of GDP for most countries and averaging 1 percent of GDP for the euro area as a whole—might appear to allow sufficient room for the operation of automatic stabilizers.¹ However, there are a number of additional factors that need to be considered, which taken together would seem to provide support for the more ambitious goal embodied in the SGP.

- The three recessions of the past 30 years may, for countries individually, provide too few episodes to assess the range of shocks to which they could be subjected. Indeed, calculating the underlying variability of output suggests that the risks for many countries may be larger than is indicated by the actual scale of past cyclical downturns, thus warranting a stronger fiscal position than suggested by the size of past recessions alone.
- Some additional room may be needed from time to time to supplement the operation of automatic stabilizers through discretionary fiscal support for economic activity. This could substitute for the past role that monetary policy played as a stabilizing tool in a few

¹While the pattern of output fluctuations may change in EMU, there is little practical alternative at present to using past experience in assessing the implications of cyclical fluctuations for fiscal policy.

countries; compensate in some countries for the relatively modest size of the automatic stabilizers (for example, Portugal); provide extra room for maneuver for countries with economic cycles that are, at least for now, less synchronized with the monetary area as a whole, or which are especially vulnerable to asymmetric shocks (for example, Ireland and Finland); and help deal with particularly difficult downturns.

- There may be additional risks not directly related to the cycle, but that could complicate the fiscal position if they should materialize at the same time as a cyclical downturn. Thus, countries with high debt levels (for example, Belgium and Italy) may need to provide a buffer against interest rate shocks, and euro-area countries that are large recipients of EU structural funds (Ireland, Portugal, and to a lesser extent Spain) may wish to provide a contingency against the possible reduction of these funds as the EU plans for increased membership.
- Given the above considerations and the difficulties in assessing the size of the output gap, and particularly the tendency to underestimate the degree of overheating late in the cycle—with a consequent overestimation of the underlying strength of the fiscal positions—it seems prudent to allow some additional margin of fiscal maneuver.

The medium-term fiscal position needs also to be considered in light of the contribution that improvements in the net-liability position of governments can make to preparing for the impact of population aging. While there are many uncertainties in the calculations, and while the situation varies somewhat across countries, population aging over the next 30 years could add cumulatively about 7 percentage points of GDP to government pension and health spending in the euro area, with a further relatively moderate increase over the following decade unless there are modifications to existing programs. Moreover,

and the stability programs to be presented to ECOFIN by the end of 1998 that they are putting in place fiscal strategies in line with medium-term needs, emphasizing strict control of spending based on forward-looking reforms. Progress toward structural balance needs to resume but the pace of adjustment should also take into account the pressing case for further tax cuts as part of a broad strategy of structural reform, with particular emphasis on the tax burden of low-wage earners. Should the recovery prove stronger than envisaged, governments must resist the temptation to relax the reins on spending. Any windfall should be used to advance deficit reduction and to accelerate tax reform.

For countries with relatively high resource utilization, however, cyclical conditions would warrant a more restrictive stance. In some of these economies (notably, the Netherlands and Portugal), the expan-

sionary fiscal policy projected in 1998–99 seems clearly inconsistent with the cyclical position and the primary structural adjustment that is now needed. Even for the countries where the primary structural position is satisfactory, spending restraint can still be consistent with the medium-term strategy, as the room created can be used for tax cuts once cyclical conditions permit.

Structural Policies

As indicated earlier, for EMU to be a long-term success, structural policies will have to effect a sea change in the performance of European labor markets, which have adapted poorly to changes in the global economic environment since the 1970s. Unemployment in the euro area rose from 2½ percent of the labor force then to 12½ percent in 1997, com-

as the tax burden also needs to be cut, an even greater effort is required to reduce the ratio of spending to GDP.

- For the euro area as a whole, achieving and maintaining a deficit of 1 percent of GDP would over a 30-year period reduce the debt ratio by almost 40 percentage points allowing a decline in the ratio of interest spending to GDP of over 2 percentage points. Moving to structural balance at an early stage would reduce the interest bill by an additional 1 percentage point of GDP over a 30-year time frame. Moreover, compared with a scenario that maintained a deficit at 1 percent of GDP, the lower deficit in the balanced-budget scenario would provide additional scope to absorb spending pressures as the aging process neared its end by letting the deficit drift back up at that time.
- Directly cutting spending programs—including but not limited to those directly affected by the aging process—is a second option. Spending on pensions and health presently accounts for about 19 percent of GDP in the euro area. A key element will be to tackle the higher pension spending that is a result of the rise in life expectancy and the decline in the average age of retirement. In addition to reducing spending, reforms (notably of pension and unemployment benefit programs) could also improve the public finances by fostering higher employment.
- The employment rate—the ratio of those employed to the working age population—is relatively low in the euro area compared with both EU countries outside the euro area and the non-European advanced economies. Boosting this rate—through policies that lower structural unemployment or foster increased participation—would reduce the burden of spending relative to GDP, for given government spending policies. Based on estimates made by the OECD, reducing the structural unemployment rate by 5 percentage points in the euro area

would improve the primary fiscal balance by 2 percentage points of GDP, even assuming that the productivity of the new workers is only one-third of already employed workers.² In addition, boosting participation by 5 percentage points, at a given unemployment rate, could produce a reduction in primary spending of 2 percentage points of GDP. Although these scenarios are used here only as an illustration, they provide an indication of the fiscal room that could be created to accommodate the fiscal costs of aging populations.

While there are thus a number of options to address the longer-term fiscal challenge of aging, the scale of the problem is likely to require some combination of the available options. The likely need for a substantial improvement in the net-liability position of governments as part of the solution would seem to reinforce the arguments for structural fiscal positions of around balance. For Finland and Ireland, significant surpluses would seem to be warranted. In Finland, this reflects the large cyclical effects on the budget in the past, related to its greater susceptibility to asymmetric shocks, and the relatively early onset of the demographic shock. In Ireland, the main considerations are the less synchronized business cycle, a greater vulnerability to asymmetric shocks, and the expected reduction in EU structural funds in the next decade. Whether there is a need in due course to strengthen the medium-term budgetary goals in euro-area countries will depend, inter alia, on the extent to which countries plan to reform spending programs and their success in fostering higher employment rates.

²See OECD, *Economic Outlook* (Paris, June 1997). The lower productivity of the “marginal” workers can be seen partly as a reflection of policies that bring less-skilled workers back into the labor force, and partly as a proxy for the effect of employment-oriented policies on the capital-output ratio over time.

pared with no increase in the United States and much more moderate increases in Canada and Japan. Job creation has compared even less well, particularly with the United States. (See Chapter II.) At the same time, developments in output per head of the working-age population in the euro area have been in line with those in the United States, reflecting in part the distortions in the euro area that have favored capital deepening. Had the incentive system been geared more toward fostering employment creation, output growth would have been stronger, with fewer people denied the full benefits of this prosperity as a result of unemployment.⁸

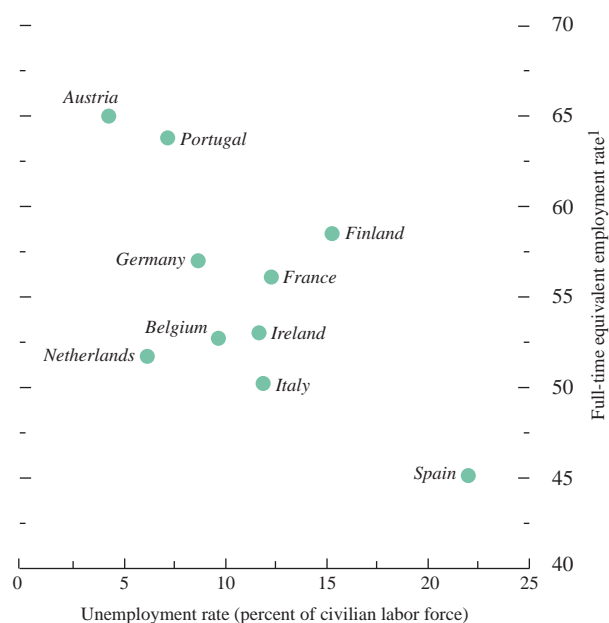
⁸The exclusion of the unemployed from general prosperity is exacerbated in the euro area by the higher incidence of long-term unemployment than in non-European industrial countries.

One indication of the size of the problem in the euro area is the employment rate (employment in percent of the working-age population), which at about 57 percent in 1997 contrasts with rates in the range of 70–76 percent in Denmark, Sweden, Switzerland, the United Kingdom, and the United States.⁹ This contrast is only partly explained by higher unemployment; differences in labor force participation are also a key factor, as discussed in Chapter II. Employment data, especially such data that distinguish part-time from full-time labor, also indicate that relative employment performance within the euro area is not adequately captured by unemployment data; for example, despite its low unemployment rate and strong employment

⁹Correction for the incidence of part-time employment would narrow the differences, but would not fundamentally alter the picture.

Figure 5.11. Euro Area: Employment and Unemployment, 1996
(Percent)

Unemployment rates alone are an inadequate guide to labor market conditions.



Source: European Commission.

¹Taking into account part-time and overtime in relation to nationally legislated work weeks.

growth in recent years, the Dutch economy has mobilized a relatively small share of its employment potential (measured in terms of full-time equivalents), while the employment rate in Finland is relatively high by euro-area standards despite a very high unemployment rate.¹⁰ More generally, if one excludes Austria and Portugal, which are in relatively favorable positions, and Spain, which is in a particularly unfavorable position, there is no clear, close linkage between employment (in full-time equivalents) and unemployment rates (Figure 5.11).

The relatively poor employment performance of the euro area underlines the scope for shifting to a virtuous path that would combine falling unemployment, increasing labor force participation, and a strengthening of the long-term foundation for the public finances. While there are many factors that lie behind differences in labor force participation—ranging from cultural factors to lack of job opportunities—even a moderate increase in euro-area participation rates could have quite a notable impact on employment, assuming of course that policies fostering job creation and wage flexibility were in place. As the relatively low participation in the euro area reflects in large part low participation by younger and older workers, the strategy particularly needs to address the labor market involvement of these groups. Without action, moreover, the cost of labor market rigidities will loom even larger, as relatively low participation rates among older workers will lead to a decline in the overall participation rate as the euro-area population ages, and as the high unemployment among younger workers affects their future employability and productivity.

The need to facilitate realignments of competitive positions and adjustments to asymmetric shocks within the euro area also underlines the importance of increasing the flexibility of markets. An example is the realignment of competitive positions that currently seems warranted over the medium term within the euro area. IMF staff calculations suggest that Germany is at a moderate competitive disadvantage relative to the euro area on average, while France, the Netherlands, and Spain, in particular, have relatively favorable competitive positions. To achieve the needed adjustments smoothly through inflation differentials, around the low average inflation rate that the ECB will target, will require greater price and wage flexibility than in the past. Without this flexibility, countries that need to strengthen their competitive positions will see increased unemployment as weakness of demand meets relatively rigid real wages. Meanwhile, greater labor market flexibility would enable countries starting from favorable competitive positions to use them as a platform to cut structural unemployment or boost

¹⁰Comparisons across countries may also be affected by the direct use of government jobs as an employment tool and by labor market subsidy programs.

participation rather than allowing them merely to increase the incomes of insiders.

Europe's structural problems have complex and wide-ranging origins—social benefit systems that provide inadequate incentives to work; tax systems that also distort incentives, placing an especially high burden on labor; excessive labor market regulations; and product market rigidities—with the importance of the different elements varying by country (see Box 5.3). As a consequence, there are no generally applicable solutions. Thus, the OECD and the EU in their respective labor market strategies have set out lists of guidelines that national authorities should endeavor to incorporate in policies that should be oriented to national needs. But while the required mix of policies varies from country to country, most countries need to address issues in each of the areas identified above, taking account of the interactions between different labor market policies and institutions.

Progress is being made with labor market reform. But this has not been enough to make a noticeable dent in structural unemployment in most countries. Thus, a recent analysis of the implementation of the OECD Jobs Strategy indicates that although euro-area countries have taken action on a fairly broad front consistent with its recommendations, the action has not yet been sufficient in most areas.¹¹ The introduction of new labor market surveillance procedures in the EU provides an opportunity to increase the momentum of reform through peer pressure and by strengthening the hands of reform-minded policymakers. The national action programs that countries have submitted to the EU represent an important step in this process but these generally need to be made more specific. Moreover, there remains a reluctance on the part of national authorities to reduce unemployment benefits and their duration or to make minimum wage and employment protection regulations more flexible. As well as actively promoting reform, an important task of stronger surveillance must be to ensure that measures such as reductions in the work week are implemented flexibly so as to prevent such adverse effects as increases in labor costs. It will also be critical to maintain the pressure for reform as the recovery proceeds since there is a danger that the attention paid to labor market problems may diminish as cyclical unemployment declines.

As the process of integration within the euro area deepens, there is a risk that pressures emerge for wages and social benefits to converge across countries in advance of productivity. The experience in a number of countries—most notably, the convergence of wages in Germany following unification, but also in Belgium, Italy, and Spain where national arrangements have contributed to serious regional diver-

gences in unemployment—underlines the dangers. To counteract tendencies toward a euro-area focus in wage agreements, national labor market policies need to address factors that tend to delink wage behavior from local labor market conditions, especially policies and institutions that give power to insiders, such as rigid employment protection legislation, practices that extend contracts to nonunion workers, and subsidies or market support to enterprises and sectors.

Beyond their importance to the performance of national and area-wide labor markets, structural policies at the national level are also relevant to the euro-area policy mix. First, more flexible markets can help economies adapt to shocks, especially asymmetric ones. This flexibility is likely to become more important in the future to the extent that fiscal policies have been brought into line with medium-term needs, as the case for using fiscal policy actively to restrain demand in cyclically advanced economies will not then be bolstered, as it is now, by the need for medium-term consolidation. Second, reforms that strengthen the euro area's supply response would tend to postpone the need for monetary tightening and reduce upward pressure on the real value of the euro as the recovery matures; the related lengthening of the recovery would improve the chance of reversing some of the past effects of hysteresis on unemployment. While some types of reform, especially in product markets, may take a considerable time to produce supply-side benefits, measures that directly increase incentives to work and to employ can have important benefits within a few years, if not sooner.¹²

The Overall Policy Mix

In light of the above analysis, the preferred policy mix for the euro area would be a moderately paced reduction of structural deficits that would realize at least balanced structural positions by 2001, combined with substantially stronger structural reform. Within this framework, the cyclically advanced economies should put particular emphasis on fiscal tightening, while the others should avoid further slippage from the SGP's medium-term goals by ensuring that deficit reduction resumes in 1999 budgets. These fiscal policy requirements are underscored by the need to ensure that monetary policy has adequate room for maneuver in light of the prevailing uncertainties. Policymakers should pay particular attention to addressing inflexibilities in their labor and product markets, including through reform of tax and benefit structures. This strategy would strengthen the recovery by deferring the emergence of supply constraints and allowing lower interest rates than would otherwise be possible.

¹¹OECD, *The OECD Jobs Strategy: Progress Report on Implementation of Country-Specific Recommendations*, Economics Department Working Paper 196 (Paris, 1998).

¹²The Netherlands since the early 1980s and Denmark in the mid-1990s are two cases where labor market reforms produced relatively early improvements in labor supply conditions.

Box 5.3. Euro-Area Structural Rigidities

While social benefits systems in the euro area play an essential role in helping to reduce poverty and alleviating the costs of economic restructuring, their design does not adequately take account of the need to foster reemployment of the unemployed. Unemployment benefits, typically provide unemployed workers with a high replacement rate of prior income, long duration of benefits, and often inadequate tests of a worker's availability for work.¹ A relatively high replacement rate can have advantages because it allows unemployed workers some time to find a good job match without being forced by income considerations to take the first job that becomes available. However, when generous replacement rates are combined with long benefit duration and weak tests of how seriously the unemployed person is searching for work, the disincentive to seek employment can be significant. Similar disincentives can result from the operation of early retirement provisions, which in many cases effectively provide an additional option for extended unemployment benefits. There are also concerns, reflected for example in the employment guidelines adopted by the Council of the EU, that an insufficient share of spending on the unemployed is devoted to active labor market measures and that the active measures that are in place need often to be made more effective (through better targeting and design of the activities of public employment services, and of training and job creation programs).

The revenue burden in the euro area has been pushed to a very high level over the past 30 years, in order to finance the expansion of transfers to households and the interest costs associated with the rise in government debt.² A particularly heavy share of increase has been levied on labor income, and less skilled labor in particular. This reflects, *inter alia*, the rise in the relative importance of social security contributions, including those paid by employers. OECD data show that, between 1978 and 1995, the increase in the marginal tax rate paid by workers who earn only two-thirds of the average production wage (APW) was clearly larger than the increase in marginal tax rates at the APW in five of seven euro-area countries (Belgium, Finland, France, Italy, and the Netherlands).³ Moreover, in

many countries, relatively high marginal tax rates combined with a withdrawal of benefits that are related to earned income (for example, housing benefits) result in particularly sharp disincentives to work at low income levels.

Regulation of labor markets in the euro area, notably through employment protection legislation (EPL) and minimum wage regulations, has received considerable criticism. As regards EPL, while the situation varies across countries, most euro-area countries have relatively strict legislation compared with Denmark, the United Kingdom, and the United States (based on the EPL indices constructed by the OECD). The concern is that EPL, by increasing the expense of firing or laying off workers, discourages new hires, though there is some debate about how important such legislation is in explaining cross-country differences in unemployment.⁴ On minimum wages, a recent OECD study concluded that there was not clear evidence of adverse effects on employment as long as minimum wages were not too high relative to the general wage level, but that adverse effects were more likely to occur with young workers.⁵

While the internal market program has contributed importantly to breaking down barriers in European markets, there are still important rigidities and distortions in product markets. Sheltered producers will tend to produce a lower volume of output than would be supplied under competitive conditions, thereby reducing employment. More generally, inefficient allocation of resources keeps output and demand below potential. In a recent report, the European Commission stated that there are significant barriers to market access in sectors accounting for half of GDP in the EU.⁶ In part this reflects areas that have been brought late into the internal market program—notably telecommunications and energy. In other areas, the implementation of the internal market program has not been as successful as had been hoped (for example, in public procurement). Government programs have also had a marked distortionary effect on price signals. Notably, subsidies to agriculture and industry remain significant, with the Commission observing in its latest report on state aid that the previous trend toward reduction in the volume of state aid to industry had not continued in 1992–94.⁷ Further liberalization of retail trade and distribution is also needed in many countries.

¹The OECD index of benefit generosity, based on the first two of these three characteristics, indicates that, among euro-area countries, benefits are particularly generous in Belgium, Finland, and the Netherlands. See Table 2 of OECD, *Implementing the OECD Jobs Strategy: Lessons from Member Countries' Experience* (Paris, 1997), for 1995 data.

²The general government revenue in the euro area in 1997 was equivalent to 47½ percent of GDP.

³For these countries, the increases in marginal tax rates for low wage earners ranged from 9 percentage points in the Netherlands to 36 percentage points in Belgium. These calculations do not include social security levies on employers. In Spain, there was also a greater rise in the marginal rate for low wage earners. However, both the differential increase over that at the APW and the scale of the increase for low wage earners (1 percentage point and 3 percentage points respectively) were small in comparison with the five countries mentioned in the text. In the case of Germany, the marginal rate fell significantly

for low wage earners while they rose for those at the APW. Data were not presented for Austria, Ireland, Luxembourg and Portugal. See OECD, *Economic Outlook* (Paris, June 1998).

⁴See Stephen Nickell, "Unemployment and Labor Market Rigidities: Europe Versus North America," *Journal of Economic Perspectives*, Vol. 11 (Summer 1997), pp. 55–74.

⁵ OECD, *Employment Outlook* (Paris, 1998).

⁶Commission of the European Communities, *Growth and Employment in the Stability-Oriented Framework of EMU*, COM 98/103 (Brussels, 1998).

⁷Commission of the European Communities, *Fifth Survey of State Aid in the European Union in the Manufacturing and Certain Other Sectors*, COM 97/170 (Brussels, 1997). State aids to the industrial sector were estimated at about 4 percent of value added in 1992–94 in the EU as a whole.

Policy requirements viewed from the perspective of individual member countries seem generally compatible with the policy mix needed for the euro area. An important issue now is whether the more cyclically advanced countries recognize the urgency of taking measures to restrain demand. In this context, there is a risk that in EMU inflation may seem less of a short-term policy concern at the national level than it has been when countries have had their own separate currencies. But inflation at the national level will carry adverse implications for competitiveness, and hence for employment, especially if adverse wage dynamics emerge. In this context, the stance of fiscal policy in some of these countries is not reassuring. Moreover, in a few cases, notably Ireland and the Netherlands, the pickup in asset prices and its implications for private sector balance sheets and the quality of banks' loan portfolios need to be watched closely.

Unfortunately, there are risks that sufficient progress will not be made in implementing the desirable policy strategy for the euro area. In part, these risks reflect the frequent tendency for policymakers to ignore the spillover effects on other economies of their actions, or lack of action. They may also reflect, in the case of some of the more cyclically advanced economies, the mistaken hope that the monetary policy stance of the ECB may compensate in part for the inadequacies of national fiscal policymaking. But, more fundamentally, they reflect the inherent difficulty that policymakers face in rallying domestic support for the adoption of policies that may seem to the public at large as unnecessarily stringent in a period of growing

prosperity. The slippage in fiscal policy that is evident in 1998, and the fears that this slippage could intensify as the recovery gathers strength, are obvious worries. Even more worrisome is the risk that the actions needed to address labor market problems will not be forthcoming as cyclical unemployment recedes.

The Euro Area and the World Economy

EMU and the economic performance of the euro area will have their largest external effects on neighboring economies in western Europe and on developing and transition countries with important trade and financial links to Europe, including countries that link their currencies to the euro (Table 5.1). Among emerging market economies, those likely to be most affected are the transition countries of central and eastern Europe and the Baltics, the developing countries of the Mediterranean basin, and countries in Africa. Other countries, in Asia and the Western Hemisphere, as well as advanced economies outside Europe, will be affected as well, but to a lesser extent.

The Current Global Environment and the Transition to EMU

The global environment has been favorable in a number of respects for the transition to EMU and the achievement of its economic objectives. As discussed earlier, strong demand for euro-area exports from industrial countries at more advanced stages of the busi-

Table 5.1. Euro Area and Selected Countries: Trade Linkages in 1996

(Exports to and imports from trading partners as percent of total trade and output)

| | Partner Countries | | | | | | |
|----------------------------|--------------------|----------------|---------------------------|---------------------|-----------|----------------|---------------------------|
| | Trade ¹ | | | Output ² | | | |
| | Euro area | Other advanced | Developing and transition | Total | Euro area | Other advanced | Developing and transition |
| Euro area | 51.0 | 30.8 | 18.2 | 22.9 | 11.7 | 7.1 | 4.2 |
| Denmark | 47.1 | 40.2 | 12.7 | 23.6 | 11.1 | 9.5 | 3.0 |
| Greece | 57.5 | 21.4 | 21.1 | 14.6 | 8.4 | 3.1 | 3.1 |
| Sweden | 44.5 | 43.1 | 12.3 | 29.1 | 13.0 | 12.6 | 3.6 |
| United Kingdom | 49.4 | 34.9 | 15.7 | 22.3 | 11.0 | 7.8 | 3.5 |
| Japan | 11.3 | 54.7 | 34.1 | 8.2 | 0.9 | 4.5 | 2.8 |
| United States | 13.8 | 53.6 | 32.6 | 9.4 | 1.3 | 5.0 | 3.1 |
| Asia | 12.5 | 67.7 | 19.8 | 19.7 | 2.5 | 13.3 | 3.9 |
| Africa | 39.8 | 34.4 | 25.8 | 19.5 | 7.7 | 6.7 | 5.0 |
| CFA franc zone | 48.1 | 23.7 | 28.2 | 25.5 | 12.3 | 6.1 | 7.2 |
| Middle East and Europe | 26.9 | 42.8 | 30.2 | 25.6 | 6.9 | 11.0 | 7.8 |
| Central and eastern Europe | 51.0 | 16.1 | 32.8 | 32.9 | 16.8 | 5.3 | 10.8 |
| Western Hemisphere | 13.3 | 61.4 | 25.3 | 14.8 | 2.0 | 9.1 | 3.7 |

Source: IMF, *Direction of Trade Statistics* and *World Economic Outlook*.

¹Imports plus exports of goods from and to partner countries as a percent of total imports plus exports.

²The average of imports plus exports of goods from and to the partner countries as a percent of GDP.

ness cycle and the depreciation of the currencies of euro-area countries over the past three years fostered a strengthening of growth in the euro area and helped to offset the effects of the Asian crisis. Demand growth from these areas is likely to slow, however, making self-sustaining demand growth in Europe more important. The recession in Asia, however unwelcome, has lowered actual and prospective inflation further and been a factor in the reallocation of global portfolios toward mature markets that has helped to reduce long-term interest rates in the euro area.

The global economic environment also provides challenges for EMU, especially since the Asian and Russian crises, and financial market volatility in emerging market economies elsewhere could have adverse spillover effects on the euro area and make monetary policy decisions more difficult. First, should these crises deepen or spread, external demand could be weaker than projected, dampening the current cyclical upswing in Europe. Confidence effects in this case could have adverse implications for domestic demand. Second, financial market volatility could add to uncertainty in the assessment of economic indicators that will be monitored by the ECB—for example, through shifts in the demand for money and other assets—and thus complicate assessments of the outlook for growth and inflation. Third, the weakness of the Japanese yen since late 1997 and the volatility of the yen-dollar exchange rate in recent months illustrate how market exchange rates among major currencies can move quickly in ways that are inconsistent with medium-term fundamentals. Such changes could influence financial market conditions and monetary policy deliberations in the euro area in the period ahead. Finally, the crises in Asia and Russia, and the possibility of a broader crisis in emerging markets could influence the transmission of policy to the real economy if euro-area commercial banks have to adjust their balance sheets to make substantial provisions for nonperforming loans.

The Euro

It is, of course, impossible to predict the precise properties of the behavior of the exchange value of the euro (Box 5.4).¹³ With regard to broad trends, however, it seems likely that the euro will tend to appreciate against the U.S. dollar and pound sterling over the next few years, but depreciate against the Japanese yen when Japan's economic recovery begins.

The cyclical position of the euro-area economy relative to other major economies is likely to be a significant near-term influence on the euro's value vis-à-vis other currencies. As discussed in the May 1998 *World Economic Outlook*, the currencies of countries in weak

cyclical positions tend to depreciate relative to those of countries that are cyclically strong. Because the United Kingdom and the United States have reached relatively advanced stages of their cyclical upswings, with resources more fully utilized than in the euro area, the euro's initial value vis-à-vis the pound sterling and U.S. dollar can reasonably be considered to be somewhat below its medium-term equilibrium. As the economic recovery in the euro area proceeds and growth in the U.K. and U.S. economies slows, some appreciation of the euro against these currencies is likely. Japan, on the other hand, remains in a weak cyclical position, having slipped into recession in late 1997, a development reflected in the recent weakness of the yen. The resumption of moderate growth in Japan, projected to begin late this year, may be expected to lead to a recovery of the yen toward values more consistent with medium-term fundamentals. Market expectations, as reflected in interest differentials, point to a yen appreciation over this period, albeit modest relative to the decline in the yen since the end of 1996.

Measures of fundamental equilibrium exchange rates are consistent with the assessment that the euro is likely to debut below its medium-term equilibrium value. The IMF uses a number of criteria to evaluate exchange rates, but the central framework is the macroeconomic balance approach, which takes into consideration medium-term prospects for national saving and investment and their implications for the medium-term equilibrium current account balance.¹⁴ For the euro area, demographic factors—in particular, a relatively high percentage of the population approaching retirement age—can be expected to raise national saving relative to investment over the medium term, warranting an equilibrium current account surplus. However, the external surplus recorded by the euro-area countries in 1997, which was strongly influenced by cyclical divergences between the euro area and its trading partners, appears to have been larger than what would constitute a reasonable medium-term equilibrium, suggesting room for the euro to appreciate in effective terms toward levels consistent with a smaller surplus (Box 5.5, on page 146).

Another important determinant of the demand for euro-denominated assets will be the degree to which investors perceive the euro to be a stable store of value, which will depend on the credibility of the ECB. It is reasonable to assume that the ECB will have a high degree of credibility in the eyes of investors at its inception because it has been given independence to pursue price stability as its primary objective, and because its governing body mainly comprises central bankers who have demonstrated their resolve to achieve and main-

¹³See Paul R. Masson, Thomas H. Krueger, and Bart G. Turtelboom, eds., *EMU and the International Monetary System* (Washington: IMF, 1997).

¹⁴See Peter Isard and Hamid Faruquee, eds., *Exchange Rate Assessment: Extensions and Applications of the Macroeconomic Balance Approach*, Occasional Paper 167 (Washington: IMF, 1998).

tain price stability and who are mostly regarded by financial markets as inflation hawks. Forward market exchange rates already indicate high credibility: forward rates vis-à-vis the U.S. dollar imply expectations of a strengthening European currency unit (ECU) and deutsche mark, which may be seen as proxies for the euro before euro trading begins (Figure 5.12).

Other factors also will affect the euro's exchange value. For example, EMU may well lead the national central banks of the euro area to reduce their holdings of international reserves because trade within the euro area will no longer need to be backed by international reserves.¹⁵ The range of estimates of the resulting surplus of international reserves is wide, from \$50 billion to \$230 billion, reflecting uncertainties in the underlying calculations.¹⁶ If the European System of Central Banks (ESCB) reduces its reserves, given that they are held mostly in U.S. dollars, there would tend to be downward pressure on the euro/dollar exchange rate; but the impact is likely to be minor, since the estimates of excess foreign reserves are very small relative to the stocks of U.S. international assets and liabilities, which are of the order of \$3½ trillion and \$4 trillion, respectively. Central banks outside the euro area are also likely to reduce their dollar positions (which amount to approximately \$775 billion), choosing to hold more euros than pre-EMU euro-area currencies, particularly if the risk-return characteristics of euro-denominated assets become more competitive with the dollar as euro-area financial markets deepen. This effect also is likely to be small, however, because the adjustment is likely to be gradual and small relative to asset stocks and private sector portfolio shifts.

Shifts in private sector supply and demand for euro-denominated assets will almost certainly swamp the effects of the rebalancing of official reserves. In the short run, adjustments in existing portfolios could result in upward pressure on the euro, as uncertainty about monetary union and ECB policy is further reduced. Over time, however, the reduction in transactions costs likely to be associated with the integration of euro-area markets has the potential to increase both supply and demand for euro-denominated instruments, making the impact on euro exchange rates difficult to predict, but also tending to make the euro a major international currency.¹⁷

¹⁵Significant changes in reserves at the national central banks will be subject to ECB concurrence because of the potential consequences for euro-area monetary policy.

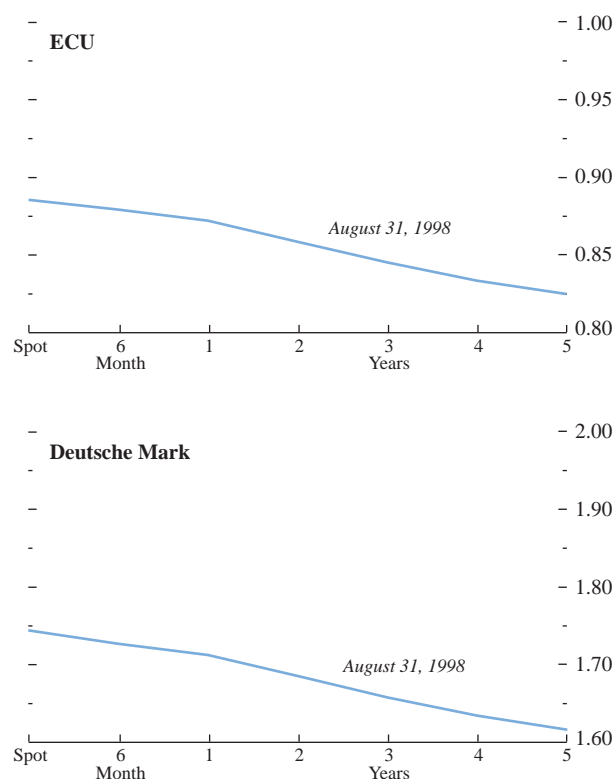
¹⁶See Paul R. Masson and Bart G. Turtelboom, "Characteristics of the Euro, the Demand for Reserves, and Policy Coordination Under EMU," in Masson, Krueger, and Turtelboom, eds., *EMU and the International Monetary System*, pp. 194–224.

¹⁷Robert N. McCauley and William R. White, "The Euro and European Financial Markets," in Masson, Krueger, and Turtelboom, eds., *EMU and the International Monetary System*, pp. 324–88, make the point that the supply of euro-denominated bonds could rise relative to the current supply of bonds in the member currencies. See also the introduction to the same volume for a review of these issues.

Figure 5.12. ECU and Deutsche Mark Exchange Rates Vis-à-vis the U.S. Dollar: Spot and Forward, August 31, 1998

(Currency units per U.S. dollar)

Financial markets expect the euro to appreciate over the next five years.



Source: Bloomberg Financial Markets, LP.

Box 5.4. Determining Internal and External Conversion Rates for the Euro¹

When the euro is created on January 1, 1999, its conversion rates against other currencies—internal and external—will need to be established. *Internal conversion* rates are the rates at which participating currencies will be converted into euros, while *external exchange* rates are the exchange rates against currencies outside of the euro area. A key distinction is that the internal rates will be irrevocably fixed while the external value of the euro will be market determined. Both, however, will depend on market rates (on December 31, for internal rates) and therefore they cannot be calculated in advance. To avoid market surprise, ministers and central bank governors of the member states that will adopt the euro, together with the European Commission and the EMI, have announced the procedures that will be followed to establish these rates.

As an initial step, it was announced in early May that the eleven currencies participating in monetary union will be converted on December 31 among each other at the current central bilateral rates of the ERM. They will be market determined until then. By preannouncing the rates at which these currencies will be fixed against each other, market expectations have been anchored and uncertainties about the final locking rates are greatly reduced. This announcement was anticipated by market participants, as reflected by a convergence of forward markets toward these rates.

In order to ensure that market exchange rates on December 31 are equal to the preannounced cross exchange rates, the central banks of the participating countries agreed to use appropriate market techniques to the extent necessary. With the progress made in nominal convergence among these countries, including the convergence of forward exchange rates to the announced parities noted above, the need for official intervention appears unlikely unless countries in the area are hit by a large asymmetric shock or similar development before the end of the year. The threat of intervention would be credible, however, because it would have no lasting impact on central bank balance sheets or monetary policy since all participating central bank assets and liabilities

will be converted to euros on January 1, 1999 at the announced parities.²

Setting the conversion rates among the participating currencies of course does not establish the *external* exchange rate of the euro, and by extension, the final locking conversion rates of participating currencies against the euro itself. These will depend on market exchange rates of the participating currencies, plus the exchange values of the three currencies in the ECU basket that will not be part of the euro area at the outset. This last constraint reflects the requirement, based on the Maastricht Treaty, that one euro must equal one ECU at the time that the euro comes into being. This requirement would be mathematically simple if all currencies included in the ECU basket were in the monetary union. However, because the Danish krone, the Greek drachma, and the British pound will not be replaced by the euro but are in the ECU basket, special procedures are needed.

The three-step process to determine the irrevocable conversion rates is illustrated in the table. In step 1, participating central banks will observe market exchange rates for their respective currencies against the U.S. dollar at a specified time on December 31. Forward exchange rates for the end of 1998 are used as proxies in the example shown in the table (first column). In step 2, dollar exchange rates, including for the three currencies that will not participate in monetary union, will be used to calculate the ECU basket in terms of dollars (\$1.13/ECU, bottom of first column); approximate weights are shown in the second column of the table. In step 3, the dollar exchange rates for the participating currencies will be multiplied by the dollar-ECU rate (calculated in step 2) to give euro area member currency exchange rates in terms of ECU (example for Austria: \$ 12.20/\$ × \$1.13/ECU = \$ 13.8/ECU³). These will become the irrevocable euro conversion rates on January 1, 1999, and by construction, will satisfy the requirement that one euro equals one ECU when trading begins.⁴ The euro conversion rates are consistent with market rates prevailing on the last day before the single currency begins and therefore the process will not create incentives for speculation.

The last column of the table shows illustrative euro exchange rates against selected currencies outside of the

¹This box is based on “The Joint Communiqué on the Determination of the Irrevocable Conversion Rates for the Euro” issued by the ministers of economic affairs and finance of the countries adopting the euro as their single currency, the governors of the central banks of these countries, the Commission, and the EMI on May 3, 1998.

²This neutrality applies to nonsterilized intervention where one euro currency is exchanged for another.

³Actual conversion rates will be calculated to six digits.

⁴The official ECU will be discontinued on January 1, 1999.

The variability of the new currency’s external value is also not easy to predict. On the one hand, the weight placed by the ECB on the euro’s external value in formulating its monetary policy may be less than the weight placed by its predecessor central banks on the exchange rates of their respective currencies, possibly resulting in greater variability of the exchange rate, if variation in the euro’s exchange rate against the U.S.

dollar has a diminishing impact on domestic inflation. This could be the case if the invoicing of international trade, such as in commodities, shifts from dollars to euros. On the other hand, in the near term at least, the euro’s exchange rate may take on added importance as an indicator for monetary policy decisions owing to the potential instability in money demand and in the relationships between money growth and future inflation.

Euro Conversion Rates and Initial Market Exchange Rates: An Illustrative Example

| | U.S. Dollar Forward Rate for End-1998 ¹ | Approximate Weight in ECU Basket ² | Illustrative Euro Conversion Rates (per euro) ³ | Illustrative Euro Exchange Rates on January 4, 1999 |
|-----------------------------|--|---|--|---|
| Euro-area countries | | | | |
| Austria | 12.20 | | 13.8 | |
| Belgium | 36.06 | 8.12 | 40.8 | |
| Finland | 5.28 | | 6.0 | |
| France | 5.83 | 20.15 | 6.6 | |
| Germany | 1.73 | 31.68 | 2.0 | |
| Ireland ⁴ | 1.43 | 1.08 | 1.6 | |
| Italy | 1,722.3 | 7.77 | 1,950.2 | |
| Luxembourg | 36.06 | 0.32 | 40.8 | |
| Netherlands | 1.96 | 9.89 | 2.2 | |
| Portugal | 179.36 | 0.69 | 203.1 | |
| Spain | 148.25 | 4.10 | 167.9 | |
| Other EU countries | | | | |
| Denmark | 6.66 | 2.63 | | 7.50 |
| Greece | 311.21 | 0.42 | | 352.40 |
| Sweden | 7.98 | | | 9.00 |
| United Kingdom ⁴ | 1.67 | 13.16 | | 1.47 |
| <i>Memorandum</i> | | | | |
| Dollars per ECU | 1.13 | | | |

¹Four-month forward rates as of August 31, 1998.

²The currencies of Austria, Finland, and Sweden are not in the ECU basket.

³Final conversion rates will be announced as six-digit numbers.

⁴Expressed in dollars or ECUs per local currency.

euro area when trading in euros begins (example: Dkr 7.5 = 1 euro). As with the internal conversion rates, these are derived by multiplying each currency's dollar value on December 31 by the ECU-dollar exchange rate, again because the euro is set up to equal one ECU at the euro's debut. Because these rates will be based on market rates on December 31, they will establish the euro's likely opening levels against currencies outside of the area when euro trading begins, assuming that there are no shocks or relevant news between the time markets close on December 31 and the time markets open on January 4. Of course, when the new currency market starts operating, the value of the euro against other currencies will be determined by market conditions.

An interesting implication of the announced procedures is that the values of the drachma, krone, and sterling against the U.S. dollar can affect the irrevocable conversion rates of the participating currencies against the euro and the initial external euro exchange rate against the U.S.

dollar. However, this is simply a question of unit of account, or numeraire, and will have no economic impact. The situation comes about because these three currencies help determine the dollar value of the ECU, which will be used to set the numeric value of the euro at the start of Stage 3. For example, if sterling (which has a 13 percent weight in the ECU basket) were to end the year 10 percent stronger against the dollar than predicted by the forward rate shown in the table, the ECU would be 1.3 percent more appreciated than shown, thus causing the euro exchange rate vis-à-vis the dollar to be stronger by the same magnitude. The more appreciated ECU-dollar rate will be exactly offset by lower conversion rates of all participating currencies against the euro, leaving the external values of the participating currencies unchanged. Underlying relative prices, for example the implied deutsche mark-dollar exchange rate (if it were to exist), would be unaffected as would external prices of euro exports and import prices of goods coming from outside the euro area.

Policy Challenges for Advanced Economies Outside the Euro Area

Developments in the euro area will have important implications for the EU members that will not participate in the first round of monetary union. Greece has continued to make significant progress toward macro-economic convergence with other EU countries and

has indicated its intention to link the drachma to the euro in the ERM-2 arrangement from the outset of Stage 3.¹⁸ Its objective of joining the euro area in 2001 will require continued tight fiscal and monetary poli-

¹⁸ERM-2 will replace the ERM. Currencies will float within a ± 15 percent band against the euro; there is a possibility for tighter bands to be arranged on a bilateral basis.

Box 5.5. The Euro Area and Effective Exchange Rates

Effective exchange rate indices are an essential tool for multilateral exchange rate analysis in the *World Economic Outlook*. With Stage 3 of monetary union and the creation of the euro, the *World Economic Outlook* will introduce effective exchange rate measures for the euro area.

The Synthetic Euro

Because the euro will not exist as a currency until January 1, 1999, a proxy measure of the euro's exchange value against external currencies will be useful for historical analysis. Prior to the announcement of the countries qualifying for monetary union, the ECU was used as an indicator of what the euro's value would have been, had it existed. Now that the participating currencies are known, it is possible to create a *synthetic euro* based on the 11 currencies that it will replace, using GDP weights (as in the ECU) to aggregate the separate currency values against the U.S. dollar (*see first figure*).¹ A conceptual concern, however, is that the properties of the synthetic euro (and estimated economic responses to its movements in the euro area and in trading partner countries) may not be representative of the new currency, since the synthetic measure is a weighted average of currencies that in the past moved relative to each other. The impact of this change in structure cannot be assessed empirically because the euro and its constituent currencies will not overlap as market-determined rates.

Effective Exchange Rates

The IMF maintains two systems of real effective exchange rate indices: one covers 21 industrial countries and is based on unit labor costs (ULC); and the second covers almost all IMF member countries and is based on consumer prices (CPI).² Given the large swings in some emerging market currencies in Asia over the past year, there is some concern that the system only covering industrial countries may understate current movements in effective exchange rates.

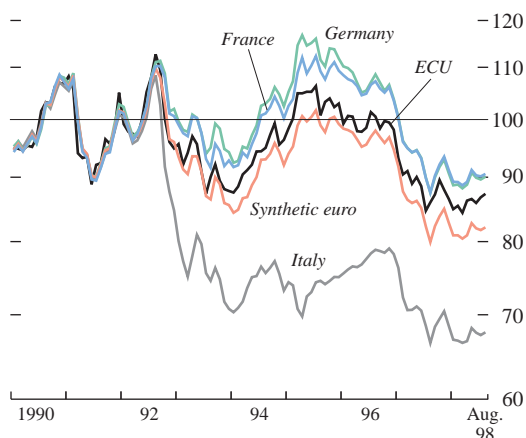
The ULC system of industrial country weights is based on manufactured goods trade data and takes into account competition between imports and locally produced goods, competition between own exports and foreign goods, and competition between own exports and foreign-produced exports in third countries. Weights

¹The choice of weights is arbitrary and GDP weights are used because they underlie the ECU. Trade weights do not affect the results significantly. To set the external level, the euro/dollar exchange rate is assumed to equal the ECU/dollar forward rate at the end of 1998.

²See Alessandro Zanello and Dominique Desruelle, "A Primer on the IMF's Information Notice System," Working Paper 97/71 (Washington: IMF, May 1997). Both sets of weights can also be employed to calculate nominal effective exchange rate indices. See also Anthony G. Turner and Stephen S. Golub, "Multilateral Unit-Labor-Cost-Based Competitiveness Indicators for Advanced, Developing, and Transition Countries," in *Staff Studies for the World Economic Outlook* (Washington: IMF, December 1997), pp. 47–60.

Exchange Rate Indices Vis-à-vis the U.S. Dollar

(Logarithmic scale; 1990 = 100)



Source: IMF, Competitiveness Indicators System.

for this system have been calculated for the euro area and preliminary results are shown in the table. Recalculation of the CPI weighting system used for all countries is more complicated owing to the higher number of countries involved and the use of more disaggregated data.

Movements in the nominal effective rate for the euro area, calculated using 11 partner countries and the synthetic euro, generally follow those of member countries, except during periods of relative exchange rate instability within Europe, for example, during the ERM crisis in 1992 (*see second figure*). More recently, the synthetic

Effective Exchange Rate Weights for the Euro Area

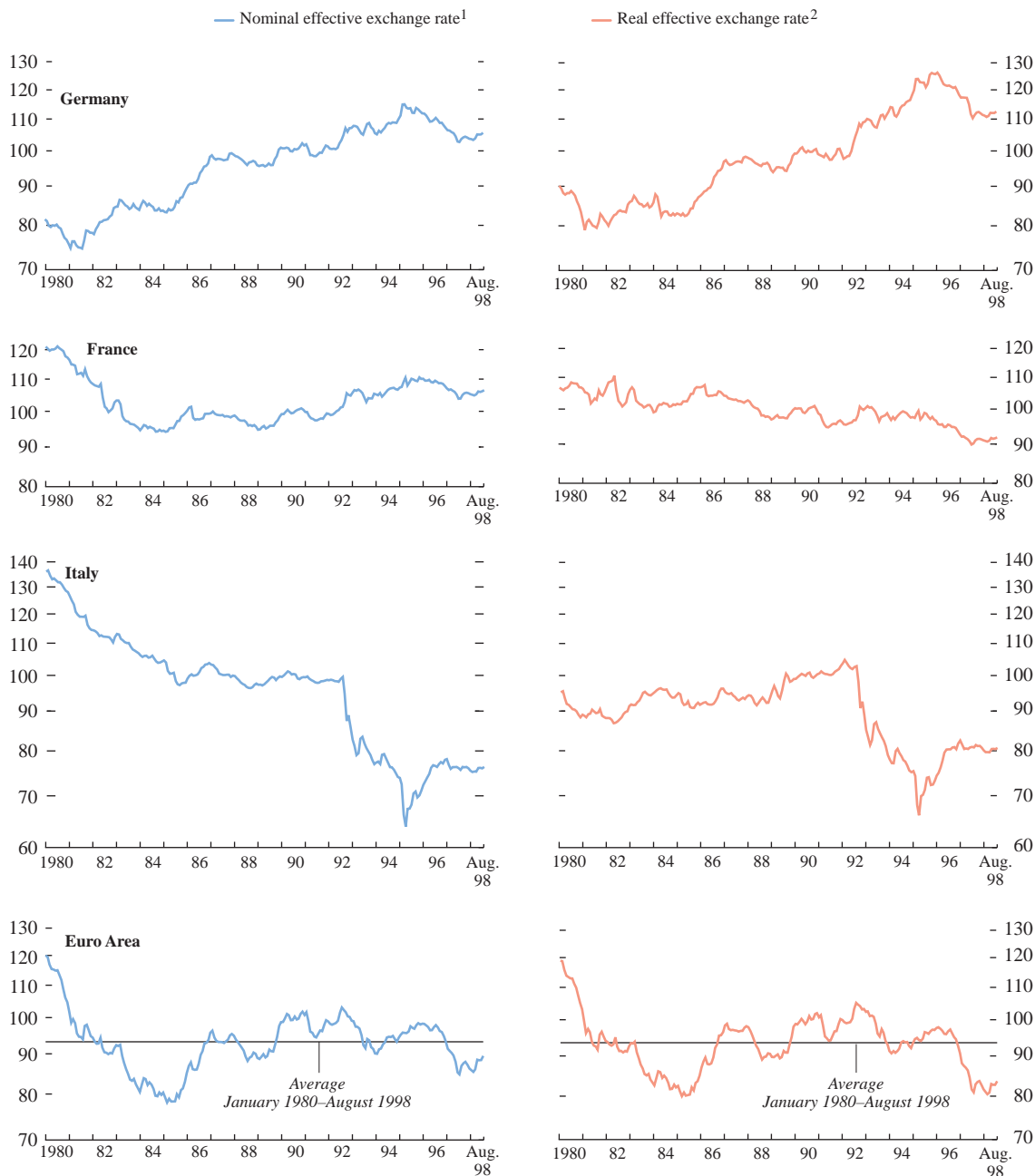
(In percent)

| Partner Countries | Euro Area |
|-------------------|-----------|
| Australia | 0.4 |
| Canada | 2.0 |
| Denmark | 3.3 |
| Greece | 1.3 |
| Japan | 14.5 |
| New Zealand | 0.1 |
| Norway | 2.0 |
| Sweden | 7.8 |
| Switzerland | 12.7 |
| United Kingdom | 30.4 |
| United States | 25.5 |

Source: IMF staff calculations.

The Euro Area and Selected Countries: Nominal and Real Effective Exchange Rates

(Logarithmic scale; 1990 = 100)



¹Estimated by the IMF's Competitiveness Indicators System, using 1989–91 trade weights.

²Defined in terms of relative normalized unit labor costs in manufacturing, as estimated by the IMF's Competitiveness Indicators System, using 1989–91 trade weights.

Box 5.5 (concluded)

euro effective rate index has moved away from the effective rates of individual member countries, but this time reflecting changes in dollar exchange rates and the fact that the euro index gives greater weight to the U.S. dollar. For example, the weight for the U.S. dollar is two and one-half times larger in the euro index compared with the weight of the dollar in the deutsche mark index. This is because intra-European trade is eliminated in the new index, giving non-euro currencies a greater weight than at the country level.

The real effective exchange rate index for the euro area (based on unit labor costs) moves with the nominal index reflecting relatively small differences in unit labor cost changes across countries (see second figure). It is currently below its long-run average, perhaps reflecting the relatively weak cyclical position of the euro area. Differences between the euro area and country indices suggest differences in competitiveness within the euro area with some countries, Germany for example, losing competitiveness relative to the euro area average while France and Italy have gained.

Implications for the World Economic Outlook

Starting with the *World Economic Outlook* prepared in the spring of 1999, nominal and real effective exchange rate indices for the euro area will be reported regularly; publication of these in the IMF's *International Financial Statistics* will begin in 1999, in conjunction with other data for the euro area. Over the historical period through 1998, euro effective exchange rate indices will be based on a synthetic euro, which will be calculated along the lines described above, and the market-determined euro exchange rate thereafter. Final estimates of the necessary weights should be similar to those in the table, but could incorporate data revisions and refinements to the weight calculations.

Historical effective indices for industrial countries in and outside of the euro area will be unchanged through 1998. From January 1999, current procedures for calculating effective exchange rates will continue to be used and the indices will be based on weights now in place. In these future calculations, the euro will be replaced by the appropriate European currencies, after converting it to national currencies using the final locking rates that will be established on December 31. While currency variation within the euro area will cease, effective exchange rates for countries in the euro area will remain useful and provide information on competitiveness outside of the euro area and among countries within the euro area, the latter reflecting differences in relative costs and prices only. A decision on how to calculate the system of effective exchange rate indices covering almost all countries (CPI system) has not been made. The results of alternatives explored for the industrial country ULC system suggest that a full recalculation effort may not be necessary.

cies in the period ahead to ensure fulfilment of the Maastricht criteria and broad exchange rate stability vis-à-vis the euro.

In 1997, Denmark, Sweden, and the United Kingdom all met the Maastricht criteria for inflation and interest rate convergence and none had excessive deficits. However, Denmark and the United Kingdom had opted out of monetary union (and therefore were not formally assessed), while Sweden indicated that it did not intend to participate initially. The decision on future participation is likely to depend, in each country, on approval by public referendum; public opinion polls have suggested that referenda would have been unlikely in recent months to approve membership.

In the United Kingdom, the government has set out five economic tests to be passed before moving ahead with membership. These benchmarks, which comprise macroeconomic and structural convergence indicators, are intended to ensure that entry into monetary union is consistent with high and stable growth and employment.¹⁹ The United Kingdom is now operating close to full capacity and official interest rates, at 7½ percent since early June, are significantly above the short-term interest rates expected to prevail in the euro area at the start of EMU. This cyclical divergence plus structural differences between the U.K. economy and the initial euro area—for example, external trade patterns and financial market practices that affect the transmission of monetary policy—led the authorities to judge in October 1997 that the United Kingdom had not yet demonstrated the sustainable and durable convergence needed for monetary union.²⁰

An important near-term challenge faced by all three of these countries if they are to participate in the euro area is how to adjust their existing monetary policy frameworks and stances to ones compatible with the single currency. For Denmark, adopting the euro and

¹⁹The five tests ask (1) whether business cycles and economic structures are compatible between the United Kingdom and the euro area; (2) whether markets are sufficiently flexible to deal with shocks; (3) whether EMU will strengthen incentives for investment in the United Kingdom; (4) what impact entry into EMU will have on the U.K. financial sector; and (5) whether EMU will promote growth and stability in the United Kingdom. See "UK Membership of the Single Currency: An Assessment of The Five Economic Tests" (H.M. Treasury, 1998; available via the Internet: <http://www.hm-treasury.gov.uk/pub/html/docs/emumem/main.html>).

²⁰Because about one-half of U.K. trade is with North America compared with about one-fourth for each of the three largest euro-area countries, changes in dollar exchange rates are likely to have stronger effects on the United Kingdom than in the euro area. With regard to the effects of monetary policy, the personal sector is often considered to be more sensitive to short-term interest rates than in other European countries because variable rate mortgages are more prevalent, and because corporate indebtedness also differs relative to other European countries—for example, large U.K. corporations rely more on equity finance. Empirical evidence on differences in the effects of monetary policy is, however, mixed: see the October 1997 *World Economic Outlook*, pages 55–56.

shifting monetary policy decisions to the ECB is likely to be a small step because the krone has for some time been linked to the deutsche mark within the ERM and will be tied to the euro through participation in ERM-2, under a narrow band arrangement. As under the present ERM, Denmark's relative cyclical position, which currently reflects a significantly higher level of resource utilization than in the euro area, will be a factor in determining the success of its peg to the euro in ERM-2, as will its willingness to continue to use fiscal policy actively as needed to prevent overheating. Sweden and the United Kingdom have both anchored monetary policy with inflation targets since shortly after the ERM crisis of 1992; their currencies have floated and not participated in the ERM since then, but it is unclear to what extent this would be an obstacle to participation in the monetary union in the future.²¹ The currencies of both countries have moved significantly in exchange markets over the past economic cycle and a decision to enter the monetary union will need to consider the appropriate entry rates of the krona and the pound. For example, had the United Kingdom entered monetary union at market exchange rates prevailing in the first half of 1998, the deutsche mark–sterling conversion rate might have been set above the rate at which sterling entered the ERM in September 1990, a rate that was also influenced by relatively tight monetary policies in the United Kingdom and that proved unsustainable.

Norway and Switzerland, which are not members of the EU and therefore not eligible for EMU, will be significantly affected by the new monetary union owing to their geographic proximity and strong trade and financial links with the euro area. Monetary policy in Norway has sought to stabilize the krone against a basket of European currencies, while leaving some limited room for short-term variations in exchange and interest rates. The authorities have indicated that they will maintain a similar strategy in Stage 3. The desire for some flexibility reflects the need to accommodate the influence of Norway's significant oil wealth as the krone tends to be sensitive to changes in world oil prices and new North Sea oil discoveries.²² The Swiss franc was subject to unwelcome upward pressure against the deutsche mark and other European currencies at times during 1996 when there was market uncertainty about EMU prospects;

²¹Participation in the ERM for two years is one of the Maastricht criteria. However, allowances were made for Finland and Italy, which rejoined the ERM in November 1996, less than two years before positive recommendations for monetary union membership were made.

²²See William E. Alexander, John H. Green, and Birgir Arnason, "A Monetary Framework for Norway: The Options," in Anne Berit Christiansen and Jan Fredrik Qvigstad, eds., *Choosing a Monetary Policy Target* (Oslo: Scandinavian University Press, 1997), pp. 26–60.

these safe-haven pressures on the Swiss franc have subsided as confidence in EMU has grown. It is unclear to what extent the larger euro-area financial market could affect banking and other financial services industries in Switzerland.

EMU and economic developments in the euro area more generally will have smaller direct effects on the non-European advanced economies. For Canada, the United States, and the advanced economies of Asia, trade with the euro area is a small share of each country's total trade or GDP, so that the direct effects of developments within the euro area on these economies is likely to be limited. (See Table 5.1.) Indirect influences, however, could be more important, especially for the United States. In addition to the implications for the dollar's exchange value discussed above, a redirection of demand for international reserves from dollars to euros will act through various channels to reduce the U.S. current account deficit as a necessary counterpart to the negative impact on the U.S. capital account. In addition, a shift in official and private demand from dollar-denominated assets to euros would redistribute some international seigniorage revenue from the Federal Reserve to the ECB, while financing costs for the U.S. government and private sector could rise marginally if greater demand for euro assets reduces investors' willingness to absorb dollar debt.²³ EMU and European integration can also be expected to have positive effects on the United States and other countries, especially as the single currency and the integrated market will facilitate financial and business transactions.

Implications for Developing and Transition Countries

More robust activity and higher import demand in the euro area stemming from the strengthening cyclical recovery and the beneficial effects of ongoing market integration and structural reforms may be expected to generate increased demand for exports from developing and transition countries. Financial linkages—reflecting, for example, exchange rate pegs to the euro, financial market developments, and capital flows including foreign direct investment—will also carry implications for developing and transition countries and their policies.

In 1996, trade with the euro area constituted 40–50 percent of total trade in goods for Africa as a whole, and stood at the higher end of this range in North Africa and the countries of the CFA franc zone, as well as in a number of countries in eastern Europe and the

²³ See the October 1997 *World Economic Outlook*, Chapter III. Kenneth Rogoff, "Blessing or Curse? Foreign and Underground Demand for Euro Notes," in Begg and others, *EMU: Prospects and Challenges for the Euro*, discusses the implications of euro currency notes replacing dollars in illegal transactions.

Table 5.2. Effect of 1 Percent Higher Output in the Euro Area on Selected Developing Countries*(In percent)*

| Country | Exports to EMU (as share of total exports, 1996) | Total Exports (as share of GDP, 1996) | Change in Total Exports from 1 Percent Higher EMU GDP | Change in Output from 1 Percent Higher EMU GDP |
|----------------------|--|---|---|--|
| Albania | 64.5 | 11.8 | 1.6 | 0.2 |
| Bulgaria | 31.0 | 44.5 | 0.7 | 0.3 |
| Croatia | 56.0 | 20.0 | 0.9 | 0.2 |
| Czech Republic | 54.3 | 38.5 | 0.7 | 0.3 |
| Hungary | 60.3 | 28.1 | 1.4 | 0.4 |
| Macedonia, F.Y.R. | 47.3 | 25.9 | 0.9 | 0.3 |
| Poland | 56.7 | 18.1 | 0.9 | 0.2 |
| Romania | 51.3 | 21.2 | 1.0 | 0.2 |
| Slovak Republic | 38.9 | 46.7 | 0.8 | 0.4 |
| Slovenia | 63.9 | 42.1 | 1.1 | 0.5 |
| Cyprus | 14.3 | 14.5 | 0.4 | 0.1 |
| Israel | 25.0 | 20.5 | 0.5 | 0.1 |
| Malta | 50.1 | 48.2 | 2.9 | 1.5 |
| Turkey | 43.5 | 12.7 | 0.8 | 0.1 |
| Algeria | 59.9 | 27.5 | 0.3 | 0.1 |
| Egypt | 39.6 | 8.1 | 1.0 | 0.1 |
| Jordan | 7.7 | 18.0 | 0.5 | 0.1 |
| Morocco | 56.9 | 12.8 | 1.1 | 0.2 |
| Syrian Arab Republic | 53.1 | 21.5 | 1.5 | 0.4 |
| Tunisia | 79.6 | 27.4 | 1.9 | 0.6 |

Source: IMF, *Direction of Trade Statistics* and *World Economic Outlook*, columns 1 and 2; and R. Feldman and others, *Impact of EMU on Selected Non-European Union Countries*, Occasional Paper (IMF, 1998, forthcoming), columns 3 and 4.

Mediterranean.²⁴ It accounted for less than 15 percent of total trade in the developing countries of Asia and the Western Hemisphere.

A rough indication of the first-round effect of higher euro area output on trading partner exports and output can be obtained by multiplying estimates of the income elasticities of import demand for the 11 EMU participants by the exports of each partner country to the euro-area countries. Such analysis indicates that a 1 percent increase in euro-area GDP will tend to result in a 0.7–1.6 percent increase in exports and a 0.2–0.5 percent increase in output for the transition countries of central and eastern Europe, with somewhat smaller effects for countries in the Mediterranean and North Africa (Table 5.2). The estimated effects of higher euro-area output on exports and GDP in Hungary and Tunisia are particularly large because these countries' exports go overwhelmingly to euro-area markets, while the effect is large for Malta because of that country's large share of exports in GDP. The effects

may be underestimated for Cyprus, in particular because tourism receipts are not included in the trade data used.

The effects of changes in euro-area output on exports and GDP for the countries in sub-Saharan Africa are likely to be much smaller than for European and Mediterranean countries, because the principal exports of most African countries are primary commodities, the supplies of which are insensitive to demand in the short term. In addition, demand for such commodities does not respond strongly to changes in income.²⁵

The above estimates indicate only rough orders of magnitude and there is considerable uncertainty attached to them. Associated with higher exports would be some "leakage" in the form of higher imports that would partly offset the direct and positive effects on aggregate demand and output. Moreover, and directly related to monetary union, increased productivity and other cost savings from EMU within the euro area could increase the competitiveness of euro-area firms and divert trade from non-euro-area suppliers, especially when the currencies of the latter are tied to the euro and cannot adjust to reflect relative productivity changes. On balance, however, it is likely that the net

²⁴Exports to the EU are a much greater share of total exports for some countries in these groups. For discussions of trade linkages, see Robert A. Feldman and Heliodoro Temprano-Arroyo, "Trade and Financial Effects of EMU on Selected Transition and Mediterranean Countries"; and Karim Nashashibi, Peter Allum, and Klaus Enders, "European Monetary Union: Prospects for the MENA Region," in R. Feldman and others, *Impact of EMU on Selected Non-European Union Countries*, Occasional Paper (Washington: IMF, 1998, forthcoming).

²⁵See Michael T. Hadjimichael and Michael Galy, "The CFA Franc Zone and the EMU," Working Paper 97/156 (Washington: IMF, November 1997).

Table 5.3. Selected Countries: Exchange Rate Regimes

| Country | Exchange Rate Regime | Basket or Target |
|----------------------------------|----------------------|---|
| Albania | Independent float | . . . |
| Bosnia-Herzegovina | Currency board | DM |
| Bulgaria | Currency board | DM |
| Croatia | Managed float | Narrow band with DM |
| Czech Republic | Managed float | . . . |
| Estonia | Currency board | DM |
| Hungary | Crawling peg | DM 70%, US\$ 30% |
| Latvia | Fixed peg | SDR |
| Lithuania | Currency board | US\$ |
| Macedonia, F.Y.R. | Managed float | De facto peg to DM |
| Poland | Crawling peg | US\$ 45%, DM 35%, £ 10%, Ff 5%, Sf 5% |
| Romania | Independent float | . . . |
| Slovak Republic | Fixed peg | DM 60%, US\$ 40% |
| Slovenia | Managed float | De facto shadow of DM; also real exchange rate rule |
| Cyprus | Fixed peg | ECU |
| Israel | Crawling peg | US\$ 54%, DM 26%, £ 8%, ¥ 7%, Ff 6% |
| Malta | Fixed peg | ECU 67%, US\$ 21%, £ 12% |
| Turkey | Managed float | Real exchange rate rule |
| Algeria | Managed float | US\$ |
| Egypt | Managed float | US\$ |
| Iran, Islamic Rep. of | Fixed peg | US\$ |
| Jordan | Fixed peg | US\$ |
| Lebanon | Managed float | US\$ |
| Morocco | Fixed peg | Basket of partner currencies |
| Saudia Arabia | Fixed peg | US\$ |
| Syrian Arab Republic | Fixed peg | US\$ |
| Tunisia | Managed float | Basket of partner currencies |
| CFA franc countries ¹ | Fixed peg | French franc |

¹Benin, Burkina Faso, Cameroon, Central African Republic, Chad, Comoros, Republic of Congo, Côte d'Ivoire, Equatorial Guinea, Gabon, Mali, Niger, Senegal, and Togo.

positive spillover of new trade resulting from higher euro-area output will outweigh the diversion of existing imports to provide a net positive effect of euro-area growth on these countries.

Benefits to emerging market economies will be reinforced by further progress with trade liberalization in the EU. There is a risk, however, of protectionist pressures that could limit imports from emerging market economies if countries in the euro area progress only slowly with labor market and other structural reforms and unemployment in the area remains high.

The countries of the CFA franc zone and most countries in central and eastern Europe and the Mediterranean link their currencies either to one of those that will be replaced by the euro or to a basket in which euro-area currencies have a prominent weight (Table 5.3). The peg for these exchange rate regimes may be expected to shift to the euro or a basket dominated by the euro. Thus, it has been announced that the peg of the CFA franc to the French franc will convert arithmetically to the euro, while Bulgaria, Cyprus, and Lithuania have announced their intentions of pegging to the euro. For countries pegging to the euro, changes in its exchange value will not affect competitiveness vis-à-vis euro-area markets. However, EMU could lead to increased variabil-

ity in these countries' terms of trade and competitiveness if it leads to larger fluctuations of the euro against the dollar and yen than have occurred with pre-EMU European currency pegs. Conversely, as countries move to a euro peg they may benefit from a currency link to the larger, more diversified euro area rather than to Germany or France, with the potential for reduced exposure to demand shocks transmitted through the exchange rate.

The extent to which changes in the value of the euro vis-à-vis the dollar and yen affect the competitiveness of developing and transition countries that peg to the euro will depend on how close an approximation the euro is to a country's effective exchange rate basket. Exchange rate movements could also have important effects on countries with substantial external debt. For example, when there is a mismatch between the currency denomination of the debt and the anchor of the exchange rate regime or the currency mix of trade partners, an appreciation of the euro would benefit countries that peg to the euro and export primarily to euro-area countries but service a substantial debt denominated in dollars, since this would decrease the domestic currency cost of debt service, probably without a fully offsetting decline in export revenue. Conversely, a depreciation of the euro would increase the

Table 5.4. Debt of CFA Franc Zone Countries*(In percent)*

| Country | External Debt (as share of GDP, 1997) | Share of Long-Term Debt Denominated by Selected Currencies, 1996 | | | |
|--------------------------|---|---|------------------------------|-------------------------------|------------------------|
| | | Euro-area currencies ¹ | U.S. dollar and Japan yen | U.K. pound and Swiss franc | Multiple currencies |
| Benin | 61.3 | 10.3 | 55.2 | 0.3 | 15.5 |
| Burkina Faso | 56.6 | 3.7 | 61.0 | — | 21.3 |
| Cameroon | 109.6 | 52.7 | 12.8 | 2.0 | 10.9 |
| Central African Republic | 78.0 | 5.3 | 58.6 | 2.4 | 25.2 |
| Chad | 55.4 | 6.5 | 53.4 | — | 25.6 |
| Comoros | 95.2 | 17.6 | 31.6 | — | 4.7 |
| Congo, Republic of | 248.3 | 47.4 | 24.4 | 6.0 | 2.3 |
| Côte d'Ivoire | 172.1 | 43.1 | 26.4 | 1.3 | 18.7 |
| Equatorial Guinea | 42.9 | 13.0 | 41.6 | — | 14.6 |
| Gabon | 80.5 | 53.8 | 12.4 | 5.6 | 9.3 |
| Mali | 113.9 | 20.4 | 27.1 | 3.7 | 19.0 |
| Niger | 69.8 | 32.7 | 39.4 | 1.1 | 3.7 |
| Senegal | 68.2 | 15.6 | 47.5 | 0.5 | 14.9 |
| Togo | 87.9 | 10.1 | 54.7 | 12.0 | 8.4 |

Sources: IMF, *World Economic Outlook*, column 1; World Bank, *Global Development Finance* (Washington, 1998), columns 2–5.

¹Euro-area currencies are composed of the deutsche mark and the French franc.

domestic currency cost of debt service. A depreciation of the euro against other major currencies would be of particular concern for countries with substantial external debt such as Bulgaria, and several countries of the CFA franc zone, but less so for other countries in central and eastern Europe that have generally small debt burdens (Tables 5.4 and 5.5).

To avoid these effects of exchange rate movements, it may be desirable for countries to adjust their exchange rate regimes, for example to basket pegs that better reflect the composition of their trade and financial links, or change their debt management policies. As the euro becomes widely used in trade and financial markets, it is likely to account for a larger share of debt securities, so that countries choosing to peg to the euro on account of their extensive trade ties will be able to reduce their exposure to variations in their dollar-denominated debt payments. Moreover, countries in the Middle East and Asia that now peg their currencies to the dollar could benefit from attaching some weight to stability vis-à-vis the euro. At the same time, it must be recognized that pegging to a basket of currencies is not as transparent as pegging to one currency and could be less effective in anchoring expectations for domestic inflation. Countries with mismatches between their currency pegs and their trade and financial linkages will have to balance the benefits of a peg to a single currency against the potential costs of exchange rate fluctuations.

While exchange rate stability vis-à-vis the euro will partially shield countries with strong trade ties to Europe from the trade-related effects of currency fluctuations, it will leave them exposed—depending on their degree of international financial integration—to changes in interest rates in the euro area, which will

necessitate adjustments in domestic monetary conditions to maintain the exchange rate link. Changes in interest rates could affect debt servicing costs as well as domestic demand. In the central and eastern European countries, the generally low levels of debt relative to GDP imply that this effect is not likely to be substantial, except in Bulgaria. In sub-Saharan Africa, given the prevalence of debt at preferential rates, servicing costs are unlikely to be significantly affected by changes in euro-area market interest rates.

EMU may tend to increase capital flows to emerging market economies.²⁶ First, deeper and more liquid capital markets in Europe will lower borrowing costs both for countries in the euro area and for countries raising funds through euro-denominated instruments. Second, EMU will allow euro-area institutions such as insurance companies and pension funds to shift some of their portfolios into emerging market investments as constraints imposed by currency matching requirements are eased.²⁷ Third, emerging market economies could benefit from direct and portfolio capital inflows if the convergence of asset returns in Europe leads global investors to increase their emerging market holdings in order to diversify across countries with a wider range of risk and return characteristics or with

²⁶See Feldman and Temprano-Arroyo, “Trade and Financial Effects of EMU on Selected Transition and Mediterranean Countries,” for a complete review of the financial implications of EMU for emerging markets in central and eastern Europe.

²⁷Currency matching rules limit the amount of foreign currency-denominated investments held by some types of financial institutions. With the single currency, investments in other euro-area countries will automatically be reclassified as domestic currency assets, thus making room for investments in other currencies.

Table 5.5. Selected Countries: External Debt and Shares of Long-Term Debt by Currency*(In percent)*

| Country | External Debt (as share of GDP, 1997) | Share of Long-Term Debt Denominated by Selected Currencies, 1996 | | | |
|-----------------------|---|---|------------------------------|-------------------------------|------------------------|
| | | Euro-area currencies ¹ | U.S. dollar and Japan yen | U.K. pound and Swiss franc | Multiple currencies |
| Albania | 35.5 | 18.8 | 75.5 | — | — |
| Bulgaria | 89.9 | 11.2 | 76.4 | 1.3 | 5.6 |
| Croatia | 33.0 | 6.2 | 77.1 | 7.4 | 6.3 |
| Czech Republic | 39.8 | 3.9 | 79.8 | 5.8 | 9.7 |
| Estonia | 22.9 | 30.4 | 21.2 | — | 28.7 |
| Hungary | 52.8 | 31.0 | 48.3 | 3.1 | 10.4 |
| Latvia | 10.8 | 7.5 | 65.5 | — | 35.1 |
| Lithuania | 26.6 | 8.0 | 62.0 | 1.0 | 13.0 |
| Macedonia, F.Y.R. | 34.0 | 7.0 | 69.1 | 6.8 | 15.5 |
| Poland | 28.1 | 22.6 | 51.2 | 2.8 | 5.5 |
| Romania | 27.8 | 9.9 | 57.3 | 0.7 | 15.6 |
| Slovak Republic | 58.7 | 5.8 | 18.3 | 0.5 | 71.8 |
| Slovenia | 22.1 | 19.6 | 55.7 | 0.8 | 7.6 |
| Cyprus | 12.8 | ... | ... | ... | ... |
| Israel | 18.1 ² | 3.1 | 96.9 | — | — |
| Malta | 27.7 | 29.6 | 34.4 | 1.5 | 1.8 |
| Turkey | 46.3 | 19.9 | 63.3 | 3.1 | 12.1 |
| Algeria | 64.0 | 26.9 | 51.0 | 1.5 | 7.8 |
| Egypt | 38.9 | 30.8 | 47.8 | 3.9 | 7.8 |
| Iran, Islamic Rep. of | 13.6 | 11.9 | 83.6 | 0.4 | 2.4 |
| Jordan | 82.5 | 16.0 | 52.1 | 7.9 | 12.7 |
| Lebanon | 26.1 | 8.9 | 65.0 | 0.1 | 6.8 |
| Morocco | 60.2 | 25.1 | 35.4 | 0.2 | 24.0 |
| Syrian Arab Republic | 46.1 | 2.9 | 85.8 | 0.7 | 2.4 |
| Tunisia | 52.8 | 19.7 | 30.6 | 0.1 | 25.5 |

Sources: IMF, *World Economic Outlook*, column 1; World Bank, *Global Development Finance* (Washington, 1998), columns 2–5.

¹Euro-area currencies are composed of the deutsche mark and the French franc.

²For Israel, net external debt.

different cyclical positions. Flows will depend on the degree of capital account convertibility.

EMU also carries financial market risks for emerging market countries, however. A successful EMU that raises productivity and growth could make Europe more attractive for investors and thus tend to increase the cost of capital for emerging market economies. Furthermore, increased competitiveness of European financial institutions and the greater depth of euro-area financial markets could lead firms in developing and transition countries to raise funds in euros rather than domestic currencies, which could pose a challenge to the continued development of local capital markets. EMU thus provides further incentive for these countries to strengthen financial intermediation and foster sound banking systems.

Finally, cyclical movements in the euro area will have an important bearing on financial conditions facing developing and transition countries, both in terms of interest rates and in terms of the magnitude and stability of capital flows available to finance investment. To the extent that cyclical volatility in the euro area can be reduced through appropriate policies that

reflect the commitment under EMU to preserve an environment with low and stable inflation, adverse spillovers on interest rates and capital flows for developing countries will be more limited.

The Challenges of EU Enlargement

While the EMU process involves a substantial deepening of the links among the 11 participants, the EU is also in the process of being broadened to include the transition countries of the Baltics and central and eastern Europe, and selected European countries in the Mediterranean area. For six countries—namely Cyprus, the Czech Republic, Estonia, Hungary, Poland, and Slovenia—the European Commission has delivered a favorable opinion on their membership applications, and accession negotiations are under way.²⁸ Countries that hope to join the EU will need to show progress toward meeting the Maastricht criteria, but these eco-

²⁸These countries already participate in special trade and other arrangements through association agreements.

Table 5.6. Prospective European Union Members: Convergence Indicators, 1997
(in percent and U.S. dollars)

| | Partner Countries | | | | | |
|-----------------|--------------------------|------------------------|---------------------|----------------|---------------------------------|---|
| | Maastricht Indicators | | | GDP Per Capita | | |
| | Consumer price inflation | Government balance/GDP | Government debt/GDP | In dollars | As percent of Euro area average | As percent of poorest EU country (Greece) |
| Czech Republic | 8.4 | -2.1 | 10.9 | 5,041 | 23.0 | 43.8 |
| Estonia | 11.3 | 2.4 | 5.6 | 3,085 | 14.1 | 26.8 |
| Hungary | 18.3 | -4.8 | 68.0 | 4,431 | 20.2 | 38.5 |
| Poland | 15.1 | -3.2 | 48.2 | 3,503 | 16.0 | 30.4 |
| Slovenia | 9.1 | -1.1 | 24.1 | 9,535 | 43.6 | 82.8 |
| Cyprus | 3.1 | -3.1 | 53.4 | 13,489 | 61.6 | 117.1 |
| Euro area | 1.7 | -2.5 | 76.2 | 21,885 | ... | ... |
| Reference value | 2.7 | -3.0 | 60.0 | ... | ... | ... |

Source: IMF, *World Economic Outlook*.

conomic objectives are not a requirement for accession, nor are new members expected to participate in EMU automatically.²⁹

The requirements for joining the EU and eventually participating in EMU are demanding and span macroeconomic, structural, and institutional areas. The countries in transition need to make further progress with privatization, to continue to reduce government involvement in the economy, and to increase the scope for resources to be allocated through market forces. Other necessary structural reforms include the removal of distortions such as monopolies and trade restraints, and the development of flexible and well-functioning labor markets. The slowness of the progress in some of the first 15 EU members in some of these areas, notably labor-market reform, is not to be emulated by the transition countries.

Unless transitional arrangements are negotiated, new countries joining the EU will have to comply from their date of accession with all the legal and institutional requirements (the so-called *acquis communautaire*) in the area of EMU. These requirements include, in particular, the establishment of fully independent central banks; the elimination of any direct financing of the general government by the central bank, or other privileged government financing; the complete liberalization of capital flows; and the coordination of macroeconomic policies, particularly exchange rate policy. Eventual participation in the euro area will also require the further development of indirect instruments of monetary policy, and the adoption

²⁹As indicated by the European Council of Copenhagen of June 1993, countries wishing to join the EU must first demonstrate their capacity to adhere to the aims of EMU. This does not imply that candidate countries will need to satisfy the macroeconomic convergence criteria laid down in the Maastricht Treaty to become members of the EU. It does mean, however, that it is expected they will participate in EMU eventually.

of modern, real-time gross settlement (RTGS) payments systems that can allow payments in euros and be connected with TARGET, the EU-wide payments system to be established upon the launching of EMU.³⁰

The six countries negotiating EU accession have generally made substantial progress in meeting the fiscal guidelines of the Maastricht Treaty, but inflation in all five of the transition countries remains higher than in the euro area (Table 5.6). There are several ways of viewing these currently positive inflation differentials. They may be considered necessary to allow real exchange rate appreciation warranted by relatively rapid productivity growth during the transition process, given pegged nominal exchange rates. The continued restructuring of enterprises and ongoing adjustment of administered prices, such as for energy and services, to market economy levels may also suggest that the elevated rate of inflation may continue for a number of years.³¹

An indicator of real, rather than nominal, economic convergence in the accession countries is per capita income relative to present EU members. Slovenia is furthest along in this convergence, with per capita income over 40 percent of the EU average, and over 80 percent of that in Greece, the EU member with the lowest

³⁰For a discussion of the institutional requirements in the area of EMU that are applicable to EU countries remaining outside the euro area, see Heliodoro Temprano-Arroyo and Robert A. Feldman, "Selected Transitional and Mediterranean Countries: An Institutional Primer on EMU and EU Relations," Working Paper 98/82 (Washington: IMF, June 1998).

³¹Alternately, rather than mainly reflecting productivity increases, real exchange rate appreciation could be driving the restructuring and increased productivity, since increased real wages drive up costs and thus serve to winnow out inefficient enterprises and reallocate resources to more dynamic sectors. See Clemens Grafe and Charles Wyplosz, "The Real Exchange Rate in Transition Economies," CEPR Discussion Paper 1773 (London: Centre for Economic Policy Research, December 1997).

per capita income. The other countries are much further behind, and it has been estimated that full convergence to income levels in the advanced economies will take 20 years even for the most advanced transition countries such as the Czech Republic, and 35 to 45 years for others.³² Central and eastern Europe is thus approximately one to two generations behind living standards in western Europe.

It would seem more relevant, and in line with Council intentions, to define economic convergence in terms of meeting a broader set of structural and institutional requirements, which would be important in helping to ensure that accession countries would be successful members of the monetary union. Unfortunately, the transition countries have also lagged in terms of a number of these requirements. Foremost among them are the preconditions for full capital account liberalization, including vis-à-vis countries outside of the EU. The Czech Republic, Hungary, and Poland have begun this process as part of joining the OECD, Estonia already has virtually open capital markets, and most countries have at least partially liberalized capital regulations. But substantial progress remains to be made, not only in eliminating barriers to capital flows, but also in the development of robust financial sectors and well-functioning capital markets, and the strengthening of the regulatory and oversight capacities needed to help ensure systemic stability and to cope with potential shifts in capital flows.

Appendix. Economic Policymaking in the EU and Surveillance by EU Institutions

Institutions

The European System of Central Banks. The ESCB comprises the European Central Bank (ECB) and the national central banks (NCBs) of all EU member states. The ECB, which makes the monetary policy decisions for the euro area, is controlled by a Governing Council consisting of an Executive Board (with six members appointed by the heads of state or governments of countries in the euro area) and the governors of the NCBs of countries in the euro area. Monetary policy decisions are made by simple majority of the Governing Council, with other voting procedures applying to matters pertaining to the finances of the ECB. A number of elements underpin the independence of the ESCB. Members of the Executive Board have nonrenewable eight-year terms, with the terms of the initial Executive Board members ranging from

four to eight years so as to stagger subsequent appointments. Terms for NCB governors must be at least five years. The Maastricht Treaty precludes member governments from attempting to influence ECB decisions and members of ECB decision-making bodies from seeking or taking instructions from governments or EU institutions. The ESCB is prohibited from financing directly either governments or EU institutions, or from assuming their commitments. Changes to the key provisions of the Statute of the ESCB must be ratified by all EU countries.

The Council of the European Union. Normally referred to as *the Council* (but also *the Council of Ministers*), this is the principal decision-making body of the EU. It consists of one representative each of national governments, normally at the ministerial level. When meeting on issues in the domain of fiscal and macroeconomic policies, the Council consists of ministers of finance or economic affairs and is referred to as ECOFIN. Voting procedures vary: unanimity is required on some issues (including any decision affecting the taxation powers of members or establishing an exchange rate regime), while for most decisions in the economic sphere qualified majority voting holds with a majority comprising 62 of the 87 votes in the Council.³³ On issues pertaining to exchange rate policy, or the application of sanctions under the SGP, ministers of countries outside the euro area do not vote. The Council is supported in its work by various committees. In the macroeconomic policy area, the principal committee has been the Monetary Committee, which effective January 1, 1999 will become the Economic and Financial Committee.

The Euro-11 Group. This is the name given to informal meetings of the ministers of finance and economic affairs of countries participating in the euro area, the first of which was held in June 1998. These meetings are intended to address issues pertaining to the joint responsibility of these countries for the single currency. It is expected that issues of economic policy coordination will be an important focus of discussion. The Commission and the ECB will be invited to take part when appropriate. Where issues of common interest are concerned, they are to be discussed by all member states. All relevant economic policy and surveillance decisions will continue to be taken by ECOFIN.

The European Commission. The Commission is the executive body of the EU. The Executive of the Commission comprises 20 members—two nationals each from the five largest countries (France, Germany, Italy, Spain, and the United Kingdom) and one each from the other member states. The Commission has

³²See Stanley Fischer, Ratna Sahay, and Carlos A. Végh, "From Transition to Market: Evidence and Growth Prospects," Working Paper 98/52 (Washington: IMF, April 1998); and Stanley Fischer, Ratna Sahay, and Carlos A. Végh, "How Far Is Eastern Europe from Brussels?" Working Paper 98/53 (Washington: IMF, April 1998).

³³The distribution of votes is as follows: Germany, France, Italy, and the United Kingdom (ten votes each); Spain (eight votes); Belgium, Greece, the Netherlands, and Portugal (five votes each); Austria and Sweden (four votes each); Denmark, Finland, and Ireland (three votes each) and Luxembourg (two votes).

the principal power of initiative: with some exceptions, the Council cannot legislate in the economic area unless there is a proposal from the Commission.³⁴ The Commission is also a key body in the process of surveillance of economic policies. In addition to preparing the surveillance decisions for the Council (for example, those related to the broad economic policy guidelines, employment policy guidelines, and the stability and growth pact—see below), it contributes to the process through its analyses of economic developments in individual countries and in the EU as a whole. The Commission has important decision-making authority of its own in the area of competition policy and it conducts trade negotiations on behalf of the EU, on the basis of a mandate from the Council and with any agreements to be ratified by the Council. The Commission also is entrusted with the implementation of decisions made by the Council, monitoring countries' compliance with EU law, and initiating legal action against noncompliant countries.

The European Council. This is the name given to the meetings of heads of state or government of EU member states which give political guidance to the EU. The European Council is scheduled to meet twice a year (in June and December) but also holds special meetings from time to time on specific issues, for example, the summit meeting on employment that took place in November 1997 in Luxembourg.

The European Parliament. The European Parliament has a largely consultative role in macroeconomic surveillance but it will also hold hearings on the policies of the ECB, which are intended to enhance the transparency of monetary policy and the accountability of the ECB. In other areas, it plays a more direct role in decisions. Under the so-called cooperation procedures, which apply, for example, to the European Regional Development Fund, research, the environment, and cooperation and development, the opinion of Parliament can only be overridden by a unanimous decision of the Council. An even stronger procedure, called "co-decision," applies to the free movement of workers, the establishment of the internal market, technological research and development, the environment, consumer protection, education, culture, and health. Here, if the Council fails to take due account of Parliament's opinion, Parliament can prevent the adoption of the proposal. Finally, decisions such as those on the accession of new member states, association agreements with third countries, the conclusion of international agreements (outside of those related to monetary and exchange rate policies), the organization and goals of the structural funds, and the tasks and powers of the European Central Bank require the "assent" of Parliament.

³⁴One exception, for example, is that an agreement on a formal exchange rate system with a non-EU country may also be made on the basis of a recommendation from the ECB.

Policymaking Responsibilities

Monetary policy. Monetary policy is determined by the ECB and implemented by the ESCB under the direction of the ECB.

Exchange rate policy. Responsibility is divided between the Council and the ECB. In particular, the Council has the right to enter into formal exchange rate arrangements with non-EU countries or to formulate general orientations for the exchange rate. In the absence of such arrangements or orientations, the management of the exchange rate is the sole responsibility of the ECB. A formal exchange rate arrangement would require unanimous support in the Council, would have to be based on a recommendation of the Commission or the ECB, and in the case of the former must be after consultation with the ECB in an endeavor to reach consensus consistent with the objective of price stability. A European Council Resolution on economic policy coordination in December 1997 indicated that ECOFIN may provide general orientations for exchange rate policy in exceptional circumstances, for example in the case of a clear misalignment. Moreover, these orientations should always respect the independence of the ESCB and be consistent with the primary objective of the ESCB to maintain price stability.

Fiscal policy. There is a small EU budget of just over 1 percent of EU GDP, devoted principally to the Common Agricultural Policy (CAP) and the EU's structural funds. Spending policies are established within multiyear frameworks, the present one covering 1993–99, and deficit financing is prohibited. Fiscal policy thus remains almost entirely the prerogative of individual countries. It is, however, subject to surveillance under procedures discussed below. Some degree of harmonization of value-added tax and excise duties (in the form of minimum rates) is also established at the EU level.

Structural policies. Matters pertaining to the free movement of capital, labor, goods, and services within the EU are a community competence. Legislation on internal market issues is for the most part enacted by the Council on the basis of qualified majority, the principal exception being matters pertaining to taxation. Except to the extent that they fall under the internal market program, labor market policies are the prerogative of national governments. For the first time, the Treaty of Amsterdam, signed in October 1997, identified employment policies explicitly as a matter of common concern among EU member states and established procedures for their surveillance.

External economic policies. When negotiations with non-EU states are needed on economic matters within the competence of the EU (notably trade), the normal practice is for the Commission to make a recommendation to the Council, which would then decide whether to authorize the Commission to negotiate. The

Council would also appoint committees to assist the Commission with such negotiations. On monetary and foreign exchange regime matters, there is no established principle on who would negotiate. The Council decides on the negotiation arrangements on the basis of a recommendation from the Commission, following consultation with the ECB.

Surveillance Procedures

Broad economic policy guidelines. These guidelines are formulated annually by ECOFIN and adopted by ECOFIN following discussion in the European Council. The guidelines cover policies in both macroeconomic and structural areas, though they have tended in the past to be much less specific on structural matters than on fiscal policy matters. The European Council has recently requested that the guidelines be strengthened in the area of structural policies. A report on progress in implementing the broad economic guidelines is produced by the Council annually and submitted to the European Council.

The Stability and Growth Pact. The SGP covers both the implementation of the excessive deficit procedure specified in the Maastricht Treaty and the medium-term surveillance of fiscal policies. Under the excessive deficit procedure, EU countries that breach the 3 percent of GDP reference value for the general government deficit will be deemed to be in excessive deficit, unless exceptional circumstances apply, and will receive advice from ECOFIN on correcting the excessive deficit. Failure to follow up effectively on this advice will result in financial sanctions for countries in the euro area. Countries are also expected to submit medium-term stability programs and update them annually (convergence programs for countries not in EMU) that will identify how governments plan to meet and maintain the pact's medium-term objective of general government positions that are close to balance or in surplus. It has been agreed that countries will submit their first stability programs before the end of 1998.

Surveillance under Article 103 of the Maastricht Treaty. Under this article, EU members recognize that their economic policies are a matter of concern to be coordinated within the Council. This is the basis for ongoing review of countries' economic policies in the Council and its supporting committees, including the

Economic and Financial Committee. The Council may on the basis of a qualified majority choose to make public the advice given to countries in this context.

Economic policy coordination. In a Resolution adopted at its meeting in Luxembourg in December 1997, the European Council envisaged that economic policy coordination would be effected through the various surveillance instruments provided for in the Maastricht Treaty and outlined above. In particular, it called for the broad economic policy guidelines to be developed into an effective instrument for ensuring sustained convergence. The guidelines should be more concrete and country-specific and more attention should be paid in them to improving competitiveness; labor, product, and services market efficiency; education and training; and to making taxation and employment systems more employment-friendly. It also emphasized the importance of early warnings under the SGP, and more effective use of surveillance under Article 103. The resolution indicated, in addition, that monitoring of the economic situation and related policy discussion should become a regular item at informal ECOFIN meetings.

Surveillance of employment policies. The EU countries have agreed to implement the provisions of the Amsterdam Treaty related to the surveillance of employment policies in advance of the formal ratification of the treaty. Under these procedures, the Council adopts employment policy guidelines and these guidelines are to be incorporated into national employment plans by the EU countries. The Council is to hold an annual review of the way in which countries have put the guidelines into practice and submit a report to the European Council. The guidelines will be revised annually on the basis of experience and countries will update their employment plans every year. The first employment policy guidelines were adopted in December 1997 and countries submitted their first national employment plans to the Council in April 1998.

Surveillance of compliance with internal market legislation. The Commission monitors compliance with the internal market legislation and produces regular reports both on compliance and on strategies to develop the internal market further. On the basis of experience, it proposes modifications to legislation where warranted and can take legal action against countries that fail to comply.