1 - INTRODUCTION

On May 1998 the European Council of Ministers of Finance (Ecofin) will announce the countries that will form the Euro Zone. At the same time, the bilateral exchange rates among their currencies will also be defined. This will be a de facto start of the single currency and of the European Monetary Union (EMU).

For several months doubts were raised whether countries would be able to fulfill the Maastricht criteria and on the possibility to launch EMU according to the pre-established schedule. Now it is almost certain that the Euro will become a reality as established by the Treaty and subsequent decisions of the European authorities. In addition, the number of countries able to join the Euro Zone is likely to be much larger than initially expected.

Indeed, countries were required to meet criteria on sound public finances, price and exchange rate stability, and on convergent low long-term interest rates. Briefly recalling such criteria:

- the inflation rate shall not be more than 1.5% higher than the average of the 3 lowest rates in the European Union;
- long term interest rates shall not be more than 2% above the average rate of the 3 countries with lowest inflation;
- the budget deficit shall not be higher than 3% of GDP;
- the public debt shall not exceed 60% of GDP or, if higher, shall be declining at a satisfactory pace;
- finally, a stable exchange rate within the European Exchange Rate Mechanism (ERM) for at least 2 years.

As you may already know, countries have, in general, reduced successfully public deficits and inflation rates. Interest rates have fallen sharply not only as a result of the progress recorded on deficits and inflation but also as a consequence of the improvement of market perception on the sustainability of such achievements and on the stronger likelihood that the Euro will become a reality ‘on time’. To point out that the approval of the Stability and Growth
Pact on the Dublin Summit of December 1996 was a major contribution on the build-up of such perception and momentum.

The imposition of those criteria raised some controversy. Some argued that they are arbitrary and not theoretically sound. According to Economic Theory, optimum currency areas require:

- substantial trade among countries and a high degree of mobility of factors of production;
- nominal wage and price flexibility;
- high level of symmetry on shocks affecting the economies;
- existence of a high degree of political integration.

After the removal of non-tariff barriers to trade, after the liberalization of capital movements and free movement of labor within the Union, the adoption of a single currency will help to consolidate, to strengthen, to deepen, the Single European Market. The absence of exchange risk and the lower transaction costs will enhance trade and investment across the European countries.

Although a logical corollary of the creation of such a Single Market, the adoption and implementation of a single currency in Europe has been mostly a political process geared not exclusively by economic forces but, and primarily, by the will and strong commitment of European political leaders. The Maastricht criteria seem, indeed, to pay little attention to those prerequisites. Sure that shocks impinging the European economies are not quite or even highly symmetric and labor mobility is not high. For these reasons, it is hard to say that EMU will be an optimal currency area. However, cyclical movements in Europe have been more and more synchronized in the last ten years. The single monetary policy, greater interdependence, and improved coordination of economic policies will increase such synchronization. In addition, labor mobility will tend to increase not only as a result of regional wage differentials but also as a result of the establishment of what we may call a European ‘consciousness and citizenship’. In short, although not fulfilling, initially, the theoretical preconditions for an optimal currency area, there are reasons to believe that, once launched, the EMU will generate its own conditions of optimality.

In my view, there are benefits to be obtained from the adoption of a single currency which outweigh the costs, namely the loss of independence on the use of monetary and exchange rate policies to adjust to asymmetric shocks to
the economy. This is particularly true for small open economies, which trade the most with their European partners, as it is the case of Portugal.

After a brief recall of what is expected to happen in the coming years I will focus my presentation on the conduct of monetary policy within EMU. Following a description of the European System of Central Banks (ESCB), its goals, instruments, and intermediary targets, I will comment on the relation between monetary policy and the other economic policies. Finally, I will refer to the Portuguese performance and perspective with respect to EMU.

2 - WHAT IS COMING NEXT?

As I mentioned before, we will have by May 1998 the selection of the countries that will launch the Euro Zone and the announcement of the bilateral conversion rates. In each country, administrations, the banking and financial community, firms, etc, will prepare changeover plans to the Euro (for example, information systems, training of personnel, double price tags, etc). In 1998, the European Central Bank (ECB) will start its implementation so it will be ready to take over on January 1, 1999. In addition, in 1998, the production of notes and Euro coins will be started and the legal framework of the single currency will be completed.

On January 1, 1999, the Euro will start de jure with the fixing of the irrevocably, locked, exchange rates. The Euro will then become a currency on its own right and will be used:

- on monetary and exchange rate policy interventions;
- on interbank, capital and money, and exchange rate market operations;
- on the issue of new government debt and on the redenomination of the outstanding debt;
- on wholesale payments.

As of 1999, during a transitional period of 3 years, we will witness a gradual switch to the Euro from the part of public and private operators.

On January 1, 2002 the Euro notes and coins will be introduced. National currencies will be withdrawn so only Euros will circulate as of July 1st, 2002. The changeover to the Euro will then be completed by public and private operators.

The introduction of the Euro will have far-reaching implications not only for EU member states but also for its partners. In terms of GDP and world trade, the Euro area will have a size similar to the USA and larger than Japan:
In addition, the degree of openness of the Euro Zone will be similar to the one for the USA. As a consequence, exchange rate fluctuations will in the future affect less the Euro area as a whole than they do now to individual countries. EMU will create a large currency area with a single monetary and exchange rate policy. As long as the changeover will not be abrupt, as long as portfolio and reserve adjustments will be gradual, the establishment of the Euro as an international currency will also be gradual and not destabilizing. Given its expected monetary and fiscal stance this currency area should constitute a force for stability in the world.

3 - MONETARY POLICY IN THE EMU

As I have already mentioned, there will be a single monetary and exchange rate policy for the Euro Zone Member States. Let us look for a while on who, for what, and how that policy will be conducted. Four major questions can be raised:

(i) Who will take and how will monetary policy decisions be taken?
(ii) What will be the goals of the single monetary policy?
(iii) What will be the instruments of the ECB? What intermediate targets will be pursued?
(iv) What is the degree of independence of the ECB? How will the ECB acquire legitimacy? How will it market its policies? Will the ECB be able to inherit the Bundesbank’s credibility?

(i) Monetary policy will be decided and conducted by a supranational entity, the ECB and the ESCB. The ECB will have an Executive Board with a president, a vice-president and 4 members. Members of this Board will be chosen ‘from among persons of recognized standing and professional experience in monetary or banking matters by common accord of governments of the Member States’ (Article 109-A 2.b)).

A Governing Council composed of the Executive Board plus the heads of the national central banks participating in the monetary union.

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<th></th>
<th>EU</th>
<th>USA</th>
<th>Japan</th>
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<tr>
<td>Share in OECD GDP (1996)</td>
<td>38.3%</td>
<td>32.5%</td>
<td>20.5%</td>
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<tr>
<td>World trade (excluding in Community trade)</td>
<td>20.9%</td>
<td>19.6%</td>
<td>10.5%</td>
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The President of the Ecofin Council and a representative of the EU Commission should be entitled to attend and speak, but not to vote, at the meetings of the Governing Council. Likewise, the President of the ECB can be invited to attend to the Ecofin meetings when matters discussed concern the ECB activity.

The Governing Council formulates the monetary policy. Its role is similar to the one of the Federal Open Market Committee (FOMC) in the USA. The Executive Board implements the monetary policy according to the decisions and guidelines laid down by the Governing Council. It will have a role similar to the USA Board of Governors of the Federal Reserve System.

National central banks will execute the policy measures decided by the ECB. Their function will be very similar to the role played by the regional reserve banks in the USA. The ECB together with the national central banks will form the European System of Central Banks (ESCB). The ESCB, besides the definition and execution of the monetary policy of the Euro Zone will have to carry the exchange rate operations, to hold and manage the foreign reserves, and to promote the well-functioning of the payments system.

(ii) The main goal of the ESCB will be to provide price stability. In pursuing this goal, the ECB shall act based on the principles of an open and market economy, and free competition.

Without prejudice of this main goal, and the provision without prejudice should be stressed, the ESCB will support the general economic policies of the Community in order to achieve the goals of:

- a balanced development of economic activities;
- a sustainable and environment-friendly, non-inflationary growth;
- a high degree of convergence of the EU economies;
- a high level of employment and social protection;
- an improvement in welfare and living standards; and
- economic and social cohesion among the Member States.

Finally, to notice that the Maastricht Treaty does not assign to the ECB a function of ‘lender of last resort’. This role is assigned to the national authorities. The ECB will be concerned with price stability but, apparently not with the stability of the banking and financial system. However, as long as it will have, inevitably, to arbitrate between these two goals, the ECB will end up, eventually, playing a role as lender of last resort.
(iii) In conducting the single monetary policy, the ESCB will use as instruments the following:
   a) open market operations;
   b) standing facilities;
   c) possibly, minimum reserves.

a) **Open market operations** will be conducted mostly based on reverse transactions. Outright transactions, issuance of debt certificates, foreign exchange swaps, and collection of fixed term deposits will also be used. Reverse transactions will be executed on the basis of standard tenders, quick tenders, or bilateral procedures. The main types of operations are:
   - **main refinancing operations** with a weekly frequency and a maturity of 2 weeks;
   - **long term refinancing operations**, with a monthly frequency and a maturity of 3 months;
   - **fine-tuning operations**, *ad-hoc* operations intended to manage liquidity and to steer interest rates;
   - **structural operations** aimed to adjust the structural position of the ESCB vis-à-vis the financial sector.

b) **Standing facilities** will be created to provide and to absorb overnight liquidity. Basically, two facilities will be put at work:
   - **marginal lending facility**, which will provide a ceiling for the overnight market interest rate; and a
   - **deposit facility**, which will provide a floor for that rate.

c) If the ECB decides to impose **minimum reserves** the possibility of interest to be paid on such reserves should be considered in order to not affect the competitiveness of the European banks.

There is no definition, yet, of an intermediate target for the single monetary policy. Money aggregates, the inflation rate, or even the exchange rate are possible choices for the ECB. The chosen target should be subject to a close control of the monetary authority and, at the same time, closely linked to the main goal of price stability.

The choice of a money aggregate is a traditional one. Such an aggregate is considered to be easily monitored by the monetary authority, however, its impacts on the price level and economic activity are not yet quite established.
Furthermore, the link between the money stock and the price level would be difficult to be defined within the new environment of the EMU.

The choice of the exchange rate as an intermediate target does not appear very appealing as long as the Euro Zone will be a more closed economy than member countries are now. For this reason, its targeting is likely to have a minor impact on the price level.

Although not directly subject to the control of the monetary authority, the inflation rate is a target more closely linked to the main goal of price stability. Its monitoring together with short term interest rates could provide an interesting alternative to achieve that goal. The experience of countries such as Canada, New Zealand, Sweden, and the UK using this intermediate target could be of utmost importance for a final choice.

iv) The Treaty and the Statutes of the ECB clearly establish the independence of the ECB and of national central banks. Neither the ECB, nor the national central banks within the ESCB, nor the members of its decision-making bodies should seek or take instructions from the Community institutions, governments or other bodies (Article 107 of the Treaty). In addition, as a corollary of this independence, the ESCB cannot monetize public debts.

Being the ECB independent, isn’t there the danger that it will lack democratic control and accountability? This question reveals how important it is to provide legitimacy to the action of the ECB. The ECB needs to build up and to gain reputation among economists, politicians, and the public. For this, the ECB has to ‘market’ its policies. One way to provide and strength such legitimacy would be through the submission of reports both at the Community and at the national level. Indeed, Article 15 of the ECB Statutes already provides a basis for this. It imposes the obligation of quarterly reports on the ESCB activities, of weekly information on the ESCB financial situation, and of annual reports on activities and on the monetary policy. Such reports and information must be presented to the European Parliament, the Council, the Commission, and the European Council. A similar obligation can be adopted at the level of national central banks with respect to national authorities, as it is the case of Portugal. Also, as already referred, the President of the Council and a representative of the Commission can attend ECB meetings. In addition, the President of the ECB can be invited to the Ecofin meetings.

These provisions already provide an important set up of obligations and of relationships between EU decision-makers that can be used to build up the
legitimacy and the democratic accountability of the ECB, without prejudice of its independence. Finally, with respect to the ability of the ECB to inherit the credibility of the Bundesbank, I believe that the way in which the launching of the Euro is being established will allow it to be as credible as the German central bank. In fact, the Treaty defines very clearly the commitment of the ECB to price stability. The institutional design of the ESCB, the Treaty, and repeated statements of responsible political authorities, ensure the importance of the ECB’s independence. Finally, fulfillment of the Maastricht criteria on a sustainable basis - and recall that the Stability and Growth pact will force to that - will provide strong initial credibility conditions to the ECB and to the Euro.
4 - EMU, THE SINGLE MONETARY POLICY AND OTHER POLICIES

Regarding the goals of growth and employment, compatible with the goal of price stability, how shall the single monetary policy be combined with the national economic (budgetary) policies? How to combine a single centrally defined monetary policy with the national budgetary and other economic policies? What should be the appropriate policy-mix?

The Stability and Growth Pact imposes already a strict surveillance framework on fiscal policy. Implementation of the Euro will reinforce the movement towards tax harmonization. The recent approval of a ‘code of conduct’ clearly shows that tax issues will become more and more relevant within the European Union. Anyway, the above questions raise an important issue, and politically more delicate. Shouldn't the setting up of a monetary governance of the Union be accompanied by a definition of an ‘economic governance’?

If ‘economic governance’ means the creation of some kind of counter-power to the ECB, some way to control its activity, that will be a dangerous way to go with. That will jeopardize the credibility and independence of the ECB and, ultimately, the goal of price stability.

If the issue of ‘economic governance’ aims only to implement a better coordination of economic policies among Member States and within the framework of the dialogue between the Council and the ECB provided by the Treaty, that should be most welcome. That will improve, as already mentioned, the synchronization of cyclical movements within the EU, which will reduce the costs of giving up to the possibility of the use of the exchange rate as a policy instrument in face of asymmetric shocks.

The discussions around this issue pointed to this second understanding, which was the one adopted on a resolution approved during the recent Luxembourg Summit.

5 - THE PORTUGUESE PERSPECTIVE

The Portuguese commitment to EMU is very strong. In the last years, macroeconomic policies have been conducted aiming to fulfill the convergence criteria required to the membership of the Euro Zone. For more than three years, the escudo exchange rate has been very stable within the Exchange Rate Mechanism of the European Monetary System. In addition, the recent evolution of the relevant indicators is outstanding, as depicted by the following table:
Portugal has much to gain politically, economically, and financially with the membership to the EMU.

Politically, Portugal will participate in the core group of countries that will decide the shape of Europe in the 21st century. This is very important as long as Portugal is a small country and geographically peripheral in Europe.

Economically, with the Single Market and the Euro, Portugal will reach and participate in a large market. Hence, Portugal will be exposed and benefit from a highly competitive environment. This will enhance initiative and entrepreneurialship. Of course, the country will face adjustment costs and lose the possibility to independently use monetary and exchange rate policies to adjust to asymmetric shocks. This is one of the reasons why structural reforms have to be implemented. Such reforms will allow for a quicker adjustment and will reduce costs. Structural reforms on the labor market (training, flexibility, etc), and on goods markets (privatization, deregulation, and opening to competition, etc) will allow for a better adjustment and a better rip off the long-run benefits from EMU. Additionally, structural reforms on public administration, health, and social security systems will be important for the sustainability of sound public finances, for a more efficient allocation of public resources, and for a more competitive economy able to create jobs.

The loss of independence on the conduct of monetary and exchange rate policies is not a big issue, in my opinion. Being a small open economy, trading mostly with Europe, and with free capital movements, de facto, there is no

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<th>PORTUGAL</th>
<th>EUROPEAN UNION</th>
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<tr>
<td><strong>Inflation 1990-91</strong></td>
<td>12.5%</td>
<td>5.2%</td>
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<tr>
<td>1997</td>
<td>2.2%</td>
<td>2.1%</td>
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<tr>
<td><strong>Public Deficit 1990-91 1997</strong></td>
<td>6.2%</td>
<td>4.0%</td>
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<tr>
<td>1997</td>
<td>2.7%</td>
<td>2.7%</td>
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<td><strong>Public Debt 1990-91 1997</strong></td>
<td>67.6%</td>
<td>56.0%</td>
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<tr>
<td>1997</td>
<td>62.5%</td>
<td>72.4%</td>
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<td><strong>Long-Term Interest Rates 1990-91 1997</strong></td>
<td>17.5%</td>
<td>10.5%</td>
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<td>5.9%</td>
<td>6.0%</td>
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<tr>
<td><strong>Short-Term Interest Rates 1990-91 1997</strong></td>
<td>17.3%</td>
<td>10.5%</td>
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<td>5.1%</td>
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Source: European Commission.
Interest rates (European Monetary Institute)
independence. Portugal would have to import, anyway, the monetary policy of the EU without participating in its definition. The alternative would be to turn our back to Europe or to impose strict capital controls. These would be, by far, much more damaging for the Portuguese economy. Furthermore, the ability to conduct an independent policy would be relevant, in a short-term perspective, only on the event of significant asymmetric shocks. I emphasize significant shocks because I do not believe on fine tuning monetary and exchange rate policies to face small shocks. However, asymmetric shocks are not very frequent and the integration in an economic and monetary area will reduce the likelihood of the occurrence of such shocks as long as they will tend to be more symmetric.

The role of the Bank of Portugal will be very similar to the one of the central banks of the other Member States:

- the Bank of Portugal will participate on the ESCB. Portugal will be represented in the Council of Governors, and thus, participate on the definition of the monetary and exchange rate orientations and guidelines to be executed by the Executive Board. The Governor of the Bank of Portugal will have a vote just like the governors of the other participating Member States;
- the Bank of Portugal will conduct the execution of monetary policy decisions having an active role on open-market operations and standing facilities as previously described;
- the Bank of Portugal will continue to conduct the supervision of the Portuguese banking system together with the other supervisory authorities for the stock exchange market and the insurance sector.

As long as price stability is an important goal for the Portuguese economy, participation in EMU will provide much more credibility and reputation to this policy and to the Portuguese authorities. After the high inflation period of the 70’s and 80’s it would be, otherwise, much more difficult to the Portuguese authorities to gain reputation and make that goal credible. The strong commitment to the single currency allowed Portugal to borrow this credibility from outside. The EMU ‘conditionality’ has been important to ‘keep on track’.

Financially, participation in EMU will have a positive impact. Belonging to integrated monetary and financial markets allows Portuguese firms, individuals, and Portuguese authorities to borrow and raise capital at lower costs.
To finish, I would like to point out that joining the Euro Zone and adopting the single currency is not a goal by itself. It is a means to provide the Portuguese economy with conditions that will allow for stronger growth, and improved standards of living. For this reason, I believe that the convergence effort and the policies that accompany this effort are worthwhile. Low inflation, stable exchange rates (fixed in the future among EMU countries), sound public finances, and low interest rates will be strong macroeconomic fundamentals. The sustainability of these fundamentals requires structural reforms that will enhance the ability of the economy to grow, to create jobs, and to adjust to external shocks without needing to rely on independent monetary or exchange rate policies.

University of South Carolina, December 15, 1997
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