

Peter Nunnenkamp*

Europe and the Crisis

Safe Haven or Menace to Global Recovery?

The crises in various emerging markets have affected Europe less than other parts of the world economy. This is largely because intra-regional relations dominate foreign trade and direct investment of EU countries. Yet, ongoing economic turbulences involve risks also for Europe.

When Euroland took shape in early 1998, the single currency 'looked like being launched at the best possible moment, promising it a smooth course in its early years'.¹ In late 1998, the starting conditions for the Euro appear to be far less comforting. The single currency will come on January 1, 1999, amid the worst international financial turmoil since the 1930s.

Yet, many European policymakers are still confident that the current turmoil will pass them by and that the Euro will add to economic dynamism in Europe. This article presents the major arguments why Europe has been less affected by the crisis so far. However, as will be shown, there is little justification for European complacency. Europe is not insulated from the crisis in other parts of the world economy. Moreover, even if Europe becomes an important growth pole of the world economy in 1999, its longer-term labor market problems are likely to persist.

The article discusses under which conditions the Euro may contribute to economic dynamism in Europe. The upshot is that the merits of the single currency may prove futile unless Euro-land tackles structural rigidities, notably in labor markets. Finally, it is shown that the start of the Euro in the new political landscape of Europe clearly reveals major policy dilemmas. The European Central Bank (ECB) is subject to political pressure not to focus on price stability exclusively. The ECB's reaction to this pressure is difficult to predict. It is open to question

whether economic policies in Euroland will be conducive to overcoming economic problems in Europe and beyond.

Why Europe Is Less Concerned

It is somewhat ironic that a phenomenon, much criticized until recently, now turns out to be a safeguard against serious repercussions on Europe of the crisis in various emerging markets: 'Economic policy in the Community has been focused on regional integration, and discouraged European companies to go global'.²

Trade as well as investment relations reflect the predominance of regionalization over globalization in Europe. Trade intensity indices, calculated for EU(12)-member countries,³ point to a strong and increasing bias of their exports towards intra-EU trade.⁴ Trade intensity among EU members rose from 1.4 in 1980 to 1.7 in 1995.⁵ Trade intensity was particularly weak with trading partners most affected by the current

¹ The Economist, October 17, 1998, p. 17.

² E. Gundlach, P. Nunnenkamp: The European Union in the Era of Globalization. Competitive Challenges, Structural Unemployment, and Policy Responses, in: Konjunkturpolitik 40 (3/4), 1994, p. 202.

³ The trade intensity index relates the share of trading partners of EU countries in total exports of EU countries to the weight of trading partners in world trade (measured by their share in world imports). The index reflects the relative importance of trading partners of EU countries that cannot be attributed to the economic size of trading partners. Hence, an index value above (below) one means that the EU countries' export orientation is biased towards (against) this particular trading partner.

⁴ P. Nunnenkamp: Trade Relations between Europe and East Asia: A European Perspective, in: B.-S. Kim (ed.): Europe-East Asia Economic Relations: Current Status and Prospects, Korea Institute for International Economic Policy, Seoul 1997, Table 4.

* Kiel Institute of World Economics, Kiel, Germany. The author appreciates comments and suggestions by Rolf J. Langhammer and Joachim Scheide.

crisis; in 1995, the index amounted to 0.3-0.4 in the cases of Japan and Asian developing countries. Index values were somewhat higher for trade of EU countries with the United States (about 0.5) and Latin America (0.55).

The regional structure of trade, reported in Table 1, supports the view that contagion via exports and imports is less likely for the EU than for Japan and the United States. All developing countries in Asia and Latin America account for about one quarter of extra-EU trade,⁶ compared with 40 per cent of US trade and 44 per cent of Japanese trade.⁷ Taking into account that the ratio of extra-EU trade to the EU's GDP is fairly similar to the ratio of overall trade to the GDP of Japan and the United States (Table 1, memorandum item), one can calculate the hypothetical GDP effects of import compression and export expansion in crisis-ridden developing countries (Table 2). For instance, if all Asian and Latin American developing countries were to reduce their imports by 10 per cent and, at the same time, to increase their exports by 10 per cent, GDP in the EU would be reduced statistically by about half a percentage point.⁸ The corresponding reduction would amount to 0.8 percentage points in Japan and the United States.

Import compression plus export expansion by Asian developing countries clearly affects Japan in the first place, while the statistical effect is of a similar magnitude for the EU and the United States.⁹ Import compression plus export expansion by Latin American countries would have a stronger impact on GDP in the United States than in the EU and Japan. Put

differently, mainly the United States would suffer from a full-blown crisis in Latin America.

Similar to trade, investment relations of EU countries are primarily an intra-regional phenomenon (Table 3). Major EU investor countries have in common that the share of all non-OECD countries (plus Mexico and South Korea) in total direct investment stocks held abroad is below 20 per cent. The share of all non-OECD countries in Japanese and US direct investment stocks is almost three times as large as their share in German direct investment stocks.

Table 1
Regional Structure of Trade: EU, Japan and the United States, 1997
(per cent of total exports and imports)

Trading partners	EU countries ¹		Japan		United States	
	ex-ports	im-ports	ex-ports	im-ports	ex-ports	im-ports
EU countries	60.4	59.2	15.6	13.4	17.4	17.8
Japan	1.9 (4.8)	3.7 (9.1)	-	-	9.6	13.8
United States	7.6 (19.2)	8.3 (20.3)	28.1	22.4	-	-
Developing countries in:						
- Europe	8.2 (20.7)	6.3 (15.4)	1.1	1.6	1.8	1.3
- Latin America	2.6 (6.6)	2.2 (5.4)	4.7	3.3	19.6	16.1
- Asia ²	6.7 (16.9)	8.4 (20.6)	42.2	37.2	18.6	24.7
four most affected countries ³	2.1 (5.3)	2.4 (5.9)	15.5	14.8	7.0	7.3
memorandum:						
ratio of exports and imports, respectively, to GDP ⁴	26.5 (10.5)	25.0 (10.2)	10.6	8.5	8.5	11.1

¹ In parentheses: share in extra-EU trade. ² Excluding Middle East. ³ Sum of Indonesia, Malaysia, South Korea and Thailand. ⁴ In parentheses: ratio of extra-EU exports and extra-EU imports, respectively, to GDP.

Source: IMF: Direction of Trade Statistics, Washington, D.C.

Table 2
Hypothetical Reduction in GDP: EU, Japan and the United States
(percentage points)

	EU	Japan	United States
Import compression by 10 per cent plus export expansion by 10 per cent in:			
Asian developing countries	0.39	0.76	0.43
Latin America	0.12	0.08	0.35

Source: Own calculations based on Table 1.

⁵ The implementation of the single European market created a break in the statistics on intra-EU trade. Especially intra-EU imports are underestimated from 1993 onwards (European Commission: The European Union as a World Trade Partner, European Economy, Reports and Studies 3, Luxembourg 1997, pp. 15 f.). It follows that the actual bias towards intra-EU trade is even stronger than the bias reflected in trade intensity indices and trade shares as reported here.

⁶ However, the relative importance of extra-EU trade differs considerably between EU countries. For instance, extra-EU exports accounted for nearly half of total exports of Finland and the United Kingdom in 1996; the equivalent figure for the Netherlands and Portugal was about 20 per cent (IMF: Direction of Trade Statistics, Washington, D.C.).

⁷ Furthermore, Japan is a far more important trading partner for the United States than for the EU.

⁸ The underlying assumption of a 10 per cent reduction in imports and a 10 per cent increase in exports by developing countries is, of course, rather arbitrary. It may be noted, however, that the IMF (IMF: World Economic Outlook, Washington, D.C., September 1998, Table A5) expects the growth of imports of developing countries (in real terms) to decline from 10 per cent in 1997 to 1 per cent in 1998.

⁹ The European Commission has reported similar results from a simulation analysis (Europäische Kommission: Wirtschaftsaussichten der EU für 1998-1999, Europäische Wirtschaft, Beiheft A, Wirtschaftsanalysen 3/4, Luxemburg 1998, p. 15).

Table 3
Regional Structure of Direct Investment Stocks Abroad: Major Investor Countries, end-1995
(per cent)

Host countries	France	Germany	Italy	Netherlands	United Kingdom	Japan ^a	United States
EU	54.8	57.0	62.1	48.6	36.3	18.2	44.3
Japan	0.4	1.9	1.5	0.8	1.3	–	5.5
United States	19.5	19.5	9.0	24.5	31.5	41.9	–
non-OECD countries ^b	15.9	10.9	15.2 ^a	18.7 ^c	19.4	31.6	28.3
European countries	0.1	0.7	0.3 ^a	1.0	0.3	0.1	0.4
Asian countries ^d	2.0	3.0	0.8 ^a	4.1	7.3	16.4	8.1
Latin American countries	1.9	5.9	5.9 ^a	n.a.	8.4	11.9	17.3
(unallocated as given in the source)	(9.4)	(0.1)	(4.7) ^a	(12.6)	(0.6)	(0.5)	(0.5)
memorandum:							
World (US\$ billion)	184.4	252.3	97.0	177.3	302.8	463.6	711.6

^a 1994. ^b Including South Korea and Mexico. ^c Excluding South Korea and Mexico. ^d Excluding Middle East.

Source: OECD: International Direct Investment Statistics Yearbook, Paris 1997.

Trade and direct investment patterns are similar in two more respects. First, the share of host countries in developing Asia in total direct investment stocks is clearly highest for Japan. Direct investment stocks of the five major EU investor countries in developing Asia sum up to about US\$ 41 billion (1995), compared with US stocks of US\$ 58 billion (1995) and Japanese stocks of US\$ 76 billion (1994).¹⁰ Second, foreign direct investment in Latin America is dominated by US investors. Direct investment stocks held by US investors in this region exceed the combined stocks

held by France, Germany, Italy and the United Kingdom by a factor of 2.5; in absolute terms, even Japan is more heavily involved in Latin America than the four EU countries taken together.

How Safe Is the EU Haven?

Trade and direct investment relations with emerging markets support the view that Europe is less affected than Japan and the United States by the current crisis in Asia and possible contagion in Latin America. Yet, it would be delusive to argue that Europe is insulated from the crisis. The risks for Europe result from bank exposure in crisis-ridden emerging markets and from stock market developments.

In contrast to the trade and direct investment relations portrayed above, the emerging markets have close financial market relations with Europe. European banks are heavily involved in developing Asia and Latin America (Table 4). In Latin America, European banks held more than 60 per cent of total claims of all BIS reporting banks at end-1997. Most surprisingly perhaps, the claims of European banks on the four most affected Asian countries (Indonesia, Malaysia, South Korea and Thailand) exceeded the corresponding claims of Japanese banks. Taking developing Asia and Latin America together, the claims of European banks were about three times higher than the claims of Japanese and North American banks, respectively. In addition, the vulnerability of European

Table 4
International Claims on Emerging Markets by Nationality of Reporting Banks, end-1997

Position vis-à-vis:	All reporting banks ¹ (US\$ billion)	of which (per cent):		
		European banks	North American banks	Japanese banks
All developing countries	784.1	55.9	15.9	17.5
– Asia ²	381.0	47.1	9.7	30.1
(four most affected countries) ³	(238.9)	(36.9)	(9.4)	(35.2)
– Latin America	283.0	61.8	26.4	5.2
Eastern Europe	123.0	80.4	8.9	3.4

¹ Totals also cover the international claims of affiliates and branches of banks which have their head-offices outside the BIS reporting area.

² Without Middle East. ³ Sum of Indonesia, Malaysia, South Korea and Thailand.

Source: BIS: Consolidated International Banking Statistics for End 1997.

¹⁰ OECD: International Direct Investment Statistics Yearbook, Paris 1997.

banks to financial crises in Eastern Europe is exceptionally high. German banks alone held claims on Russia in the order of US\$ 30 billion at end-1997 (i.e., 42 per cent of total claims on Russia).

As a result, European banks may have to absorb substantially higher losses than their Japanese and North American competitors from defaults in emerging markets. According to press reports, international financial turbulences, especially the Russian crisis, have led to dwindling operating income of Deutsche Bank in 1998.¹¹ Widespread defaults in emerging markets would have a more serious GDP impact in Europe than in the United States and Japan. The loan exposure of EU banks in all countries outside the BIS reporting area amounts to nearly 8 per cent of the EU's GDP; the equivalent figures for US and Japanese banks are about 1.5 and 4 per cent.¹²

Stock market developments represent another risk. Declining share prices may reduce economic growth in two ways:

- The negative wealth effects of declining share prices depress consumer demand.

¹¹ In the third quarter of 1998, operating income of Deutsche Bank was down to DM 70 million from DM 1.3 billion in the third quarter of 1997 (Handelsblatt, October 30, 1998).

¹² Bank for International Settlements: Consolidated International Banking Statistics for End-1997, Press Release, Basle, May 25, 1998.

¹³ A. Boss, J. Döpke, E. Langfeldt, J. Scheide, R. Schmidt, H. Strauß: Aufschwung in Deutschland ohne Dynamik, in: Die Weltwirtschaft 4, 1997, p. 371.

¹⁴ The Economist, September 5, 1998, p. 19.

¹⁵ A. Boss et al.: Aufschwung in Deutschland ohne Dynamik, op. cit., p. 372. Stock market capitalization amounted to 40 per cent of GDP in Germany in 1997; the average figure for the EU (except the United Kingdom) was 51 per cent, compared with 166 per cent in the United Kingdom (Europäische Kommission, op. cit., p. 16).

- Declining share prices raise the cost of enterprise financing through the emission of shares and may, thus, depress private investment.

For two reasons, the growth-reducing effects of declining share prices are likely to be modest in Europe, relative to the United States. Demand effects in Europe are contained by the minor importance of shareholdings in overall private assets. In Germany, for example, shareholdings of private households accounted for just 6 per cent of their financial assets at end-1996.¹³ Currently, household shareholdings are equivalent to less than 20 per cent of annual disposable income in France and Germany, compared with 65 per cent in the United Kingdom and 100 per cent in the United States.¹⁴ Likewise, stockmarkets play a minor role in enterprise financing in much of continental Europe. In 1996, for instance, new emissions of shares by German manufacturing enterprises represented less than 10 per cent of their gross investment.¹⁵ This implies that private investment is less depressed by declining share prices in continental Europe than in the United Kingdom and the United States.

Nevertheless, recent stockmarket developments may affect economic growth in Europe to a significant degree. Stockmarket developments in Europe varied considerably, if the change of share price indices is calculated on an annual basis (Table 5, first column). However, the decline in share prices from their record highs is fairly similar between European countries. The (weighted) average decline in European share prices by 23 per cent is almost three times as large as the decline in US share prices from their record high. Hence, the effects of declining share prices on private

Udo Reifner/Jan Evers (Hrsg.)

Credit and New Entrepreneurs

Examining the question of access to appropriate finance for small and/or new firms, this book considers the different approaches which may assist in overcoming the obstacles such firms often face.

1998, 209 pp., paperback, 58,- DM, 423,- öS, 52,50 sFr, ISBN 3-7890-5766-5
(Schriften des Institut Für Finanzdienstleistungen e.V., Vol. 3)

 **NOMOS Verlagsgesellschaft**
D-76520 Baden-Baden

Table 5
Stockmarkets, as of October 21, 1998

	Percentage change of share price indices on:	
	one year	record high
Selected European countries	10.2 ^a	-23.2 ^a
Austria	-22.6	-36.8
Belgium	30.6	-14.0
Denmark	-9.2	-23.0
France	15.0	-21.3
Germany	8.4	-26.7
Italy	22.3	-25.6
Netherlands	6.0	-26.2
Spain	24.2	-21.4
Sweden	-7.4	-26.2
Switzerland	5.7	-27.1
United Kingdom	1.1	-15.7
Other industrialized countries		
Japan	-19.6	-63.5
United States	6.0	-8.8
World (Morgan Stanley Capital International index)	5.5	-11.1

^a Weighted average of the 11 European countries listed below (GDP in US\$ taken as weights).

Source: The Economist, October 24, 1998.

consumption and investment in Europe may not be too different from the effects in the United States, even though stockmarkets are less important in Europe than in the United States.¹⁶

Why High Growth Is Not Enough

Uncertainty related to stockmarkets and the exposure to risk of European banks notwithstanding, recent GDP forecasts suggest that economic turbulences in Asia and recessionary tendencies in about two fifths of the world economy play a minor role for GDP growth in Europe (Table 6). Except for the EU and the United States, the IMF revised GDP growth projections downwards in the course of 1998, as the crisis turned out to be more severe than anticipated in late 1997. Worldwide growth in 1998 is now expected to be 2 per cent, compared with the earlier forecast of 3.5 per cent. Downward revisions were most pronounced for Japan and newly industrializing Asian economies.¹⁷ By contrast, GDP growth in

¹⁶ For a more detailed discussion of stockmarket effects on economic activity in Germany and the United States, see A. Boss, J. Döpke, J. Gottschalk, E. Langfeldt, J. Scheide, R. Schmidt, H. Strauß: Trotz Belastungen: Aufschwung in Deutschland setzt sich fort, in: Die Weltwirtschaft 3, 1998, pp. 235-257, and The Economist, September 5, 1998.

¹⁷ In December 1997, Asian NIEs were still expected to grow at 3.6 per cent. Nine months later, the IMF forecast was -2.9 per cent.

Table 6
GDP Growth Forecasts

	1998				1999	
	IMF Dec. 1997	IMF Sept. 1998	Institutes' Oct. 1997	Institutes' Oct. 1998	IMF Sept. 1998	Institutes' Oct. 1998
European Union	2.7	2.9	2.8	2.8	2.5	2.5
(Euro area)	(-)	(3.0)	(-)	(2.8)	(2.8)	(2.7)
Japan	1.1	-2.5	2.0	-2.8	0.5	0.5
United States	2.4	3.5	2.5	3.3	2.0	2.0
Developing countries	4.9	2.3	-	-	3.6	-
World	3.5	2.0	-	-	2.5	-

¹ Joint forecast of six German economic research institutes.

Sources: IMF: World Economic Outlook: Interim Assessment, Washington, D.C., December 1997; IMF: World Economic Outlook, Washington, D.C., September 1998; Arbeitsgemeinschaft deutscher wirtschaftswissenschaftlicher Forschungsinstitute: Die Lage der Weltwirtschaft und der deutschen Wirtschaft im Herbst 1997, Berlin 1997; Arbeitsgemeinschaft deutscher wirtschaftswissenschaftlicher Forschungsinstitute: Die Lage der Weltwirtschaft und der deutschen Wirtschaft im Herbst 1998, Berlin 1998.

the EU is still expected to be close to 3 per cent in 1998. Moreover, in 1999, the EU is likely to record the highest GDP growth among industrialized countries. Forecasts suggest that Euroland (i.e., the eleven countries forming the Euro area) will perform slightly better than the EU average in 1999.

Various observers agree that domestic demand will be the main engine of high growth in the EU. Factors that boost domestic demand (e.g., declining interest rates and rising terms of trade) compensate for lower extra-EU exports to trading partners in economic trouble. In other words, the crisis in other parts of the world economy may continue to be of minor relevance to Europe. From this perspective, it may be surprising that economic policy debates in Europe have become highly controversial recently. Especially central banks are under attack. Members of the newly elected German government, for instance, are blaming the Bundesbank for having contributed to high unemployment by pursuing strict monetary policies.

Relatively high GDP growth notwithstanding, unemployment will indeed remain the central policy challenge in Europe. According to recent forecasts, the rate of unemployment will decline only slightly (Table 7). In 1999, the EU as a whole will still suffer from unemployment in the order of 10 per cent. The average rate of unemployment will be about twice as high as in Japan and the United States. It is highly dubious, however, whether a more accommodative stance of European central banks would result in

better labor market outcomes. Empirical studies suggest that European unemployment is of a structural, rather than of a cyclical nature.¹⁸ Structural unemployment has increased for various reasons, including labor market rigidities, inflexible social security systems as well as insufficient restructuring of employment and exports. Against this backdrop, two questions are discussed in the following: First, will the single currency help overcoming unemployment by adding to economic dynamism in Euroland? Second, will Euroland play a constructive role in containing the current crisis, or will recent policy initiatives give rise to serious conflicts within Europe and beyond?

Does the Euro Make Much of a Difference?

The Euro may still lack popular support, but European policymakers, across the ideological spectrum of relevant political parties, are convinced of the merits of the single currency. EU countries such as Italy took harsh fiscal adjustment measures in 1997 in order to meet the so-called convergence criteria and

Table 7
Unemployment Rates in the EU, Japan
and the United States
(per cent)

	1997	1998 ^a	1999 ^a
Austria	4.4	4.5	4.3
Belgium	13.3	12.8	12.2
Finland	14.5	12.3	11.0
France	12.5	11.8	11.3
Germany	11.4	11.2	10.7
Ireland	10.2	9.0	8.0
Italy	12.3	12.3	12.0
Luxembourg	3.6	3.0	3.0
Netherlands	5.5	4.5	4.0
Portugal	6.8	6.0	5.5
Spain	20.8	19.0	17.5
Euro area^b	12.2	11.7	11.1
Denmark	7.8	6.7	6.5
Greece	10.5	10.5	10.5
Sweden	8.0	6.7	6.5
United Kingdom	5.5	5.0	5.5
European Union^b	10.8	10.2	9.8
Japan	3.4	4.3	5.0
United States	4.9	4.5	5.0

^a Forecast. ^b Weighted average (number of persons employed in 1997 used as weights).

Source: Arbeitsgemeinschaft deutscher wirtschaftswissenschaftlicher Forschungsinstitute: Lage der Weltwirtschaft und der deutschen Wirtschaft im Herbst 1998, Berlin 1998, Table 1.1.

to qualify for joining the Euro-club from the very beginning.

The economic benefits of the single currency could indeed be substantial. The Euro enhances market integration among EMU members. Economic agents will save by handling one money, rather than many. Exchange-rate risk will cease to exist in Euroland. The European Commission has estimated that the benefits of lower transaction and hedging costs amount to about 0.5 per cent of the EU's GDP. Greater transparency related to prices and wages in Euroland encourages arbitrage and, thus, efficiency. In the absence of exchange-rate risk, a liquid Euro-wide capital market may lower the cost of capital and improve its allocation. While fiercer competition will require enterprise adjustment and restructuring, overall growth and employment prospects improve to the extent that competitive pressure leads to higher investment and stimulates product and process innovations.

However, the Euro does not offer a free lunch. The single currency involves a loss of flexibility, as individual EMU members can no longer adjust nominal exchange rates. The costs of doing without bilateral exchange rates as a shock absorber may be even greater than the aforementioned benefits. This could imply still more serious employment problems in Europe.

Euroland does 'not remotely resemble an optimum currency area'.¹⁹ EMU economies do not behave as one, and labor market flexibility is rather low.²⁰ The single currency may adversely affect employment particularly in those EMU economies in which asymmetric shocks are most likely, and in which labor market rigidities are most pronounced (group 4 in Table 8).²¹ The likelihood of asymmetric shocks is

¹⁸ J. Döpke, K.-J. Gern, J. Gottschalk, E. Langfeldt, J. Scheide, M. Schlie, H. Strauß: Euroland: New Conditions for Economic Policy, Kiel Discussion Papers 326, Institute of World Economics, Kiel 1998; E. Gundlach, P. Nunnenkamp: Labor Markets in the Global Economy: How to Prevent Rising Wage Gaps and Unemployment, Kiel Discussion Papers 305, Institute of World Economics, Kiel 1997.

¹⁹ The Economist, October 24, 1998, p. 107.

²⁰ In contrast to the United States, the level and structure of wages have proven to be fairly rigid in continental Europe since the late 1970s; see: E. Gundlach, P. Nunnenkamp: The European Union in the Era of Globalization. Competitive Challenges, Structural Unemployment, and Policy Response, op. cit.; E. Gundlach, P. Nunnenkamp: Labor Markets in the Global Economy: How to Prevent Rising Wage Gaps and Unemployment, op. cit.

²¹ The classification of EU countries given in Table 8 draws on various studies on the relevance of asymmetric shocks and on labor market conditions in the EU; for details, see D. Dohse, C. Krieger-Boden: Währungsunion und Arbeitsmarkt: Auftakt zu unabhängigen Reformen, Kieler Studien 290, Mohr Siebeck, Tübingen 1998.

considered high in those EU countries that reveal striking peculiarities, e.g., in terms of production and export structures, and dependence on commodity imports. Labor markets are considered inflexible if wages are rigid, working time is inelastic and the mobility of workers is low. According to these criteria, the single currency involves substantially higher employment risks for countries such as Italy and Spain than for countries such as Austria and the Netherlands. France and Germany are in an intermediate situation: While labor market flexibility is rather low, their vulnerability to asymmetric shocks appears to be below the EU average.

Table 8 portrays status-quo conditions. One may expect that the single currency will reduce the likelihood of asymmetric shocks and increase the pressure to deregulate labor markets. However, closer market integration in Euroland does not necessarily reduce the likelihood of asymmetric shocks. National business cycles may converge, but structural differences within Euroland may even increase. The latter will happen if closer market integration encourages more specialization within Euroland, and goes along with geographical concentration of specific economic activities. Labor market deregulation has indeed been started in several EU countries, albeit in different ways and at different speeds.²² It remains to be seen whether labor market reforms will continue, and whether European labor markets will become sufficiently flexible.

It would not only be a European affair if the Euro venture were to fail in improving labor market outcomes. Persistently high unemployment in Euroland may have serious international repercussions. European policymakers may increasingly blame 'unfair'

competition for labor market problems. Rather than adjusting to fiercer competition by means of structural change, demands for an international harmonization of production standards may win the upper hand. The debate on the so-called social dimension of EMU, i.e., the introduction of European minimum standards regarding working conditions and industrial relations, represents a first step in this direction.

The next step follows almost automatically as soon as effective social harmonization in the context of EMU clashes with productivity differences between EU countries:²³ the EU will press harder for a multilateral agreement on production standards in order to protect member countries against fiercer competition from outside the EU. Eventually, European harmonization may impair the opportunities of lower-income trading partners of the EU to make full use of their comparative cost advantages and, thereby, catch up with more advanced economies. The retreat to innovative forms of protectionism would shift the adjustment burden to third countries. This is exactly the opposite of what the EU should do in order to overcome the current crisis and prevent a global slump: i.e., to speed up structural change internally and to guarantee free trade externally.

Euroland's Role in Overcoming the Crisis

Uncertainty about Euroland's future economic policy does not only refer to the longer-term question of structural adjustment. The immediate concern is that launching the Euro accentuates various policy dilemmas. It is open to question whether Euroland will pursue appropriate monetary, fiscal and exchange-rate policies. Intra-European conflicts in these policy areas may even create tension on a global scale and render it more difficult to overcome the current crisis.

The current controversy in Europe centers around the question as to whether monetary, fiscal and exchange-rate policies should be utilized for fighting high unemployment. Governments in several EU countries, notably the newly elected German government, are favoring interest rate cuts, fiscal expansion and exchange-rate stabilization. As a result, central banks are under serious attack and the ECB faces a contentious environment from the very beginning of its operations in January 1999.

Table 8
Classification of EU Countries:¹ Vulnerability to Asymmetric Shocks and Labor Market Flexibility (status-quo conditions)

	Labor market flexibility ²		
	high	low	
Likelihood of asymmetric shocks ²	low	group 1: Austria, Netherlands	group 3: Belgium, (Denmark), France, Germany
		high	group 2: Ireland, Portugal, (United Kingdom)

¹ Non-EMU members in parentheses. ² Relative to EU average.

Source: D. Dohse, C. Krieger-Boden: Währungsunion und Arbeitsmarkt: Auftakt zu unabdingbaren Reformen, Kieler Studien 290, Mohr Siebeck, Tübingen 1998.

²² Ibid.

²³ Siebert has shown that labor productivity, for example, in Portugal reaches only 35 per cent of the West German level (H. Siebert: Arbeitsproduktivität und Löhne in der Europäischen Währungsunion, in: Die Weltwirtschaft 2, 1998, pp. 115-120).

Even without political pressure to lower interest rates, the ECB's monetary stance will be surrounded with some uncertainty in the short term.²⁴ First, confusion in financial markets may result from the ECB's decision to refer to a somewhat ambiguous basket of economic indicators in designing monetary policy, rather than pursuing a clear-cut strategy of either monetary targeting (as done by the German Bundesbank) or inflation targeting. Second, the ECB will have to strike a difficult balance as long as EMU economies are in different phases of the business cycle. The common monetary policy 'cannot do anything about regional differences',²⁵ it may be too loose for booming economies (e.g., Ireland and Spain) and too tight for others (e.g., Germany). Moreover, in the short term at least, the common monetary policy is like 'shooting at a moving target in the fog'.²⁶ The effects of central bank decisions on economic activity differ significantly across EMU economies, partly because transmission mechanisms depend on country specific financial structures and partly because the relative importance of extra-EU trade varies considerably within Euroland.²⁷ Third, monetary policy by the ECB is complicated further if, as expected, the Euro will be widely circulated outside Euroland.

Political calls for lower interest rates add to uncertainty as long as the ECB's reaction is open to question. According to various European politicians, the ECB should pay as much attention to employment as to price stability. On paper, 'the ECB will be the most independent central bank ever'.²⁸ It may simply ignore 'advice' given by the so-called Euro-11, the group of Euroland's finance ministers that represents a political counterweight to the ECB. For the time being, central bankers have good reasons to resist political pressure:

□ As mentioned before, strong domestic demand is the main engine of relatively high GDP growth in Euroland.

□ Interest rates in major EU countries such as France and Germany are lower already than the US interest rate.²⁹

Other EMU members (Ireland, Italy, Portugal and Spain) have reduced interest rates recently. In contrast to earlier expectations, European interest rates will converge *downwards* to the French and German level until the end of 1998. In other words, for Euroland as a whole, monetary policy is actually quite easy.³⁰

Central bankers, notably Tietmeyer and Duisenberg, have dismissed calls for deeper cuts in interest rates under current circumstances. However, central bankers must be sufficiently flexible to prevent Euroland from tumbling into recession if global economic turbulences mount. The risk for Euroland and the world economy is that politically blackmailing central bankers today may produce perverse results when it comes to such a critical situation. Political pressure renders it all the more important for the ECB to establish a reputation for anti-inflationary rigor.³¹ In order to demonstrate its independence and inherit the credibility of the German Bundesbank, the ECB may pursue a tighter monetary policy than it would have done if its independence had remained unchallenged politically. Hence, hard-pushing politicians may produce an outcome that is exactly opposed to their intentions: the ECB may react too slowly and send Euroland and the world economy another recessionary blow.

The ECB will face a still more serious dilemma, if European governments consider fiscal expansion to be a promising alternative to structural reforms for fighting high unemployment. Efforts to reduce structural budget deficits have been halted already by various European governments after they had met the fiscal deficit criterium to qualify for the Euro.³² If fiscal policy were to become more expansionary now, this would violate the rules laid down in the so-called Stability Pact.³³ However, the rules can be circum-

²⁴ J. Döpke, K.-J. Gern, E. Langfeldt, J. Scheide, M. Schlie: Quo Vadis, Euroland?, Kiel Discussion Papers 313, Institute of World Economics, Kiel 1998.

²⁵ J. Döpke et al.: Euroland: New Conditions for Economic Policy, op. cit., p. 14.

²⁶ R. Dornbusch, C. Favero, F. Giavazzi: Immediate Challenges for the European Central Bank, in: Economic Policy 26, 1998, p. 52.

²⁷ R. Ramaswamy, T. Sloek: The Real Effects of Monetary Policy in the European Union: What Are the Differences?, IMF Working Paper WP/97/160, International Monetary Fund, Washington, D.C. 1997.

²⁸ The Economist, October 31, 1998, p. 91.

²⁹ Overnight rates (as of October 21, 1998) amounted to 3.4 per cent in France and Germany, compared with 4.9 per cent in the United States (The Economist, October 24, 1998, p. 141).

³⁰ J. Döpke et al.: Quo Vadis, Euroland?, op. cit.

³¹ D. Begg, F. Giavazzi, C. Wyplosz: Options for the Future Exchange Rate Policy of the EMU, CEPR Occasional Paper 17, Centre for Economic Policy Research, London 1997.

³² J. Döpke et al.: Euroland: New Conditions for Economic Policy, op. cit., p. 19 ff.

³³ This pact, which was added to the Maastricht Treaty mainly because the former conservative government in Germany pressed for continuous fiscal discipline, limits budget deficits of EMU members to 3 per cent of GDP. Heavy fines may be imposed on any country exceeding this figure.

vented in several ways. Currently, there are moves to redefine the deficit criterium by (fully or partly) excluding public investment outlays, and to shift the financing of infrastructure projects from national budgets to the Community level. Furthermore, governments may decide not to fine each other if several countries exceed the deficit criterium.

The Stability Pact was meant to enhance monetary credibility by protecting the ECB 'from pressure for an inflationary debt bailout'.³⁴ As a corollary, an overly expansionary fiscal policy may compromise monetary credibility. The ECB's reaction to this threat is difficult to predict. Again, it may respond by pursuing tighter monetary policies than it would under less expansionary fiscal policy conditions. This would lead to higher interest rates in Euroland and might strengthen the Euro. As before, economic consequences would extend beyond Euroland. Especially emerging markets might be affected. On the one hand, a stronger Euro would support the price competitiveness of emerging markets relative to Euroland. On the other hand, however, higher interest rates in Euroland would render it more difficult for emerging markets to regain their attractiveness to foreign capital. This could prolong the crisis in these economies.

A final, and perhaps the most serious, conflict evolves from recent suggestions by the finance ministers of France and Germany to establish target zones for the exchange rate of the Euro against other major currencies.³⁵ If left to the market, the Euro may turn out to be stronger than expected earlier.³⁶ In addition to recent signs of a softening US-Dollar, the Euro's challenge to the US-Dollar as the traditional 'hegemonic' world currency may strengthen the Euro. The Euro will rise against the US-Dollar if portfolio investors shift quickly from US-Dollar-denominated into Euro-denominated assets, thereby outstripping the increase in the supply of Euro-denominated liabilities.³⁷ Such a scenario would impair Euroland's exports and put jobs in world-market-oriented industries at risk.³⁸ As unemployment figures are at the top of the political agenda, it is not surprising that politicians are opposed to a strong Euro.

It follows that calls for exchange-rate stabilization via target zones are effectively meant 'to hold the euro down against the dollar'.³⁹ This strategy creates problems within and outside Euroland. Euroland will

import inflation if the Euro is kept artificially cheap. This undermines the ECB's efforts to maintain price stability. At the same time, any attempt to tackle internal labor market problems at the expense of external trading partners gives rise to conflicts on an international scale. Most probably, trading partners would retaliate. Once protectionism regains ground, a truly global crisis would be looming, as the depression of the 1930s witnesses.

Summary

The crises in various emerging markets have affected Europe only modestly so far. However, Europe is not insulated from economic turbulences in other parts of the world economy, even though intra-regional ties dominate trade and investment relations. European banks are highly exposed to credit risk in emerging markets. Favorable growth forecasts may have to be revised downwards if stockmarkets continue to be bearish.

True, the single currency may foster economic dynamism in Europe. Potential benefits may go unrealized, however, if the fight against high unemployment takes the wrong route. For the Euro to be successful, greater labor market flexibility is essential. For unemployment to come down, Europe needs more structural change. If fiscal expansion and exchange-rate intervention are falsely considered to be promising alternatives to structural reforms, the credibility of the ECB is at risk from the very beginning of its operations.

Serious internal policy conflicts are not just a European affair. They may prevent Euroland from playing a constructive role in overcoming the current crisis. Ultimately, the world economy may plunge into deep recession if European politicians and central bankers will be preoccupied with blocking each other. The appropriate division of labor between them is straightforward: politicians should push structural reforms; central bankers must be flexible enough to prevent another important part of the world economy from tumbling into recession.

³⁴ For example, Döpke et al.: Quo Vadis, Euroland?, op. cit., assumed the Ecu/US-Dollar rate (Euro/US-Dollar rate, respectively) to be stable at 0.92 from mid-1998 to end-1999. In late October 1998, the Ecu/US-Dollar rate stood at 0.84.

³⁵ R. Portes, H. Rey: The Emergence of the Euro as an International Currency, in: *Economic Policy* 26, 1998, pp. 305-343.

³⁶ Döpke et al.: Euroland: New Conditions for Economic Policy, op. cit., have estimated that a one per cent change of the real external value of the Ecu affects Euroland's real exports by about 0.5 per cent.

³⁹ The Economist, October 31, 1998, p. 15.

³⁴ B. Eichengreen, C. Wyplosz: The Stability Pact: More than a Minor Nuisance?, in: *Economic Policy* 26, 1998, p. 71.

³⁵ Note that, according to the Maastricht Treaty, governments (rather than the ECB) are in charge of exchange-rate policy for the Euro.