Withdrawal/Redaction Sheet
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DOCUMENT NO. AND TYPE	SUBJECT/TITLE	DATE	RESTRICTION
001. memo	Lawrence Summers to Secretary Rubin re: Conclusions of Treasury/Fed Meeting on EMU (partial) (1 page)	06/12/96	P3/b(3)
002. memo	Robert E. Rubin to POTUS re: Visit of French President Chirac (2 pages)	01/26/96	P5

COLLECTION:

Clinton Administration History Project

OA/Box Number: 24126

FOLDER TITLE:

[History of the Department of the Treasury - Supplementary Documents] [27]

jp24

RESTRICTION CODES

Presidential Records Act - [44 U.S.C. 2204(a)]

P1 National Security Classified Information [(a)(1) of the PRA]
P2 Relating to the appointment to Federal office [(a)(2) of the PRA]
P3 Release would violate a Federal statute [(a)(3) of the PRA]
P4 Release would disclose trade secrets or confidential commercial or financial information [(a)(4) of the PRA]
P5 Release would disclose confidential advise between the President and his advisors, or between such advisors [a)(5) of the PRA]
P6 Release would constitute a clearly unwarranted invasion of personal privacy [(a)(6) of the PRA]

C. Closed in accordance with restrictions contained in donor's deed of gift.
PRM. Personal record misfile defined in accordance with 44 U.S.C. 2201(3).
RR. Document will be reviewed upon request.

Freedom of Information Act - [5 U.S.C. 552(b)]

b(1) National security classified information [(b)(1) of the FOIA]
b(2) Release would disclose internal personnel rules and practices of an agency [(b)(2) of the FOIA]
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b(8) Release would disclose information concerning the regulation of financial institutions [(b)(8) of the FOIA]
b(9) Release would disclose geological or geophysical information concerning wells [(b)(9) of the FOIA]

1999-SE-000238

DEPARTMENT OF THE TREASURY
Washington

January 11, 1999

TO: SECRETARY RUBIN
DEPUTY SECRETARY SUMMERS

FROM: Timothy Geithner TFG

SUBJECT: Q and A on the Dollar

Here are the dollar options we put together last week. It is worth a conversation with Greenspan before we do this.

YEN/DOLLAR COMMENTS: POSSIBLE PRESS LANGUAGE
(in descending order of preference)

Q: **Any dollar question**

Option 1:
Our dollar policy remains unchanged. We are closely following developments in exchange markets.

Option 2:
Our dollar policy remains unchanged and, as I have said, a strong dollar has served our interests well.

Option 3:
We are closely monitoring developments in exchange markets. Our [strong] dollar policy remains unchanged. We believe that exchange rates should reflect economic fundamentals [and that excess volatility and significant deviations from fundamentals are undesirable]. The fundamentals of the US economy remain strong.

Option 4:
[Add to any of the above:] ... Japan's concerns about the yen seem appropriate to us at the present time.

If Japan intervenes

Q: Do you support the Japanese intervention?

A: We do not, as a general matter, comment on actions by other countries in the exchange markets.

Could add: We believe that exchange rates should reflect economic fundamentals. As always, we will continue to monitor market developments and to cooperate as appropriate.

1/6/99

DOLLARIZATION

1999-SE-001874

DEPARTMENT OF THE TREASURY
WASHINGTON

February 22, 1999

ASSISTANT SECRETARY

ACTION

MEMORANDUM FOR SECRETARY RUBIN

FROM: Ted Truman CS
Assistant Secretary (International Affairs)

SUBJECT: Memorandum to the President on dollarization

Action Forcing Event: President Clinton asked you to send him a memo outlining the issues concerning dollarization in Argentina or other countries.

Recommendation: That you sign the attached memorandum to the President (tab A) laying out the pros and cons of dollarization from the U.S. perspective and from the perspective of potential dollarizing countries.

Agree ________ Disagree ________ Let's Discuss ________

Background: As noted in the attached memorandum, dollarization has both potential costs and benefits for the United States. Our public and private position on Argentine dollarization has been one of "active listening" but studious neutrality. Argentina has not yet made a formal proposal on dollarization, but plans to give us a paper in early March outlining their objectives and discussing possible arrangements to share seigniorage revenues from Argentine dollarization.

DEPARTMENT OF THE TREASURY
WASHINGTON, D.C.

SECRETARY OF THE TREASURY

March 1, 1999

MEMORANDUM FOR THE PRESIDENT

FROM: Robert E. Rubin R.E.R

SUBJECT: Dollarization

Argentine financial officials have expressed interest in adopting the dollar as their national currency, and the Argentine initiative has attracted renewed attention to this option in other Latin American countries, including Mexico and El Salvador. Dollarization has also attracted considerable interest in the United States, as reflected in the questions on that subject addressed to Chairman Greenspan during his recent Congressional testimony. The Argentines view dollarization as a means of helping to lock in the stability they have gained from their "convertibility" plan, a currency board-like arrangement. They also hope a successful Argentine dollarization would encourage other countries in the region to dollarize, which they believe will contribute to increased economic integration and greater financial stability in the Hemisphere. Senior Argentine Economy Ministry officials have visited us and the Federal Reserve to discuss the potential advantages and disadvantages of dollarization for both the dollarizing country and for the United States, as outlined below.

DOLLARIZATION FROM THE PERSPECTIVE OF DOLLARIZING COUNTRIES

Potential advantages

- Lower inflation expectations (if the markets view dollarization as a sustainable policy), which contribute to a more favorable growth/disinflation tradeoff.
- Improved inflation performance, especially for countries with poor inflation track records (monetary financing of fiscal deficits no longer an option).
- Lower nominal and real interest rates from reduced inflation and elimination of devaluation risk.
- Stronger economic growth due to lower inflation, lower interest rates, and enhanced market discipline on macroeconomic policies.
- Acceleration of the process of financial deepening, as the dollar's credibility and greater price stability lead to longer maturities and greater variety in financial instruments.

Potential disadvantages

- Dollarization is an extreme form of a fixed exchange rate regime. Renouncing use of the exchange rate to adjust relative prices means that domestic output, employment, wages, and prices would have to bear the entire burden of adjusting to shocks, as in Europe under EMU. If Argentina were to dollarize without being joined by its major Latin American trading partners, such as Brazil, it could be subjected to large adjustment costs as the currencies of those countries fluctuated against the dollar.
- Loss of monetary independence leaves fiscal policy as the only demand management tool for responding to cyclical swings in the economy.

- The costs of failure could be high, but markets would likely view dollarization as more credible than a fixed exchange rate precisely because of the high cost of failure.
- Loss of the central bank's lender-of-last-resort function limits authorities' ability to respond to bank runs, though it could also enhance market discipline and reduce moral hazard.
- Loss of seigniorage revenues derived from currency issuance, currently only 0.2% of GDP in the case of Argentina because the economy is already partially dollarized as a legacy of past high inflation.
- Dollarization cannot substitute for sound macroeconomic policies and flexible markets.
- Renunciation of monetary sovereignty could offend nationalist sentiments.

<u>Dollarizing countries might seek U.S. agreement to share some of the responsibilities associated with dollarization. Such an agreement could in principle cover</u>:
- sharing seigniorage in whole or in part from foreign dollarization;
- access to the Federal Reserve's discount window for the dollarizing country's banks;
- shared responsibility for bank supervision in the dollarizing country; and
- consultations on monetary policy.

Agreement on one or more of the first three points would likely require U.S. Congressional approval in one form or another.

DOLLARIZATION FROM THE U.S. PERSPECTIVE

Potential advantages
- Improved economic performance in the dollarizing countries would benefit U.S. producers.
- U.S. firms and investors would benefit from lower transaction costs and reduced transfer risk.
- Enhanced seigniorage revenues from the dollar's increased circulation abroad.
- If Latin America became a dollar zone, it would tend to reinforce our leadership in the region, and the dollar's role in the global financial system.

Potential disadvantages for the United States

If a country dollarized unilaterally, with no explicit reciprocal obligations on our part:
- Increased trade and investment links with dollarized countries would increase U.S. economic vulnerability to financial instability in those countries.
- A financial crisis in a dollarized country could put downward pressure on the dollar, just as the Mexican peso crisis contributed to the dollar's weakness in early 1995.
- Possible domestic political criticism even without any explicit U.S. obligation to support the dollarizing country.
- Even with unilateral dollarization there would be the risk of a perception that the United States stands behind the economic and financial policies of the dollarizing country.

If a country dollarized in the context of a bilateral agreement with the United States:
- In principle, an agreement to share seigniorage could generate a net budget gain for the U.S. taxpayer, but U.S. budget law might still require offsets.
- Access to the Federal Reserve's discount window and/or U.S. responsibility for banking supervision in the dollarized country could prove technically and politically problematic. Even without these features there could be a perception of influence on U.S. monetary policy by the dollarized country.

Under either scenario, there would be a risk that dollarization would increase international political pressures on the Federal Reserve with respect to U.S. monetary policy, especially when the U.S. is doing well and the dollarized countries are not. There is disagreement about the seriousness of this risk compared with the situation today in which Federal Reserve policy decisions already have profound consequences for some of these countries.

ADDENDUM: Panama's Experience with Dollarization

- Panama has used the dollar as its currency since gaining independence early this century, but its GDP of about $9 billion is less than 3% of Argentina's.
- Panama's inflation performance has been outstanding, but its long-term growth record is only modestly better than elsewhere in Latin America.
  - Annual inflation averaged just 3.6% in Panama from 1970-96, compared to more than 80% in the rest of Latin America and 5.5% in the United States.
  - Annual real GDP growth per capita was 1.9% for the period, a little higher than in the rest of Latin America and the United States, both at 1.5%.
- Panama's dollarization did not fully guarantee good economic policies. Panama used ample bank credit available to developing countries in the 1970s to run fiscal deficits averaging 10% of GDP from 1977 to 1981. Public external debt totaled nearly 75% of GDP in 1982, when Mexico's debt service moratorium marked the beginning of the 1980s debt crisis.
- But Panama's GDP growth averaged 3.4% from 1982-87 compared to 1.8% elsewhere in the region, despite Panama's higher debt levels than in Mexico, Brazil and many other Latin American countries.
- Panama did experience a financial crisis in 1988, when U.S. economic sanctions contributed to a sharp drop in dollars in circulation in Panama. The result was a 27% decline in domestic bank deposits, a substantial build-up of public sector debt service arrears, a 13% decline in GDP in 1988, and the need for Panama to reach agreement with commercial bank creditors on a Brady-style debt reduction agreement that was signed in 1995.

cc: Federal Reserve Chairman Greenspan, Secretary of State Albright, Sandy Berger, Gene Sperling, Janet Yellen.

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with respect to U.S.

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cc: Federal Reserve Chairman Greenspan, Secretary of State Albright, Sandy Berger, Gene Sperling, Janet Yellen.

EXECUTIVE SECRETARIAT CORRESPONDENCE MEMO COVER SHEET

Tuesday, February 23, 1999

PROFILE #: 1999-SE-001874

DATE CREATED: 02/23/1999

ADDRESSEE: Robert E. Rubin, Secretary

AUTHOR: Truman, Ted, International Affairs

SUBJECT: Memorandum To The President On Dollarization

ABSTRACT: Memorandum to the President on Dollarization.

RM 3419

TO REVIEWERS

IN: To PA 2/23/99

TO EXECUTIVE SECRETARY

IN:

TO THE SECRETARY

DATE SIGNED:

PA to NCC 2/23/99

DISTRIBUTION: AS, INTERNATIONAL AFFAIRS

PA cc DL/AK

3/1/99

- NCC to REN (signature) 2/26/99
- Ted Truman revised per REN 3/1/99
- NCC to REN as revised 3/1/99
- NCC revised again per REN
- REN signed
- AK original to WH

OASIA to Distribute cc's

02/23/1999 09:56:21 AM

- NCC/AK cc to LS in his 3/2 briefing book

EURO

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001. memo	Lawrence Summers to Secretary Rubin re: Conclusions of Treasury/Fed Meeting on EMU (partial) (1 page)	06/12/96	P3/b(3)

This marker identifies the original location of the withdrawn item listed above. For a complete list of items withdrawn from this folder, see the Withdrawal/Redaction Sheet at the front of the folder.

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1996-SE-004827

THE DEPUTY SECRETARY OF THE TREASURY
WASHINGTON

6/12/96

MEMORANDUM FOR SECRETARY RUBIN

FROM: Lawrence Summers
Deputy Secretary

SUBJECT: Conclusions of Treasury/Fed meeting on EMU

I convened an informal meeting last week to discuss EMU and its probable effects on the dollar and the U.S. economy. In addition to Treasury staff, Ted Truman and other Fed staff, [redacted] and Peter Kenen, who is visiting here from Princeton, attended.

The group concluded the following:

1. **The odds are high that EMU, in some form, will happen on schedule.** The group foresaw a liberal interpretation of convergence criteria and placed the odds of a core group going ahead on time at 75%. Which countries will form the core group is still unclear; Germany and France must be in, and most observers expect another three to five countries, including the Benelux and possibly Ireland and Austria, to be founding members. If the deficit criterion is interpreted liberally for France and/or Germany, however, there may be pressure to admit a wider group. Italy in particular is expected to make a strong push for membership in the first stage or, as a fallback, for some special status that sets a path for early entry.

2. **The transition is likely to be bumpy.** With the membership of the core group not to be decided until spring 1998, we should expect currencies to be tested by shifting winds -- both economic and political -- which alter assumptions about which countries will participate. There are also a number of technical issues to be worked out, one of the most problematic being the decision on the exchange rates at which currencies will be fixed to and then converted into Euro. These uncertainties may cause volatility in exchange markets during the next 2 ½ years which may affect the dollar. In addition, even if EMU should go ahead on schedule, the changeover from national currencies to the Euro will not be complete until 2002. It is therefore probable that for the next few years the Europeans will be internally preoccupied.

3. **The macroeconomic effects on the United States are likely to be small.** EMU may slow European growth in the run-up to 1999 as states strive to reduce fiscal deficits, probably more quickly than would happen in the absence of EMU. However, the effect on net U.S. exports is likely to be small. Even if EMU has a measurably negative impact on European growth in the short to medium run, the core European group is a small component of U.S. trade, which is in turn a fairly small part of U.S. GDP. In addition, at

least a few weak-growth scenarios have tight monetary policy in Europe putting upward pressure on rates and the Euro, which would counter the effects of slow European growth on U.S. exports.

4. **EMU will remain a marginal factor in the fate of the dollar.** The group did not believe that the arrival of the Euro would lead to a sustained appreciation or depreciation of the dollar over the long term. While some argue that the Euro will be a formidable competitor to the dollar from day one, it may take time before its credibility is established. In the transition period following 1999, uncertainties arising during the process of conversion from national currencies will likely favor the dollar at the expense of the Euro. In addition, with monetary policy being implemented through former national central banks dispersed across Europe, there are questions about whether the Euro will have sufficient liquidity and depth to provide a real alternative vehicle currency. In fact, the group believed that it was as likely that the dollar would rise during the period after 1999 as fall.

   Consequently, we do not believe EMU will pose a major challenge to the dollar's role as a reserve currency. The group adamantly rejected the notion that there would be large-scale dumping of dollars after EMU, either inside or outside Europe. In the long run, there are a number of factors affecting the dollar's reserve currency status; as long as confidence in the long-term value of the dollar is maintained, there is no reason to be overly concerned about the impact of EMU.

Going forward, we need to find a way to take the edge off of our public statements about EMU. Our attitude of studied neutrality is still appropriate. However, as Europeans are increasingly focused on this process, which represents a momentous development in European integration, we should look for ways to assure them that we are putting no barriers in the way of EMU and are committed to constructive engagement.

The Deputy Secretary of the Treasury

December 12, 1996

MEMO TO: BOB RUBIN
JEFF SHAFER
DAVID LIPTON
TIM GEITHNER

FROM: LARRY SUMMERS

This is the best paper I have seen on the $/Euro question. Note especially the observation that a liquid Euro market, by raising Euro debt supply, could raise the dollar, and the Annex 1 discussion of how portfolio effects are likely to be small. Do OASIA/the Fed agree with this paper?

cc: Sheryl Sandberg

To: Above distribution
From: Bob Rubin
1) I too, starting from a far more humble base, found this very interesting.
2) Question: what short and longer term policy implications for the U.S., if ~~[illegible]~~ any. I would guess that the Euro debt ~~[illegible]~~ factor notwithstanding, maintenance of a strong currency and attraction of foreign investment capital will place even greater emphasis on sound fiscal, monetary, exchange rate policy.

Room 3326 622-1080

The Secretary of the Treasury

January 6, 1997

NOTE FOR LARRY SUMMERS
JEFF SHAFER
DAVID LIPTON
TIM GEITHNER

FROM: BOB RUBIN

1. I too, starting from a far more humble base, found this very interesting.

2. Question: What short and longer term policy implications for the U.S., if any? I would guess that the debt factor notwithstanding, maintenance of a strong currency and attraction of foreign investment capital will take even greater emphasis on sound fiscal, monetary, exchange rate policy.

Attachment

Copy to: Sheryl Sandberg

1997-SE-004060

THE DEPUTY SECRETARY OF THE TREASURY
WASHINGTON

INFORMATION

MEMORANDUM FOR THE SECRETARY

FROM: Lawrence Summers

SUBJECT: EMU Seminar

On March 28 I presided over an informal Treasury seminar on EMU. Ted Truman (Fed), Jeff Frankel (CEA), Josh Gotbaum, and our academic advisors, Peter Kenen and Andrew Rose were invited to participate. Here is a summary of our discussion. My brief preliminary answers are shown in italics.

KEY ISSUES:

1. What are the prospects for EMU proceeding on time?

1.a What are the chances of delay? -- *40%.*

The probability of delay was rising earlier this year, but it appears to have stabilized recently or even declined a little. Participants' views on the probability of delay were in the range of 30-60%.

We looked at three different scenarios: launch on time without Italy, Spain, and Portugal (the Club Med), launch on time with the Club Med, and delay.

- A participant suggested that the best case scenario for the U.S. would be a launch on time without the Club Med, to establish the credibility of the Euro, followed by expeditious admission of the Club Med.
- Someone pointed out that it may be difficult politically to exclude the Club Med if Spain and Portugal are closer to meeting the Maastricht criteria than France and Germany--a distinct possibility. Including Spain and Portugal but not Italy would be very unlikely.
- There seemed to be no clear view of what non-EMU alternative was open to Europe. One suggestion was wide exchange rate bands and inflation targeting. The present Exchange Rate Mechanism with effectively narrow bands would be unlikely to last if there were no prospect of EMU in sight.

1.b What are the implications for the U.S. of a messy transition?

The biggest concern for the U.S. is a contentious postponement of EMU that results in capital flight from Europe, slow growth in Europe, and an appreciation of the dollar with adverse consequences for U.S. trade performance.

There was general agreement on this point.

2. **Can the U.S. constructively influence the nature of macroeconomic and structural policy now under consideration in Europe? Are there specific European policies that we could promote that would enhance the prospects for a more credible EMU?**

I suggested that our most important interest in the entire project is that EMU not divert Europe's attention from more important matters: the enlargement of the EU and structural labor and product market reform.

This view was shared by a strong consensus of the participants.

- One of the biggest costs of a delayed launch of EMU would be the lack of progress in these areas while governments devote more effort to fiscal and monetary austerity in order to qualify for EMU at a later date.

- Further adjustment of the macroeconomic policy mix offers little scope for gain . Real and sustainable improvements depend on market liberalization and structural reform.

3. **What are the external implications of EMU?**

3.a Short-term effects on the dollar exchange rate.

The best tentative guess is that the dollar is likely to appreciate during the transition and early launch period.

- During a smooth transition, the dollar appreciation will be modest and the exchange rates of both the "in" and the "out" countries will move together.

- During a turbulent transition, the dollar appreciation against the "out" and weaker "in" currencies may be substantial, but the DM and stronger "in" currencies may either appreciate or depreciate against the dollar.

3.b Medium- and long-term effects on the dollar's role in the international monetary system.

A modest attenuation of the dollar's reserve currency role.

The participants were not concerned about the "Bergsten Thesis." C. Fred Bergsten contends that the Euro will gain credibility rapidly and supplant the reserve role of the dollar. Such a development would cause the dollar to depreciate against the Euro. Most seminar participants reacted skeptically.

- A participant said he "..just doesn't see it." If the DM does not play a major reserve role now, why should there be a quantum change because the DM is renamed the Euro?

- I re-phrased the argument by characterizing the change as replacing an A+ currency from a modestly large economic area with an A- currency from an economic area 4 times as large. Initially, the Euro will be a novelty, not a reserve quality asset in the minds of the cautious people who make such decisions.

- The role of reserve currency is overrated. Most of the seignorage benefits are associated with the supply of actual currency (e.g. Latin American drug dealers, Middle-Eastern mattress cash, the cash currencies of Eastern Europe), not the holding of reserve assets by central banks. Replacement of the DM by the Euro would initially be more likely to increase demand for dollars.

The bottom line on this issue is that if the Euro does develop a role as a reserve currency, the change will take place over many years, without important economic implications for the U.S.

3.c Implications for the exchange rate system and cooperation on exchange rate policy.

Power could flow to the European Central Bank away from central governments.

3.d Institutional questions: What changes in European representation make sense? When should we begin discussion of these changes?

Before we raise these questions, we should wait until the current tension over EMU delay subsides.

We were concerned about two basic types of institutional issues: the external representation of the EMU and the credibility and strength of the proposed European Central Bank (ECB).

- We are still not sure who will speak for the EMU and how they will be represented in international fora (e.g. G-7, WP-3, and the IMF)--the "Who answers the phone?" question.

- This question cannot be definitively answered until the "ins" are selected in mid-

1998, although it may be appropriate to raise the issue with the Europeans sooner than that.

- He noted that some questions have more immediate policy significance than others. Who will make practical policy decisions for the EMU is a vital question. How Europe will eventually chose to be represented in the IMF and G-7 in the more distant future is interesting, but less important.

- I expressed my view that until the chances for an on-time launch of EMU reach 80% (vs 60%., at the present time, in my opinion) we should not raise these questions.

- The Maastricht Treaty grants the ECB a high degree of formal independence from both the national governments and the EU authorities. A independent ECB that is not accountable to the public may be vulnerable to populist pressure in bad economic times.

TREASURY CLEARANCE SHEET

NO. ______
Date

MEMORANDUM FOR: ☐ SECRETARY ☐ DEPUTY SECRETARY ☐ EXECUTIVE SECRETARY
☐ ACTION ☐ BRIEFING ☐ INFORMATION ☐ LEGISLATION
☐ PRESS RELEASE ☐ PUBLICATION ☐ REGULATION ☐ SPEECH
☐ TESTIMONY ☐ OTHER:

FROM: Deputy Secretary Summers
THROUGH:
SUBJECT: EMU Seminar

REVIEW OFFICES (Check when office clears)

☐ Under Secretary for Finance
- ☐ Domestic Finance
- ☐ Economic Policy
- ☐ Fiscal
  - ☐ FMS
  - ☐ Public Debt

☐ Under Secretary for Int'l Affairs
- ☐ International Affairs

☐ Enforcement
- ☐ ATF
- ☐ Customs
- ☐ FLETC
- ☐ Secret Service

☐ General Counsel
☐ Inspector General
☐ IRS
☐ Legislative Affairs
☐ Management
☐ OCC

☐ Policy Management
- ☐ Scheduling

☐ Public Affairs/Liaison
☐ Tax Policy
☐ Treasurer
- ☐ E & P
- ☐ Mint
- ☐ Savings Bonds

☐ Other ______

NAME (Please Type)	INITIAL	DATE	OFFICE/ROOM NO.	TEL. NO.
INITIATOR(S)				
K. Austin	KA	4/16/97	OASIA/IMI 5050	622-0174
REVIEWERS				
J. Gagnon	JG	4/16/97	OASIA/IMI 5050	622-0138
T. Geithner	TG	4/16/97	OASIA/IM 3221	622-0656

SPECIAL INSTRUCTIONS

☐ Review Officer Date ☐ Executive Secretary Date

1997-SE-007377

DEPARTMENT OF THE TREASURY
WASHINGTON, D.C. 20220

July 10, 1997

MEMORANDUM FOR SECRETARY RUBIN
DEPUTY SECRETARY SUMMERS

FROM: Timothy Geithner TfG
Senior Deputy Assistant Secretary (International Affairs)

SUBJECT: Europe and EMU

Here are a few thoughts on Europe and EMU based on our discussions this week at WP3, and separate meetings I had in Paris, Frankfurt and at the European Monetary Institute.

- The consensus view, with very few dissenters in the official and private sectors, is that EMU will go forward on schedule with a broader initial group than initially envisioned and somewhat greater concerns about the credibility of the macroeconomic policy regime. The dominant scenario now leaves one more confident it will happen on time, but probably less confident about its ultimate viability.

- Key factors that contribute to this broad judgement:

  - The political commitment to move ahead appears very credible.

  - Growth on the continent is slowly strengthening, with monetary conditions very supportive.

  - Germany can get to 3.0, and France quite close, to perhaps 3.2 or 3.3, both without resorting to measures that might be politically untenable. Spain and Portugal look better than both France and Germany. Italy looks very good in 1997 and capable of doing what's necessary to hold 1998 down; its principal challenge is German opposition.

  - The technical preparations seem on track.

  - And there is no credible delay or postponement scenario that would not cause terrible political damage to the French and the Germans, considerable economic and financial costs to the Italians and the other Mediterraneans, and jeopardize the entire endeavor.

- There are still compelling risks to this scenario.

- Constrained by Jospin's campaign rhetoric and convinced Germany has lost some credibility and some leverage, France could try to walk too close to the edge of what Germany can tolerate and fail to take tax or expenditure measures that will convincingly get them to 3.2 or so.

- German public opinion could make things untenable for Kohl.

- Some unrelated external or internal event could lead the market to reassess the prospects for the whole thing. The narrowness of spreads and the extent of convergence in the financial markets has the paradoxical effect of making success more plausible because of the virtuous circle of lower rates, stronger growth and lower debt service, but also more vulnerable to reversal than it otherwise might be.

    - A sharper than expected rise in U.S. rates, fall in the dollar, or earlier than expected German tightening are some candidates for pressure. The extent of French intervention over the past two months provides one measure of vulnerability.

- These risks are significant, but not sufficient at this point to challenge the conventional wisdom about the broad and early launch.

- The broad confidence that EMU will proceed has been accompanied by growing concerns about the credibility of the regime and perhaps its ultimate viability. These concerns have several sources, and they are more concrete and damaging than the popular concern that the presence of the Club Med will dilute the probity of the German, Dutch, and Belgian core:

    - Under even the most optimistic scenario for growth between now and the January 1999 start, unemployment will still be around current levels in France and Germany, fiscal deficits will not have fallen far enough to take advantage of the limited room for maneuver in the stability pact, output gaps will remain significant in key countries with significant disparities across the region, and there will have been inadequate and very uneven progress on structural reforms.

    - Monetary policy will be caught between the requirement of establishing credibility and political pressure to generate enough growth to bring down unemployment.

    - The French efforts to provide some form of counterbalance to the European Central Bank in the form of a "Stability Council" with stronger legal language on employment and some capacity to mess around with the exchange rate of the Euro will be corrosive, even if they do not appear to be effective in actually limiting the independence of the monetary policy.

- All this should be troubling to us, but we are not in a position to do much about it beyond what we are now doing.

- We have already provided the Europeans a very supportive external environment, with a strong dollar, strong U.S. demand, and relatively low U.S. interest rates.

- We could push actively for a more accommodative German monetary policy and tolerate a significant further decline in European currencies against the dollar. However, monetary conditions in the continent are already quite accommodative and further cuts would take some time to take effect.

- We could try a more active push for structural reforms, but we don't have any direct leverage and whatever general pressure we could provide would probably be less compelling than what they already face domestically.

• If there is any reason for greater optimism than suggested here, it lies in the changes underway in the private sector in parts of Europe.

  - I think we have underappreciated the extent to which European industry has restructured, and the constructive pressures for further restructuring that may eventually be imposed by monetary union. This has been obscured by the paralysis of the Governments to move on a range of sensible, but politically difficult policy measures. Yet, it seems hard to make the case that progress in private industry has been sufficient and will come quickly enough to mitigate these broader challenges.

1998-SE-003993

THE DEPUTY SECRETARY OF THE TREASURY
WASHINGTON, D.C. 20220

March 30, 1998

NOTE TO: Bob

FROM: Larry

SUBJECT: Monetary Policy After EMU

You ask how the new European Central Bank is going to set monetary policy. Probably the same way that the Federal Reserve set policy when we had a bi-coastal economy, or a depressed south-west, or a "Swiss Cheese" economy -- based on some kind of aggregate. Remember, too that given fairly fixed exchange rates there has not been much scope to reduce interest rates in response to cyclical conditions in Europe over the past decade.

1998-SE-004784

DEPARTMENT OF THE TREASURY
WASHINGTON

April 15, 1998

ASSISTANT SECRETARY

INFORMATION

MEMORANDUM FOR SECRETARY RUBIN
DEPUTY SECRETARY SUMMERS

FROM: Timothy F. Geithner TFG
Assistant Secretary (International Affairs)

SUBJECT: European Economic and Monetary Union (EMU)

With the approach of EMU, I thought it would be useful for us to revisit our previous assessment of the implications for the United States. Attached is a paper prepared by Kenneth Austin with contributions from a number of Treasury staffers, under the direction of Caroline Atkinson and Joe Gagnon, and includes the benefit of suggestions from the staffs of the Council of Economic Advisors and the Federal Reserve Board..

The principal conclusions of the report are:

- Stronger-than-expected growth in key countries late last year kept budget deficits below the 3% criterion for 1997. As a result, EMU looks highly likely to begin with 11 countries, including Italy, on January 1, 1999.
  - -- The Europeans plan to announce decisions on EMU initial membership, internal exchange rate parities, and the senior management of the new European Central Bank (ECB) on the weekend of May 1-3.
- The Europeans still face daunting challenges of structural reform of their labor and product markets and their success in this area will be critical to the success of EMU.
- The economic implications for the United States largely depend on whether Europe is successful in generating domestic-demand-led growth with low inflation. If this is so, then Europe will be a greater source of demand for U.S. exports and the new euro is likely to be credible and "strong," both of which would obviously be good for the United States. As ever, it is difficult to know the extent to which EMU itself will contribute to these objectives.
- If Europe succeeds in achieving domestic-demand-led growth with low inflation and in creating significantly deeper financial markets, then it would be prudent to assume that the creation of the euro probably would lead to a gradual erosion of the dollar's international role. The economic benefits to the United States of healthy growth in Europe would exceed the costs of a gradual erosion in the dollar's international currency role.

- If European governments fail to establish the conditions for domestic-demand-led growth and that leads to pressure for the ECB to use exchange rate policy to pursue export-led growth, the euro is not likely to challenge the dollar's role any time soon.

- For what it is worth, conventional wisdom has moved from the "soft euro" consensus of six months ago to a view that the euro could strengthen significantly against the dollar in the short-term. The proponents of this view believe that the new monetary regime will be credible and cyclical recovery in Europe will require a significant monetary tightening at the beginning of EMU. This may coincide with both a deceleration of growth in the United States and growing concern about the size of the U.S. current account deficit.

- U.S. firms should benefit, in part, because of transactions cost savings, but they need to prepare for the transition. EMU will hasten the integration of a single market in Europe, which may play to the advantage of U.S. firms that are already used to operating in a large, unified market. Legal and tax implications for U.S. firms do not appear serious, but Treasury will monitor developments in these areas closely.

LOOKING AHEAD

The United States should continue to focus on a number of specific implications of EMU.

- There is still some risk that an unanticipated event could prove destabilizing between the selection of the conversion rates and the establishment of EMU on January 1, 1999. With national monetary and exchange rate policies effectively constrained, a shock would be harder to deal with.

- We will have to move to modify European representation in international institutions, such as the G-7 itself, by giving the ECB a seat at the table.

- We also may need to work out new arrangements for cooperation on exchange rate issues, given the shift of responsibilities on these matters within EMU.

- At some point reasonably soon, we will have to make a decision whether to convert our entire holdings of DM to euros and which instruments to choose to invest in.

- We will continue to watch for regulatory threats to U.S. financial institutions, or opportunities created for them, by EMU.

- We should continue to urge Europe to press ahead with policies to support domestic demand-led growth, structural reforms of its economy, and to keep EU expansion on track.

cc: Under Secretary Lipton

Attachment: *European Economic and Monetary Union: Analysis of the Issues*

EUROPEAN ECONOMIC AND MONETARY UNION:

Analysis of the Issues

Office of Industrial Nations and Global Analyses
Office of the Assistant Secretary for International Affairs
U.S. Treasury Department

April 16, 1998

Prepared by Kenneth Austin under the direction of Joseph Gagnon and with contributions from Steven Backes, Je Baik, Robert Conley, Stephen Donovan, David Joy, Wilbur Monroe, Susan Rzemien, Brad Setser, and Erik Weisman. Thanks to Caroline Atkinson, Jeffrey Frankel, and Ellen Meade for helpful comments.

European Economic and Monetary Union: Analysis of the Issues

Overview

EMU Launch Appears on Track for January 1, 1999

European Economic and Monetary Union (EMU) is now considered a virtual certainty and is widely expected to begin with 11 members, including Italy, Spain, and Portugal. The remaining vulnerability of EMU is its lack of popular support in Germany. However, governing parties, and their major political opponents, support EMU in all countries expected to join initially, including Germany.

The final key decisions to establish EMU: who qualifies, conversion rates, and the selection of the European Central Bank (ECB) president and executive board, will be made at the EU summit, May 1-3, in Brussels. Most of the remaining institutional decisions cannot begin to be made until after the initial membership is decided in May.

Last year's doubts about EMU's timely launch have largely disappeared due to extraordinary economic and financial convergence of prospective members toward the agreed EMU targets.

- Inflation rates of likely members have converged to a narrow range of 1-2%.
- Financial markets seem to like EMU and to believe in it. Rather than speculating against it, market participants have worked EMU "convergence plays" -- arbitraging away the differences between long-term interest rates across likely members.
- Strenuous efforts to cut fiscal deficits, combined with an upturn in growth late last year, led to a better-than-expected performance on the fiscal criteria.
- The European Commission, the European Monetary Institute, and the German Bundesbank all issued reports in late March 1998 confirming that 11 aspiring members have satisfied the Maastricht treaty's criteria on inflation, interest rates, exchange rate stability, and fiscal positions. Only the sustainability of Belgium's and Italy's fiscal positions was seriously questioned.

Greece's March 14 announcement that it has joined the ERM and that it will take additional measures to control fiscal deficits now makes it likely that all EU member states that wish to join will qualify within three years.

Europe's Challenges under EMU

The first, and probably least serious, challenges for Europe are the mechanics of launching EMU and gaining credibility for ECB policy. Switching accounting systems and introducing a new currency are technically complex processes that must be managed with care. Gaining credibility for the new ECB will depend critically on the choice of its president and executive board, the operational target for monetary policy, and policy performance and outcomes during the opening months and years of its existence. It is possible that markets could test agreed exchange rate parities in the months prior to or shortly after EMU's launch, particularly in the face of an unexpected economic or political shock.

A more important and long-lasting challenge is the need for structural reform of labor, product, and capital markets to increase the flexibility of EMU economies, since they will have less monetary and fiscal independence under EMU. Such reforms would also enable them to grow faster and reduce chronically high unemployment rates.

Yet another long-term challenge for Europe will be the politics of EMU, especially when countries are at different cyclical positions, and in relation to EU expansion. The full implications of the fiscal Stability Pact will not be known until it is tested the first time a member country encounters fiscal difficulties.

EMU Implications for the United States

EMU is likely to have few significant and direct effects on the United States; however, it will affect the United States indirectly through the economic performance of the EMU countries. The United States would benefit from a successful EMU that led to robust growth in Europe led by domestic demand.

A successful EMU might lead to a gradual erosion of the dollar's international role toward rough equality with the euro. However, the costs associated with such a shift would be small. A sharp decline in the dollar's role is unlikely, and is likely to occur only in the event of serious policy errors in the United States.

EMU will raise legal, tax, and accounting issues for U.S. firms. It is important that U.S. firms take the necessary steps to prepare for EMU. The Administration will monitor developments in these areas closely to ensure that U.S. firms do not suffer an unfair burden. By encouraging the development of a truly unified financial market, EMU may actually yield better opportunities for U.S. financial services firms in Europe.

Finally, EMU raises some questions about the external representation of its member countries in international macroeconomic fora. These questions need to be addressed soon after the initial membership of EMU is settled.

EMU Timetable

May 1-3	Ecofin and the European Parliament make formal recommendations on which countries qualify for EMU.
	The European Council (heads of state or government) selects the initial EMU members.
	The Council is *expected* to choose either the final bilateral parities of national currencies in EMU or the method for selecting them.
	The Council is *expected* to select the ECB President.
	The decision-making bodies can be officially constituted.
May 6	Dutch elections.
July 1	Deadline for selection of the ECB Executive Board (including the president) by the Council. The ECB replaces the EMI.
	Austria assumes the EU presidency.
September	German and Swedish elections.
January 1, 1999	**EMU Begins:**
	Irrevocable fixing of exchange conversion rates to euro.
	One-to-one conversion of the ECU to euros.
	ECB begins operations as central bank.
	New public sector debt issued in euros and some countries begin to convert existing debt to euros.
	Large portion of interbank market begins to operate in euros.
	National currencies become nondecimal denominations of the euro.
	Germany becomes EU president.
January, 2002	Deadline for the introduction of euro notes and coins.
July, 2002	Domestic currencies lose legal tender status.

I.1 1997 Economic Outcomes and Membership Qualification

The European Commission and the European Monetary Institute issued reports in late March 1998 confirming that statistics on 1997 economic performance in EU countries showed that all except Greece met the Maastricht criteria on inflation rates, interest rates, and fiscal positions. Greece and Sweden did not meet the exchange rate stability criterion.[1] The statistics released in late February were stronger than most analysts expected and much stronger than many had feared last year. This, in large part, reflects stronger economic growth during the last half of 1997.

EU Performance and the Maastricht Criteria

	Deficit/GDP		Debt/GDP		CPI		L-T Interest Rates	
Maastricht Ceiling	3.0%		60.0%		2.7 % 1/		7.8% 2/	
Year	1996	1997	1996	1997	1996	1997	1996	1997
Wish to Participate								
Austria	3.8	2.5	69.5	66.1	1.9	1.1	6.3	5.6
Belgium	3.2	2.1	126.9	122.2	2.3	1.4	6.5	5.7
Finland	3.1	0.9	58.0	55.8	1.3	1.3	7.1	5.9
France	4.1	3.0	55.7	58.0	1.3	1.2	6.3	5.5
Germany	3.4	2.7	60.4	61.3	1.8	1.4	6.6	5.6
Ireland	0.4	-0.9	72.7	66.3	1.4	1.2	6.6	6.2
Italy	6.8	2.7	123.8	121.6	2.2	1.8	9.4	6.7
Luxembourg	-2.6	-1.7	6.6	6.7	1.6	1.4	6.5	5.6
Netherlands	2.3	1.4	77.2	72.1	2.1	1.8	6.2	5.5
Portugal	3.2	2.5	65.6	62.0	2.2	1.8	8.7	6.2
Spain	4.7	2.6	70.1	68.8	3.4	1.8	8.7	6.3
Do Not Intend to Participate Initially								
Denmark	0.8	-0.7	71.6	65.1	2.1	1.9	7.1	6.2
Sweden	3.7	0.8	77.8	76.6	1.8	1.9	8.1	6.5
UK	4.9	1.9	54.4	53.4	2.4	1.8	7.8	7.0
Does Not Qualify								
Greece	7.6	4.0	112.6	108.7	8.5	5.2	na	9.8

1. Maastricht Treaty-based formula: Average of three lowest countries + 1.5%.
2. Maastricht Treaty-based formula: Average of three lowest inflation countries + 2.0%.

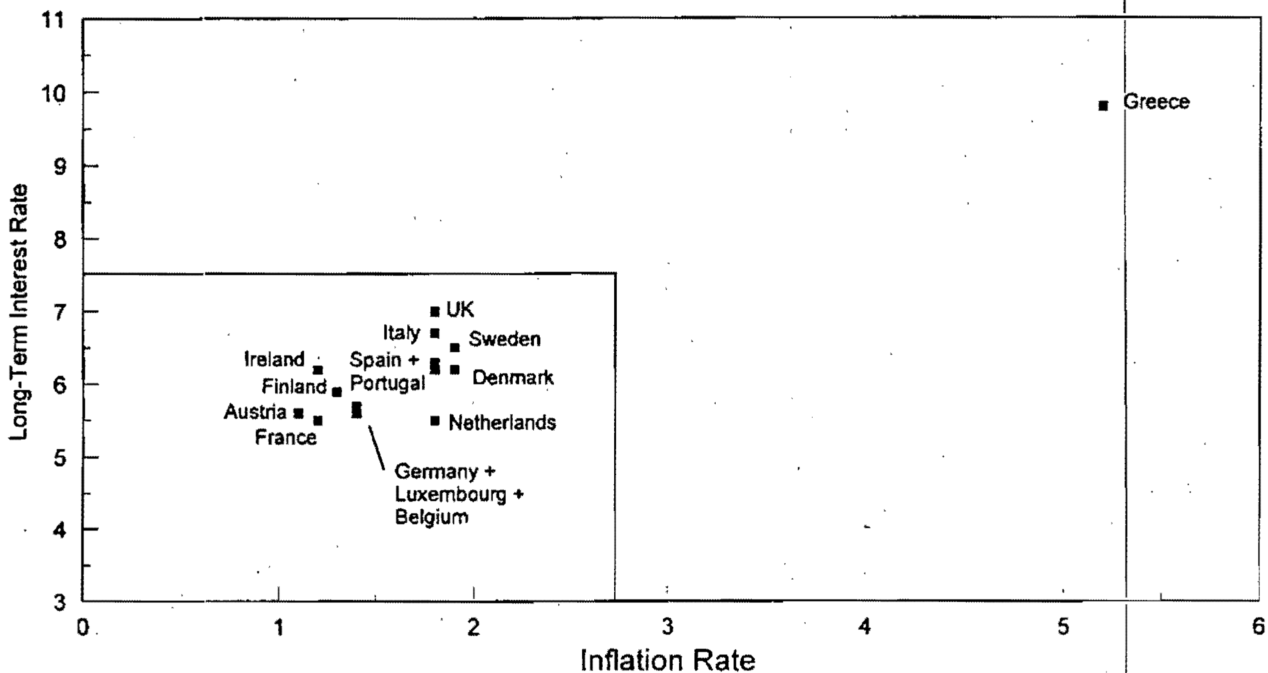
There are still some questions about the sustainability of deficit reductions, particularly concerning Italy. Italy and France met the criteria with the help of one-off measures that are

[1] The reports were silent on whether the U.K. satisfied the exchange rate criterion because it has opted out of EMU. The Maastricht treaty stipulates that a currency must remain within "the normal ERM bands for at least two years prior to entry." Some have interpreted this clause to mean that a currency must be in the ERM to become a member of EMU; others have argued that exchange rate stability is all that matters.

Convergence Criteria for EMU

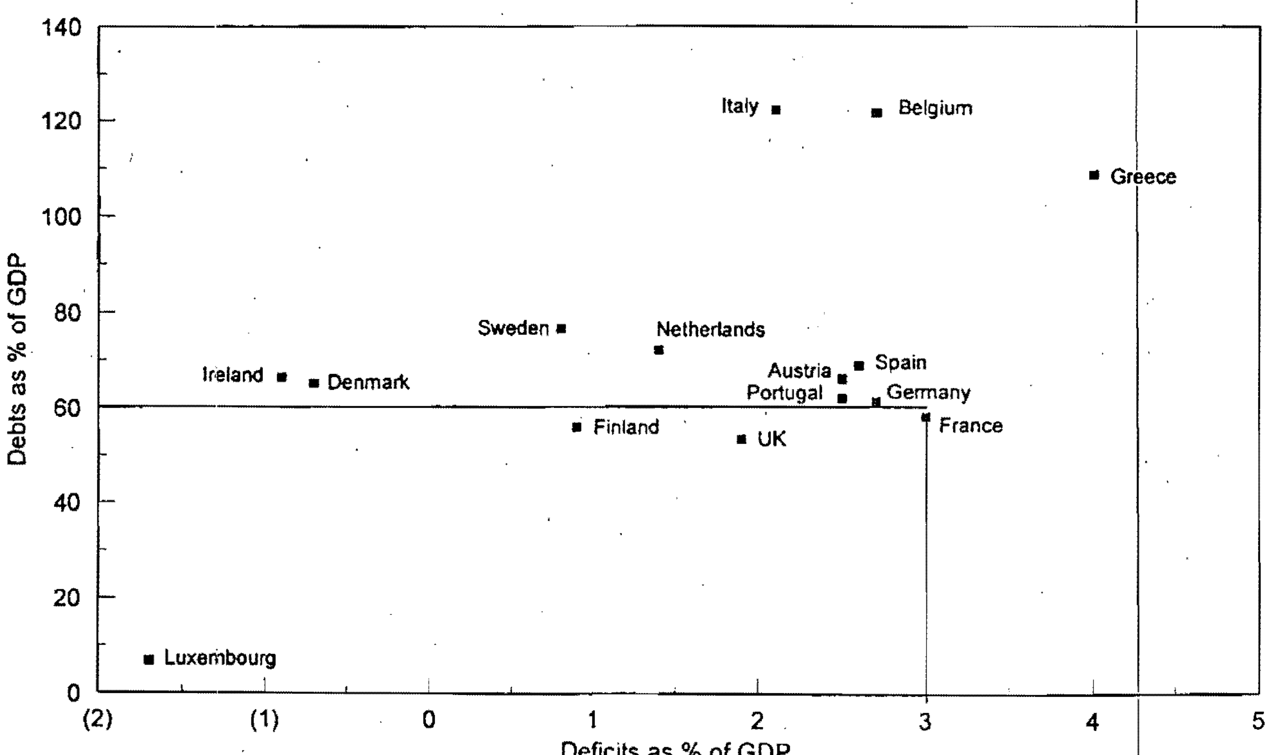
1997 Performance

CPI Inflation and Long-Term Interest Rates



1997 average for 10 year government bonds
1997 EMI harmonized consumer price index (yoy)

Government Debts and Deficits



considered suspect by some. Italy would have missed the target without the use of a special "eurotax" -- which may be refunded -- to raise the equivalent of 0.6% of GDP. France used an internal transfer from the restructuring of a state company worth 0.5% of GDP.

The big three, Italy -- France, and Germany -- actually had the highest deficit/GDP ratios except for Greece. Ironically, the three opt-outs -- Denmark, Sweden, and the UK -- turned in three of the strongest performances.

Interest rates and inflation performances are now strong enough that they are essentially non-issues as performance criteria (with Greece as an outlier.) The debt/GDP ratio is a soft target. The Treaty states that the criterion can be satisfied even if the ratio is above the threshold if "..the ratio is sufficiently diminishing and approaching the reference value at a satisfactory pace." The large Italian and Belgian ratios are falling significantly, although the high levels may represent a source of budgetary instability. The Italians have proclaimed that they will reduce the ratio below 100% in six years. The ratios for other countries above the 60% level are also falling except for Germany, which may be considered in technical violation of the criterion, though the ratio is only slightly above 60% and continuing unification expenses may be viewed as an exceptional one-time burden.

Greece's ERM entry now makes that country's bid to join EMU credible if the Greek Government can withstand political pressures for public sector wage increases and honor its commitments to structural reform. The Greek government currently has a large primary surplus, but runs a deficit because of its large interest payments on public debt. Reducing Greek interest rates to core European levels would bring the deficit near balance or even generate a small surplus. The potential for creating a virtuous cycle like the recent examples of Spain, Italy, and Portugal is obvious. Should financial markets begin to work a Greek convergence play, Greece's qualification for EMU may become a self-fulfilling prophesy.

I.2 Financial Convergence and Market Stability

Economic Fundamentals Support Financial Convergence

Within the last year, financial markets have provided strong support to the EMU project. Markets have speculated that EMU will happen, rather than speculating on its failure. While this speculation has been supported by a strong convergence of economic fundamentals, such as inflation rates and deficits, in some cases it has also gone beyond the basic fundamentals.

In theory, as countries join EMU, giving up independent monetary and exchange rate policies, interest rates should converge as exchange rate risk is eliminated for similar securities.[2] Government bonds, of a similar term, should have similar yields except for differing default rates. Over the last few years, interest rate differentials have clearly diminished. In early 1995, interest rate spreads between German and Italian 10-year government bonds were over 500 basis points (bps) and Spanish and Portuguese bonds paid a spread of over 400 bps. By early 1997, these spreads had dropped dramatically, even though Spain, Italy, and Portugal were considered unlikely to qualify for EMU initially. It was possible to attribute the smaller spreads, at least in part, to better fundamental economic performances, particularly concerning inflation.

By the summer of 1997, financial markets became increasingly convinced that EMU would happen, and that the Club Med countries had a fighting chance of joining. Interest on 10-year Club Med bonds began to drop below those of "opt-outs" Denmark, Sweden, and the UK, despite the latter countries' stronger economic fundamentals. (See attached chart.)

As the following table shows, all of the expected EMU entrants have 10-year spreads against Germany (which has the lowest rates in the EU) of 20 bps or less, except Italy, which still is prey to minor residual doubts about EMU admission. The "opt-outs" have experienced a less dramatic convergence of interest rates, and non-European countries have not experienced any similar interest rate behavior at all.

Shorter-term rates are also converging. There are still concerns about the extent to which this will ultimately be achieved by an easing of monetary conditions in Ireland, Spain, Portugal and Italy (where short-term rates remain substantially higher) versus a tightening in the Northern European core, including France and Germany. Most observers believe that rates are more likely to converge near the lower end of the spectrum by late in the year. However, there remain concerns that cyclical differences still pose some coordination problems.

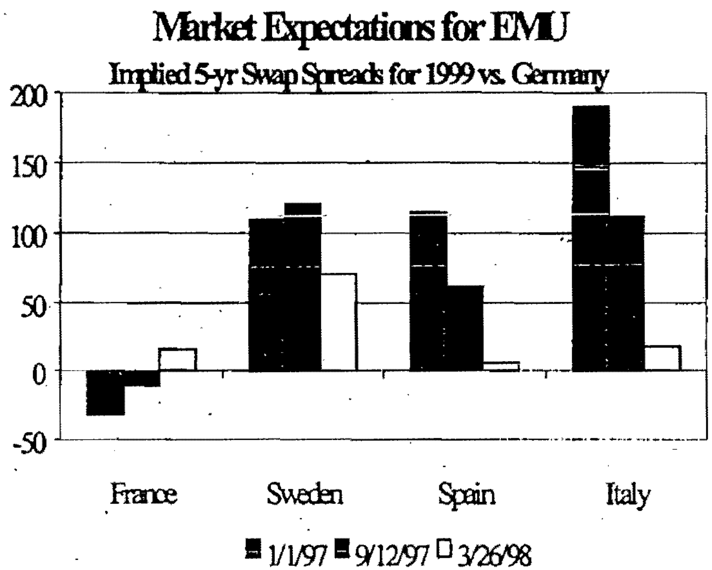
A similar story has occurred in regards to exchange rates. Since it became popularly accepted

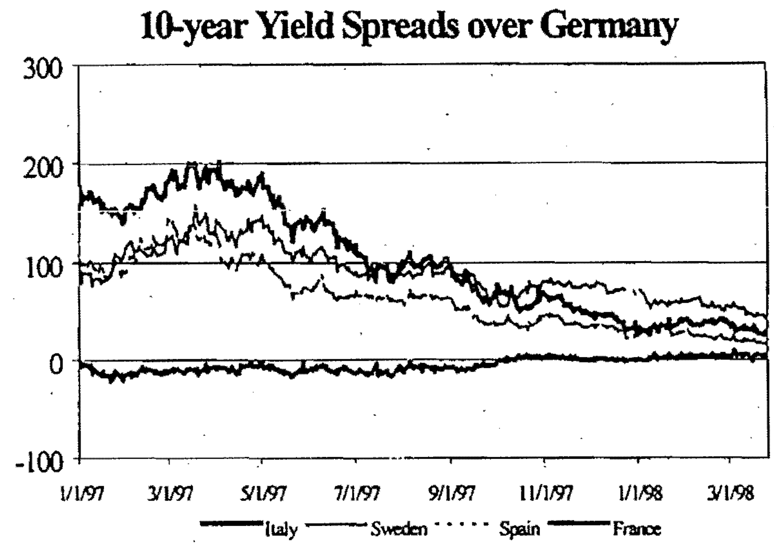
[2]To some extent this convergence already happened long ago for countries that had credibly committed to maintaining a narrow exchange rate link with Germany. However, under the ERM, governments were free to change their parities or leave the system without parliamentary votes or national debate. EMU clearly raises the threshold of commitment to a common monetary policy.

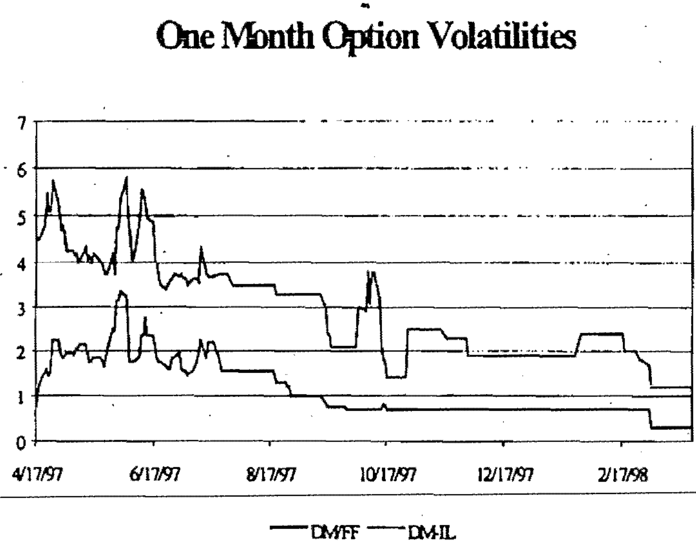
last year that the EMU conversion rates would be based on ERM central rates, most exchange rates have hovered very close to their central parities. The exception was the Irish punt, which is torn between two poles of attraction, its central parity and the pound sterling. Until the realignment of March 14, the punt moved steadily towards its old central parity and closed the gap from 10% over parity last fall to less than 3%. The realignment appreciated the punt close to its market value and the punt is now trading within 1% of its new parity.

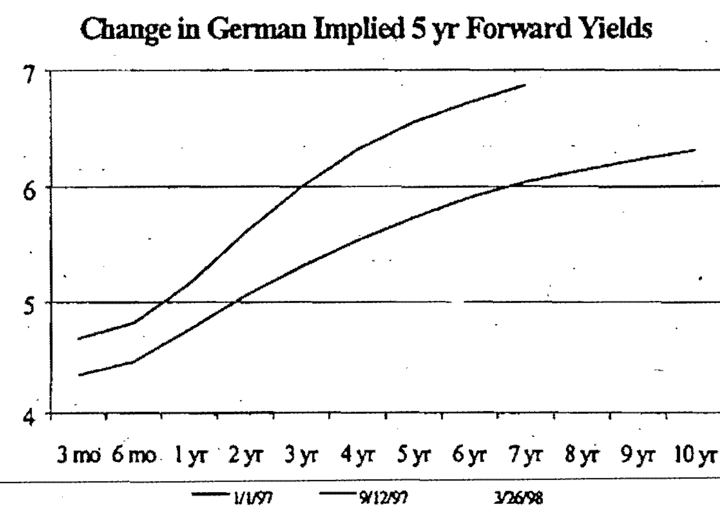
Interest Rate Convergence: August 1997 vs. March 1998

	06-Aug-97				30-Mar-98			
	5-yr Rates	5-yr spread vs lowest	10-yr Rates	10-yr spread vs lowest	5-yr Rates	5-yr spread vs lowest	10-yr Rates	10-yr spread vs lowest
Wish to Participate								
Austria	4.83	5	5.74	13	4.63	25	5.01	9
Belgium	4.87	9	5.75	15	4.51	13	5.06	14
Finland	4.83	5	5.91	30	4.38	0	4.99	7
France	4.78	0	5.62	1	4.57	19	4.98	6
Germany	4.87	9	5.68	7	4.55	17	4.92	0
Ireland	5.80	102	6.33	73	4.74	36	5.05	13
Italy	6.34	157	6.67	107	4.79	41	5.18	26
Netherlands	4.81	3	5.61	0	4.53	15	4.97	5
Portugal	5.65	87	6.38	78	4.53	15	5.08	16
Spain	5.64	86	6.35	74	4.64	26	5.10	18
Do Not Intend to Participate								
Denmark	5.17	39	6.24	64	4.68	30	5.15	23
Sweden	5.83	105	6.55	95	5.06	68	5.32	40
UK	7.09	232	7.05	145	6.29	191	5.95	103
Won't Qualify								
Greece	9.86	508	9.53	392	8.91	453	7.92	300
European: Non-EU								
Norway	5.36	58	6.09	49	4.87	49	5.18	26
Switzerland	2.59	-219	3.51	-209	2.20	-218	2.96	-196
Non-European								
Australia	5.93	115	6.50	90	5.48	110	5.83	91
Canada	5.35	57	5.98	38	5.22	84	5.41	49
Japan	1.46	-332	2.40	-321	1.20	-318	1.90	-302
New Zealand	6.97	219	6.83	122	7.20	282	6.99	207
US	6.10	132	6.21	61	5.68	130	5.69	77









IMO: Susan Rzemien and Martin Geislinger 03/26/98

Market Stability in the Runup to EMU

This strong, market-led convergence makes it unlikely, at this time, that there will be any serious speculative attacks on EMU currencies during the transition period. The fact that so many market participants are convinced of the underlying convergence of EMU fundamentals implies that central banks may not have to intervene to defend the conversion rates if, as expected, the conversion rates are based on ERM central parities. Moreover, during the transition period, the central banks of the initial members will have certain unusual advantages in defending against speculative attacks.

- Speculators, in a normal speculative attack, know that a central bank must be prepared to defend exchange rates indefinitely. Speculators know that central banks will eventually exhaust their reserves if speculation continues long enough. However, the future EMU central banks need intervene successfully only on the last day of trading in 1998.

- Speculators also know that the Treaty and the need to establish the EMU's good reputation will make the central banks far more committed to a successful defense.

This is not to say that speculation is impossible, but so far no one has identified any convincing speculative strategy.

- Although the EU's preferred conversion rates or formulas will be chosen in May, by the Treaty, the member states will not choose the irrevocably fixed rates until the starting date of the third stage (January 1, 1999.) Thus, there will be an approximately eight month window during which markets could attack the preferred conversion rates.

If there is to be a successful speculative attack on the announced conversion rates, it would have to be the result of a "shock' in the traditional sense of the word: a large, sudden, unanticipated change in economic conditions. That shock would, in turn, have to convince markets that the chosen conversion rates were not viable. As in all successful speculative attacks, the market must identify a reason the government might actually prefer to change the announced parity. At this point, no such scenario seems likely.

Indeed, the extent of the market's acquiescence to the inevitability of EMU is apparent in anecdotal reports of a sharp decline in foreign exchange transactions of intra-EMU currencies since last autumn. In addition, the implied exchange rate volatilities on options on mark crosses have dwindled to extremely low levels (see chart), further reinforcing the conclusion that markets are not likely to attack the expected conversion rates based on ERM central parities.

Conversion Rates of National Currencies to the Euro

Conversion rates of national currencies to the euro will be irrevocably fixed on January 1, 1999. The decision on the planned conversion rate method (rather than the rates *per se*) will be announced at the European Summit on May 1-3. One of the flaws in the Maastricht Treaty is that it lacks a clear formula for the conversion rates of national currencies to the Euro. The Treaty states that:

- On January 1, 1999, the conversion rates will be irrevocably fixed by a unanimous decision of the participating countries.

- Rates will be market-based and the ECU will be converted to the Euro at 1:1 in a manner that will not alter the external value of the ECU (at which point, the official ECU basket will cease to exist.)

In addition to satisfying the stipulations of the Treaty, the conversion formula should minimize the potential for speculative attacks.

Pre-announcement of Bilateral Exchange Rates for EMU Entrants

At an informal meeting in mid-September, 1997, the EU Finance Ministers announced that they would reveal in May 1998 the formula for choosing the bilateral rates at which currencies entering EMU will be fixed. It is difficult to find any knowledgeable observer who does not believe that central parities, or some formula closely based on the central parities, is the most likely option.

- Before the March 14 ERM realignment, there was concern that a central parity formula would be inappropriate for the Irish punt and the Finnish markka, whose central parities were regarded as too low. The realignment of the punt seems to have eliminated the punt's problem: The punt is trading close to its central parity. The markka continues to trade close to its central parity and the Finnish Government has declared that it will not revalue the markka before the conversion rates are chosen in May.

An alternative conversion method would be to choose an average market price for some pre-announced period.

- The European Commission considered a proposal to use the average exchange rates from January 1, 1997 - December 31, 1998. This is unlikely now, although it would yield conversion rates very close to the central parities for most currencies.

Another possible solution, in the event that market rates begin to diverge from their central parities, would be to let freely determined market rates on 12/31/98 be the conversion factors.

- This strategy would be vulnerable to speculation and even last minute manipulation by governments. Any distortions existing on that day would be irrevocably fixed.

However, the actual conversion rates generated by any of these methods: central parities, market averages, or market price on December 31, may yield almost equivalent results if market exchange rates continue to move in very tight ranges around their central parities.

Speculative Pressures under EMU

- Some analysts have suggested that after EMU is launched, bank depositors could make a safe, one-sided speculative bet on the breakup of EMU by shifting deposits in such a way that they could be paid in stronger currencies if EMU breaks up.

  -- This might be done by shifting deposits to banks in former strong currency countries, such as Germany or the Netherlands.

  -- Alternatively, during the period when the individual national currencies circulate as denominations of the euro, customers could ask that their domestic deposits be denominated in the stronger national currencies.

While a shift in deposits to Germany, for example, could cause the Bundesbank to accept more exposure to Italian assets, it seems unlikely that this would result in any exceptional burden that the Bundesbank was not prepared to accept. In the event of a breakup of EMU, the Bundesbank's exposure would be in euros, unlike a traditional currency crisis where the Bundesbank would be forced to acquire assets denominated in a weak currency.

Speculative movement of bank deposits could result in lower interest rates beyond the very short term in EMU's northern European core, which, at least initially, may serendipitously be helpful in light of current cyclical differences across likely EMU members.

II.1 The Politics of Monetary Union

Origins of Monetary Union

EMU, like previous moves toward greater European integration, is the product of an attempt to use an economic means to achieve a political end. Like previous moves towards integration, its impetus has flowed from the top down rather than from the bottom up. The current drive towards monetary union originated in an implicit bargain between former French President Mitterrand and German Chancellor Kohl in 1990: a bargain that has been described as "the whole of Deutschland for Kohl; half the Deutschemark for Mitterrand." Kohl, who believes that a united Germany needs to be firmly anchored in a united Europe to resist the demons of Germany's past, considered such a bargain to be clearly in the interest of the German people.

EMU: Motor for Integration or Force of Disintegration

Motor for Integration. Monetary union represents the beginning of a new phase in European politics. Intelligent supporters realize the euro is no panacea, but argue that the need to make the euro work will create a powerful dynamic that will encourage compromise on critical issues. Ultimately, they imagine that the euro will prompt the development of a harmonized system of taxation, a limited system of counter-cyclical fiscal transfers and, ultimately, the institutional reforms needed to facilitate decision making in Europe's currently cumbersome political institutions. In short, the creation of the euro will push Europe's political leaders toward a true political union.

Force of Disintegration. Skeptics paint a different picture. They argue that the political and economic foundation for a common monetary policy does not currently exist. The absence of a true European consensus on the appropriate role of monetary policy will generate tension, notably between France and Germany. Current temptations to scapegoat "Europe" will be enhanced by the creation of the European central bank -- the first independent, pan-European institution with real teeth. Even responsible politicians will be tempted to blame Europe's economic problems, particularly persistently high unemployment -- and the first post-euro cyclical slowdown -- on the ECB. States that participate in the EU's current intergovernmental political institutions only reluctantly, like the UK and Denmark, will not participate in a more federal union, effectively dividing the current European Union into two. In short, EMU pushes the European project one step too far, and, by exceeding the optimum level of integration, risks a backlash against the entire European project.

Evaluating the Euro's Political Risks

The European Central Bank initially will lack the popular authority the Bundesbank enjoys in Germany and the democratic legitimacy political control traditionally assured the Bank of France. Such popular authority and support will have to be built over time. To acquire such legitimacy, monetary union will need to replicate, at least partially, the economic and political success of Europe's previous seminal event: the creation of the customs union in 1958.[3]

- Politically, the EU replaced the rivalry and competition that had characterized Franco-German relations between 1870 and 1948 with deeply ingrained habits of permanent institutionalized cooperation that ensured that the inevitable conflicts of interests between the member-states were not resolved by force or the threat of force.

- Economically, the common market was credited for sustaining, if not creating, thirty years of continuous expansion, full employment and rising living standards. The economic success of the European states in the 1960s did much to legitimize the "construction" of Europe -- and to draw reluctant states like Britain into the EU's institutional fold.

There are significant differences between 1958 and 1998 which suggest that securing the same level of ex post facto popular legitimacy of the euro may prove more difficult. The economic climate is less benign than in the 1950s and 1960s; and, more critically, the political gains from the euro may be less evident than the political gains both France and Germany derived from the original customs union.

- A euro-induced boom which would generate immediate and widespread legitimacy for the ECB is unlikely to materialize. At least inside the core European countries, the creation of the euro is unlikely either to augment or to reduce persistent problems with unemployment.

- Germany's post-war generation may find Kohl's argument that Germany cannot be trusted unless it is bound tightly into a stronger European Union less compelling than Kohl's generation. German public opinion is "resigned" to losing the DM, not enthusiastic.

- The French elite realizes that France has not had an independent monetary policy for the past ten years, and thus *sees the sacrifice of the franc as a way to regain a degree of monetary sovereignty*, and to increase Europe's -- and France's -- international political and financial clout. The French public is less convinced that sacrificing a symbol of French sovereignty will increase France's de facto economic sovereignty.

Conclusion

While the euro is unlikely to be considered an unqualified success, apocalyptic predictions that

[3]The origins of the EU may be traced back to the European Coal and Steel Community in 1952. However, most historians view the key development to be the Treaty of Rome, which founded the European Economic Community in 1958. This evolved into the European Community in 1967 and the European Union in 1993. For simplicity we use the term EU to refer to all of these institutions.

the euro will generate future conflict go too far. Europe's political class has too much at stake to allow the euro to fail completely: both the mainstream left and mainstream right in France and the mainstream right in Germany are so implicated in the decision to create the euro that they have a strong incentive to do enough to make the euro work -- or at least to make the euro work as well as the ERM.

- The greatest political risk is probably not that the euro will be an outright failure that will endanger the European Union, but that the creation of the euro will result in political paralysis. Europe's current political institutions may be unable -- or alternatively, European public opinion could reject efforts -- to match the bold move toward monetary union with other bold economic and political reforms, leaving current economic and social problems to fester.

II.2 Will the "Outs" Join and When?

EMU is expected to begin with 11 initial participants. The UK, Sweden, Denmark, and Greece will almost certainly not join next January.

- **Greece** will not join because it does not currently qualify. Its March decision to enter the ERM makes clear that it intends to join and has a well-defined path to entry.

<u>The Politics of Opting Out</u>

The other three countries (the "Opt-Outs") will not join because of lack of popular support. In Continental Europe, EMU has been sold as an economic means to achieve the political integration of Europe. In the "Opt-Outs," the opposition takes two forms: some opponents to joining have expressed concern that EMU is a move towards ceding sovereignty to a supranational European government; others are simply concerned about whether it is economically advantageous to join.

- Neither the UK nor Sweden currently participates in the ERM and both governments have indicated that they have no immediate intention of joining.

The **UK** is the only economically large opt-out and the only one with organized political opposition to EMU. John Major's Tory government was negatively disposed to EMU and the Tory party faces a serious split between those who are unconditionally opposed to EMU and those who would consider joining at some future date. Labor PM Blair is much more receptive and flexible, but not yet ready to brave the political risks of leading Britain into EMU.

- The Labor government has hinted that it will probably try to lead the country into EMU:
  - -- when economic conditions are right, i.e., UK and continental business cycles are harmonized;
  - -- not before the next election (which must happen by 2002) and probably after a referendum.
- Britain refused to join the Common Market until the economic success of the original "six" made nonparticipation unviable.

The opposition to EMU is not well-organized in Denmark and Sweden, but EMU is not popular. Both countries traditionally try to avoid involvement in continental politics.

- **Denmark**'s political establishment is still shell-shocked by the narrow rejection of EMU in a 1992 referendum. The government believes that eventual membership is an economic imperative and will continue to participate in the ERM.

- A **Swedish** Government commission study, "The Calmfors Report," recommended against immediate membership. The commission judged the short-term economic disadvantages of membership to outweigh the political advantages of increased Swedish influence with the EU.

  -- The report concluded that the balance would shift strongly in a few years in favor of membership, particularly if public finances and labor market conditions improve.

Long-Term Pressures to Join

Another stimulus to EMU membership is potential competitiveness of corporate and financial institutions. Sweden is home to a relatively large number of medium-sized multinationals that have extensive operations throughout Europe and plan to switch to euro-based bookkeeping.

- The City of London is concerned that if the UK does not join EMU its status as Europe's financial center will erode. A number of measures have been put into place to prevent it, and the government proclaims itself confident that London's status is not under threat.

Certain EMU membership priviledges, such as access to intra-day credit in the TARGET payments system, may be deliberately denied to opt-outs as an incentive to membership. The recent decision to limit the participation of the outs in the "Euro-X" Council of EMU finance ministers is another example. The UK has also given up its chairmanship of the Deputy Finance Ministers' Monetary Committee, which had been held by Sir Nigel Wicks.

In the end, all the theoretical arguments pro and con will be superseded by the perception of EMU as an economic success or failure. If EMU is a roaring success, the political concerns about the loss of British sovereignty will be as valid as ever, but overwhelmed. Similarly, if EMU is an economic failure or a very meager success, the opt-out status may persist indefinitely.

II.3 EMU and EU Expansion

In December 1997, the EU announced plans to invite eleven countries to apply for eventual EU membership. Ten are former Soviet territories or satellites that comprise much of Central and Eastern Europe (CEE). Among these transition countries, EU membership is universally viewed as a desirable goal, both economically and politically. Even for the relatively progressive "fast-track" applicants it will likely take several years to meet membership conditions, particularly in the fields of banking and agricultural reform and industrial restructuring.

- Currently, none of the reforming CEE countries is close to satisfying all of the convergence criteria of EMU, and it is unlikely that any EU expansion applicant will be ready to join EMU in the near future.

Nonetheless, after the announcement of potential entrants to EU (Cyprus, Czech Republic, Estonia, Hungary, Poland, and Slovenia on the fast track; and Bulgaria, Latvia, Lithuania, Romania, and Slovakia on the slow track), several of the CEE candidates declared that they would like to join EMU simultaneously with joining the EU. Many EU candidates view EMU accession and EU expansion as interconnected. To this end, EU aspirants may take highly visible economic measures in an effort to signal their preparedness and willingness to join the monetary union.

- In their enthusiasm to meet EMU criteria, EU aspirant countries may be tempted to choose economic policies inappropriate to their own economic conditions, e.g., prematurely pegging their currencies to the euro or implementing overly constraining fiscal and monetary policies.
  - -- Economists have debated whether the relatively advanced and integrated economies of western Europe constitute an optimal area for monetary union; clearly the CEE countries are less likely to benefit from EMU at their current stage of development than present EU members.
- On the other hand, it is possible that the desire to join EMU may serve to accelerate reforms in CEE, thus speeding up the EU accession process and providing a counterweight to domestic pressures for overly loose monetary and fiscal policies.

Meeting EMU's membership criteria will require more severe adjustment measures in Eastern Europe than in Western Europe. Low levels of inflation, fiscal deficits, government debt, and interest rates are certainly desirable goals. But given the initial conditions in CEE, the quantitative convergence criteria of EMU are likely to take many years to achieve.

For the fast-track EU applicants, EMU expansion will almost certainly follow EU accession by at least a few years. For the second-tier EU candidates, EU and EMU accession may be more likely to coincide as the countries will have more time to deal with both sets of issues. The two criteria that are most likely to hold up EMU expansion among EU candidates are:

- The long-term interest-rate criterion, which may take many years to achieve,
- The exchange rate stability criterion, which is an area where CEE is particularly vulnerable and will continue to be so for the near future.

TABLE 1
EMU Convergence Criteria for EU Candidates

Country	Consumer Price Inflation		General Government Deficit/GDP		Gross Government Debt/GDP		Long-Term Interest Rates[2]
	1996	1997[1]	1996	1997[1]	1996	1997[1]	January 1998
Poland	18.5	13.0	3.1	4.0	**51.5**	N.A.	N.A.
Czech Rep.	8.6	10.0	**0.2**	**0.7**	**12.3**	N.A.	14.1
Hungary	19.8	17.0	3.5	4.9	71.1	68.0	17.8
Slovenia	8.8	9.7	**0.3**	**1.0**	**23.2**	**23.5**	N.A.
Estonia	15.0	11.2	**1.5**	**0.4**	**6.9**	**6.8**	N.A.
Romania	39.0	151.0	3.9	4.5	N.A.	**9.0**	N.A.
Slovakia	5.4	6.0	**1.2**	5.4	**24.6**[3]	N.A.	N.A.
Bulgaria	311.0	584.0	13.4	4.4	111.4	107.7	N.A.
Lithuania	13.1	10.0	3.6	**0.7**	**13.2**	N.A.	N.A.
Latvia	13.0	9.0	**1.4**	**0.9**	N.A.	**12.1**	N.A.
Macedonia	**0.2**	6.0	**0.4**	**-0.1**	35	35	N.A.
Albania	17.4	41.4	11.4	17.0	N.A.	N.A.	N.A.
Reference Value	**2.6**	**2.7**	**3.0**	**3.0**	**60.0**	**60.0**	**7.8**

Notes: Figures in bold represent data that adhere to EMU convergence criteria.
[1] 1997 figures are estimates.
[2] Four CEE countries have long-term fiscal instruments: the Czech Republic issues a 7-year bond and Hungary, Lithuania, and Poland issue 5-year bonds. We are unable to obtain market interest rates on the Polish and Lithuanian bonds. Other countries do not issue bonds with maturity greater than 12 months.
[3] Figure may include only central government debt.

If EU aspirants can resist the temptation of prematurely trying to meet EMU criteria, there is no reason to believe that EU expansion will have a negative impact on the timing of EMU expansion or vise versa. The goal of joining both unions may, in fact, be mutually reinforcing. Alternatively, if the lure of early acceptance to EMU leads EU aspirants to make unwise economic policy choices, both EU and EMU expansion will be delayed, perhaps considerably.

II.4 Monetary Policy and Central Bank Governance

By treaty, the primary objective of the European System of Central Banks (ESCB), which includes the European Central Bank (ECB) and National Central Banks (NCBs), is price stability. The members of the 6-person Executive Board, including the President and Vice President of the ECB, are to be appointed by the European Council (heads of state or government) for 8-year terms. Monetary policy will be decided by the Governing Council, consisting of the ECB Executive Board and the Governor of each member NCB.

Arguably, the ECB's Governing Council will be the most independent monetary authority in the world. Under treaty, neither the European Council nor the European Parliament can revoke the terms of the Executive Board members, and each national government is required to grant similar independence to its own NCB Governor. Nor is there any statutory requirement for the ECB to explain its policies to any political body.

However, concerns about the true political independence of the ECB have already arisen in connection with the choice of the first ECB President. Most observers thought that agreement had been reached on the Dutch central bank Governor, Wim Duisenberg, when he became President of the ECB's predecessor, the EMI, in 1997. However, later that year the French stunned Europe by announcing their preference for Banque de France Governor Jean-Claude Trichet. Since then, rumors have circulated about possible compromise arrangements, including the choice of Duisenberg for a limited 4-year term to be followed by Trichet. Since the treaty does not allow for 4-year terms, this rumor and the general politicization of the choice of President have already raised fears about the ECB's future credibility.

Monetary Policy and Policy Instruments

The EMI has decided that the intermediate targets will be either a monetary target or an inflation target. Exchange rate, interest rate, and nominal income targeting have been rejected. The choice between monetary targeting and inflation targeting will be made in late 1998 by the newly-appointed Governing Council of the ECB.

- The Germans favor monetary targeting and argue that it would increase the ECB's credibility, given the Bundesbank's use of monetary targeting and its credibility. However, the Bundesbank's eclectic use of monetary targets in practice may argue for an inflation target.

- Whatever target the ECB ultimately chooses, the ECB will have to build up credibility by placing a high weight on meeting the intermediate policy target. This, in turn, may make an inflation target more attractive, given initial uncertainties about monetary behavior under EMU.

The EMU will have the full range of monetary instruments available to it. These include:

- Open market operations

- Standing facilities (including a marginal lending or "Lombard facility" to set an upper limit on overnight rates and a deposit facility to set a lower limit on overnight rates).

- Minimum reserve requirement systems (preparations are being made to introduce such a system, but a decision *whether* to do it has been deferred).

- There remains a question whether there should be any role for the ESCB as a lender of last resort. Germany has opposed such a role.

In line with the broad EU principle of subsidiarity, policies will be made and carried out at the lowest level possible; monetary policy decisions will be made at the ECB level and carried out at the NCB level. The ECB may have some operational responsibilities, but no final decision has been made.

Exchange Rate Policy

While it seems clear that institutional arrangements have been created that would give the ESCB independent control of monetary policy, exchange rate policy remains in the hands of the governments. This is consistent with current arrangements in the United States and Europe. Some concern has been expressed that this does create a possible loophole, by allowing the Ecofin to create a general orientation of exchange rate policy under Article 109 of the Maastricht Treaty which might imply an easier monetary policy stance than the ECB would normally follow.

- At this point, most observers believe that this line of speculation is something of a stretch. Article 109 makes clear that these exchange rate provisions are "without prejudice to the primary objective of the ESCB to maintain price stability."

II.5 The Stability Pact and Fiscal Policy

The Stability and Growth Pact was agreed by all EU member countries in December 1996 as a means of preventing Euro member countries from abandoning fiscal discipline after monetary union has begun. Each year EMU countries will publish multiyear stability programs that will state their medium-term fiscal objectives and show how these objectives will be met. The pact states that governments should aim for a balanced budget or surplus in the medium-term. As designed by the Germans with laudatory language on growth added by the French, the pact specifies that in the course of a normal business cycle a government's deficit should not exceed 3% of GDP. Countries that exceed the 3% limit can be fined as much as 0.5% of GDP.

The stability pact was designed to become operational with the start of EMU in January 1999. On the fringes of an Ecofin meeting on March 22, 1998, German Finance Minister Waigel proposed that the sanctions mechanism of the stability pact start once the heads of governments take the decision on going ahead in May. There was no reaction from the other finance ministers and the issue may be addressed in an April Ecofin meeting.

<u>Steps to Impose a Financial Penalty</u>

Once the Commission notifies Ecofin that a member's deficit/GDP ratio exceeds 3%, that member would be told by Ecofin that it must take corrective action within 10 months.

If, after 10 months, Ecofin judges that no adequate corrective measures (spending cuts/revenue increases) have been taken, a non-interest bearing deposit would be made with the ECB. Amounts would be as low as 0.2% of GDP to as much as 0.5% of GDP depending on by how much a country has exceeded the 3% limit.

<u>Generous Exceptions</u>

The violating country would receive an uncontested exception if GDP had declined more than 2% (annualized) for four consecutive quarters.

If the recession were not as severe (between 2.0% and 0.75%), the penalty would be subject to appeal to the Ecofin. In this case the government can argue that the situation is exceptional by referencing the pact's clause "abruptness of the downturn or the accumulated loss of output relative to past trends." It should not be too difficult for countries to make this case in most downturns.

If the annual fall in GDP is less than 0.75%, then the presumption in the stability pact is that any budget deficit above 3% of GDP would trigger an automatic sanction. Even here there is considerable wiggle room. The pact states that "as a rule" a downturn 0.75%, or more, should be seen as a severe. Countries can still seek exceptions if they can show how their recession is "severe" even if the downturn is less than 0.75%.

Long Time Before Fine Is Imposed

Even if a deficit is determined to be excessive, there is a considerable time lag before sanctions are applied. Suppose, for example, a country exceeds the 3% limit in 1999. By the end of 2000, if measures are not taken to correct the situation, a non-interest bearing deposit would be deposited in Brussels. Only if the deficit remains above 3% for two years would the deposit be converted to a fine -- a gap of at least three years between when the deficit first exceeded the limit and a fine is imposed.

The Importance of Precedent

As in the evolution of other EU institutions and practices, the true operational nature of the Stability Pact will not be known until after it is tested by an EMU member exceeding the 3% deficit ceiling. Ultimately, Ecofin will decide by a qualified majority whether a fine should actually be imposed using the stability pact as a guide. Finance Ministers certainly will look for any reason to avoid imposing fines on other countries at a time when they can least afford it. Even the tough-minded Germans would find it uncomfortable to pay a fine for breaching the 3% limit. Such a fine would have been DM 10 bn ($5.6 bn) for 1996 had the stability pact been in place at the time.

The pact's power is primarily as a surveillance mechanism and deterrent, as there is little chance that any actual fines will be promptly imposed. Its primary purpose is to reassure markets and skeptical German voters of the fiscal "seriousness" of EMU. It is hoped that peer pressure will keep EMU members deficits low so that fines will never need to be imposed.

III.1 Exchange Rate and Current Account Prospects

A natural question from the U.S. policy perspective is whether the economic developments and policies of the EMU are consistent with medium-term external balance or whether Europe will continue to rely on export-led growth.

<u>Europe's Investment Climate Is Key</u>

Persistent low levels of domestic European investment have resulted in capital outflows, weak aggregate demand, weak exchange rates of the EMS currencies against the dollar, and a reliance on export-led growth. While there may have been a temporary coincidence of interests when a strong U.S. economy raised fears of overheating, this will not persist indefinitely. Furthermore, the Asian economic crisis makes an export growth-led strategy more problematic.

In the five years from 1992 to 1997, real fixed investment in each of the largest of likely EMU member countries <u>declined</u>: by 2% in Germany, 3-1/2% in France, and 5% in Italy. Over this same period real fixed investment <u>increased</u> by 5% in Japan, 13% in the UK, and 43% in the United States.[4]

- At the current time, there are signs that Europe <u>may</u> be beginning a domestic demand-led recovery. It is not clear how robust this recovery is and, in particular, how strong the domestic investment component is.

- The structural reforms of labor and product markets necessary to create a strong domestic investment climate have, thus far, been resisted by most European governments as too politically sensitive.

- Structural reform has the short-term political disadvantage of depriving some groups of accustomed benefits. However, in the longer-term, structural reform raises economic growth on both the supply- and demand-sides.

- If European governments are reluctant to take adequate structural measures to encourage investment, then the temptation to revert to export-led growth will be particularly strong.

A weak corporate investment climate would be aggravated by the fears of portfolio managers of a weak euro. These fears would cause investors to avoid euro-denominated assets and invest elsewhere, making expectations of a weak euro self-fulfilling. The ECB might demonstrate its

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[4]The U.S. real investment data may not be comparable to data from other countries due to differences in adjusting for quality improvements of computer equipment. However, the relative performances are similar when measured in terms of nominal investment. The share of U.S. fixed investment in nominal GDP increased by 2 percentage points over this period, while the share of fixed investment in German nominal GDP declined by 3 percentage points.

commitment to a strong euro by raising interest rates. This would initially create a double-whammy on interest rates: interest rates would rise as portfolio managers attempted to pull their money out of European capital markets and would rise again as the ECB tightened.

A stronger European investment climate in the early years of EMU would slow or reverse the capital outflows and, in turn, maintain a strong euro without a tight monetary policy or ECB intervention. At the same time it would contribute to economic growth and help move Europe's current account back to balance. *This would be the ideal outcome for both European and American policy-makers.*

However, the European investment climate may not improve in the absence of vigorous structural reform. In this "weak investment case" the euro could be strong or weak, but in either case, result in very unappealing outcomes.

<u>The weak-investment/strong-euro case</u>: The ECB may overestimate the strength of domestic demand and, in order to gain credibility, might tighten monetary policy to appreciate the euro and reduce inflationary pressure. This could result in recession with ambiguous effects on the current account. Weak demand would reduce European imports and the stronger euro would reduce exports. (least likely)

<u>The weak-investment/weak-euro case</u>: Alternatively, in response to weak domestic demand, the ECB might lower interest rates and allow the euro to depreciate. This would stimulate export-led growth and aggravate external imbalances with the United States. (more likely)

<u>The weak-investment/stable-euro case</u>: The ECB may elect to hold the current course and allow economic growth to remain sluggish and the euro to remain at the current level of the ECU. This would imply continued European current account surpluses or even a slight uptrend. (most likely)

<u>The weaker-investment case</u>: It is possible that investment levels could decline from current depressed levels. This might result, for example, if the investment community is disappointed that promised structural reforms are not delivered. This would give a stronger downward impetus to the euro and economic growth, implying a further increase in Europe's current account surplus.

Thus, if Europe cannot improve its domestic investment climate coincident with the creation of EMU, it will be difficult to obtain a good outcome at any euro/dollar exchange rate.

III.2 EMU and Economic Reform

There have been substantial economic achievements by EU countries in the run-up to the launch of Economic and Monetary Union. The question remains as to whether EMU will spur needed fiscal and labor market reforms.

Need for Economic Reform

In order for EMU to succeed and for the member countries to profit from sustained economic growth, progress is needed on structural reforms, particularly in labor. The advent of EMU will make it more, rather than less, vital for governments to proceed with these reforms. Given a shock to domestic demand, individual members of EMU will no longer have any freedom to respond by adjusting their exchange or interest rates. Nor will they -- given the combined constraints of the fiscal stability pact and existing debt and deficit levels -- have much room to use fiscal stimuli to support growth. The major challenges include:

- Labor market reforms: The average unemployment rate for the EU is above 11 percent, nearly twice its level of 1979. Most analysts believe that as much as 75 percent of this is due to structural factors. Measures to increase labor market flexibility and lower costs are needed.

- Other market reforms: Competitive and unrestricted markets for products, services, and capital are important for promoting employment growth. For example, restrictions on shopping hours discourage employment and growth in wholesale and retail trade.

- Fiscal challenges: Although much progress has been made, most countries will still need to make substantial efforts to move to fiscal balance, in order to allow automatic stabilizers to work in cyclical downturns. The impending heavy burden on pension systems and health care costs that is posed by aging populations also requires long-term fiscal reforms.

A recent IMF study tried to quantify the effects on a hypothetical EMU-15 under two scenarios: one where fiscal and labor market reforms were undertaken, and one without reforms.

- In the reform scenario, there were substantial positive gains for the EMU countries. Compared to a baseline scenario which assumed a continuation of underlying trends observed in the 1990's, by 2010 the level of output increases by about 3 percent. The general government fiscal balance improves by 2 percent of GDP by 2003.

- In the "reform fatigue" scenario, inflexible labor markets and rising structural unemployment lead to a decline in GDP of 2.5 percent by 2010 relative to the baseline. Government fiscal deficits would worsen by more than 1 percent, and government debt ratios increase by nearly 10 percent of GDP by 2010.

Will EMU Spur Needed Reforms?

One school of thought is that EMU itself, with the discipline of the Stability Pact and the increased competition brought about by the strengthened single market, will spur fiscal reforms and structural improvements in labor and product markets. Government leaders in the EU have stressed the need for structural reforms. Business heads are enthusiastic about EMU in part because they believe it will force market-based reforms. The European Commission has called for member countries to exploit the full potential of EMU by making structural adjustments to increase employment.

However, the lack of serious reform in many countries despite years of slow growth and high unemployment certainly raises grounds for caution. There is a danger that the political difficulties of reform, along with preoccupation with the institutional and technical aspects of launching the euro, will delay action. Mounting social pressures from populations not fully convinced about the benefits of EMU, weary of tight government budgets, and somewhat fearful of increased competitive pressures will make it difficult for governments to pursue restructuring of welfare and pension systems, further deregulation, and tough labor market reforms. In fact there is a risk that EMU could become the scapegoat for high unemployment, especially if the ECB needs to take a tough monetary stance from the start to demonstrate its commitment to price stability. A tight monetary policy combined with a constrained fiscal policy across Europe could stall many of the necessary structural reforms.

- There is already evidence of serious backsliding, such as French and Italian efforts to cut the legal workweek.

Even without key labor and product market reforms, EMU is likely to increase competition within Europe by making prices easier to compare across countries and providing an incentive for businesses to view the EMU bloc as a single market. This development may be especially beneficial to U.S. firms, who have the prior experience of operating in a large continental market and are more likely to view Europe as a single geographic region.

Although the Maastricht treaty does not specify capital market reforms, the single currency is widely expected to lead to capital market integration and modernization in Europe. More efficient and competitive capital markets are expected to hasten restructuring of private corporations and improve access to financing for new firms.

III.3 EMU and Europe's Financial Market Development

The launch of EMU has the potential to alter significantly the European financial market landscape by reducing long-standing market segmentation and providing the catalyst for the development of the world's largest single-currency capital market. At the end of 1995, the value of EU bonds, stocks, and tradable bank assets exceeded $27 trillion, compared to $23 trillion in the United States and $16 trillion in Japan. Such a market, if integrated, would have significant liquidity and depth and would result in efficiency gains, including lower transactions costs and more optimal resource allocation, would encourage securitization in a region which has traditionally relied heavily on bank financing, and would contribute to the evolution of the euro as an international currency similar to the dollar and yen.

The introduction of a single currency and the redenomination of EU assets in terms of euro, however, is not a guarantee of European market integration but more of a step toward such integration. Significant structural adjustment will also be needed to dismantle existing barriers to cross-border financing and to introduce uniformity and transparency to legal, accounting, and payments procedures. Furthermore, the ESCB will need to adopt tools with which to conduct monetary policy that will foster integration.

The Banking System

Distorting taxes and regulations coupled with relatively thin national securities markets have biased European finance more heavily toward the banking system than in other industrial nations. With the introduction of the euro, however, EU capital markets could potentially become more liquid; this would increase the incentives for firms to seek non-bank capital, thereby fostering securitization and stimulating competitive pressures in the banking system.

- At the *wholesale banking* level, EMU will eliminate the few remaining barriers to unfettered cross-border competition. Bond issues will no longer have to be lead-managed by domestic institutions, and insurance companies and pension funds will no longer face restrictions on foreign currency exposures when purchasing assets in other EMU member countries. The increased cross-border competition will benefit the most efficient European wholesale banks and will result in some consolidation of the weaker firms. However, the wholesale banking system in Europe is already relatively competitive and is not expected to undergo dramatic, let alone detrimental, changes due to EMU.

- At the *retail banking* level, EMU has the potential to force much needed restructuring of a sector that is notoriously noncompetitive and inefficient. The lack of strong market forces in the retail banking sector has led to overstaffing, higher transactions costs, and suboptimal firm size. EMU may help alleviate some of these inefficiences. Securitization will squeeze retail banking profits as their customer base shifts toward alternative capital financing options. The elimination of a home currency advantage and the harmonization of banking requirements will stimulate demand for EMU-wide banking services and will motivate market participants to seek the most favorable rates when lending or borrowing capital. The end result will be consolidation of weaker and smaller firms and a faster rate of financial innovation.

At both the wholesale and the retail banking level, however, efficiency gains from EMU will be limited as long as structural adjustment in the labor and corporate control markets is ignored. Labor laws will hinder needed downsizing, while diffuse ownership of banks and regulatory barriers will fail to provide an environment for strong managerial discipline.

The Securities Markets

Even without a single currency zone, financial deregulation, bank disintermediation, and the deepening of secondary markets due to large global bond issues have stimulated the integration and efficiency of the European bond markets. EMU will only add to the factors behind this trend by eliminating exchange rate risk, harmonizing regulations, tax treatment and accounting practices, and reducing a number of currently existing barriers to cross-border capital flows. Furthermore, EMU will provide new avenues for technological and financial market innovation and will stimulate demand for currently nonexistent assets including a large menu of euro-based derivatives.

- Integration will enhance securitization, partially at the expense of bank financing, because the cost of capital will decrease as the securities markets become more liquid and as transactions costs diminish.

- By eliminating currency risk and reducing differences in legal, accounting and settlement procedures, EMU will focus market attention more closely on credit risk. This will not only result in more uniform pricing but may also stimulate efficiency by enhancing competitive pressures. This could hold true for both private corporations and national governments.

Even if EMU is successful at integrating the European capital markets, it should be noted that the government bonds from the member countries will not be fungible and will, therefore, not develop into a European government debt market similar to the U.S. federal debt market. Instead, EMU government bonds will continue to reflect interest rate spreads due to the different credit risks and liquidity premiums of the issuing countries in a manner analogous to U.S. state and municipal bonds. To a large extent, EMU has resulted in a steady convergence of interest rates between prospective member countries by motivating an improvement in the economic fundamentals and by lowering exchange rate volatility. However, it is unlikely that interest rates on the various government bonds will perfectly and permanently align with each other. Nor is it likely that EMU member countries will coordinate their securities auctions for maturity matching. Without these conditions, government bonds will not be considered perfect substitutes for one another.

The Payments System

In an effort to increase the effectiveness of EMU monetary policy and to improve the settlement procedures within the euro zone, two cross-border clearing systems are currently being developed for the euro.

- The Trans-European Automated Real-Time Gross Settlement Express Transfer (TARGET), which will be the payment transactions system for the ESCB, is a decentralized mechanism linking local systems. Essentially, each bank will submit payments to its domestic national real-time gross settlement system (RTGS). TARGET will link the national RTGS systems, allowing national central banks to verify the creditworthiness of counterparties.

- The Euro Clearing System (ECS) is a central net system owned by private banks and operating by the Euro Banking Associations (EBA). The ECS will operate in a similar fashion as TARGET, with individual banks submitting payments to the ECS. The ECS will process payments within limits and will indicate daily net positions of the individual banks. The EBA is currently preparing an agreement on the depositing of collateral for a facility to limit default risk.

An efficient cross-border payments system will grow increasingly important after the introduction of the euro due not only to the euro-denominated transactions that will presumably increase each year but also as an important factor in the evolution of integrated money markets.

Preparedness of U.S. Firms

U.S. financial firms contacted recently by Treasury in Europe indicated this is their highest priority right now. Emphasis is on technical and systems preparation.

- There is concern regarding EMU if or when something goes wrong on day two or three, such as a mismatch in the currency in which an order has been booked.

- There is also concern about the Y2K problem, which some feel may not be getting the attention it deserves in view of EMU.

- Executives of U.S. firms thought it would be useful to have consultations between regulators and the banking and securities industry on both issues.

IV.1 External Representation of the EMU Bloc

Formal decisions on external representation of the EMU and various related issues in IFIs cannot be addressed until the requisite decision-making bodies are seated after the members are selected in May. After the members are chosen, the executive board of the ECB can be selected and the Ecofin can make decisions based on qualified majority votes among EMU participants. In addition, the nature and powers of the so-called Euro-X council may be clarified. It will be these bodies, in turn, which will develop the EMU's position on the modalities of external representation.

- The representation issues are inherently sensitive. Although many advocates of EMU see it as a step toward the political integration of Europe, national governments are extremely sensitive about giving up any of the trappings and prerogatives of sovereignty.

- The U.S. will need to encourage this decision making process, but must be careful not to become involved in Europe's sensitive internal controversies.

At this point, it does seem clear that no one believes that EMU will take the status or legal position of a sovereign country. Institutional arrangements that directly involve central banks will be more complicated.

<u>International Monetary Fund</u>

The IMF has concluded that:

> The rights and obligations of Fund membership are conferred on countries. Therefore, from an institutional perspective, (as opposed to a legal perspective) EMU membership does not affect rights and obligations under the Fund's articles as such. However, it may affect the manner in which Fund members may exercise their rights and comply with their obligations.

Member states will continue to choose their own governors and EDs. Smaller EMU members, which do not have the right to appoint their own ED, may join together in a single constituency to elect an ED, but this is not required. EMU participants may, of course, consult on a common position, but this is not necessarily different from current practice.

- Since member states will no longer have independent monetary and exchange rate policies, Article IV consultations will need to involve the ECB.

- One arrangement being considered in Brussels is that the ECB representative will be posted to the office of one of the EMU EDs, and will speak whenever appropriate.

The Group of Seven (G-7) Countries

Because the G-7 is an informal, rather than a legally constituted, organization, it is a stickier dilemma. EMU members will be giving up their independent monetary policies, but will keep a strong degree of independence on fiscal and microeconomic policies.

It has been suggested that the President of the European Central Bank participate in G-7 meetings. Other alternatives are to allow the Presidents of the National Central Banks (NCBs) to attend or to have some combination of NCB and ECB representation.

- Allowing the NCBs, but not the ECB, to represent the EMU members would exclude the most important policy-maker.

- Allowing both ECB and NCB representation would aggravate the problem of European over-representation.

- Allowing the ECB to attend as the sole central bank representative of the EMU would be our preferred option, but may cause problems for the Europeans. It will also create asymmetries on the finance ministry side.

On the finance ministry side, the creation of the EMU creates representational problems in a variety of fora besides the G-7. There are three solutions that have been suggested thus far.

The first solution is allowing the president of the proposed Euro-X (Euro-11) Council to represent EMU members. The French, in particular, are strong advocates of the Euro-11 and want it to be a player. They see an important role for the Euro-11 as "Europe's telephone number" on monetary/exchange rate issues and as a finance ministry counterpart to the ECB.

- The obvious problem with allowing G-7 representation by the (rotating) chair of the Euro-11 is that often this person will be from a non-G-7 country.

A second possibility is representation by the European Commission. Commissioner de Silguy desperately wants a seat at the G-7 table. In the past, the European members of the G-7 have felt strongly that the Commission does not deal with, and cannot represent, the Europeans on macroeconomic policy. Decision-making authority in the EU still remains (and will remain) at the member state level.

- This option may create problems because of the lack of a one-to-one correspondence between the EU and EMU. This would not be a short-term transition problem. Even if the current opt-outs and Greece join relatively soon, future EU members are not likely to join EMU for several years after gaining admission to the EU.

The third solution is allowing ECB or Commission representation of EMU members on an *ad* *hoc* basis, appropriate to the topic, but not the entire session of the G-7 or other meetings. Some smaller role could be worked out. For example, the G-7 could follow the precedent established for the IMF Managing Director, i.e. ECB participation in the macroeconomic surveillance portion of the G-7 discussion only.

Bank for International Settlements

There has been no formal discussion yet on how EMU will affect European NCB representaton at the Bank for International Settlements (BIS). German officials have said privately that they oppose any changes. Other European countries may also wish to avoid ceding their rights and privileges within the BIS to the ECB, but have yet to take a position on the matter. No movement is expected on the matter until after the initial members are chosen at the May summit.

IV.2 The Euro and the Dollar's Role as an International Currency

There are several dimensions on which an international currency may be measured. Presently, the dollar enjoys a dominant role in each of these areas, including:

- the currency denomination of cross-border financial assets,
    - of these, central bank foreign exchange reserves have attracted most attention--62% of all central bank reserves are denominated in dollars;
- the currency denomination of international trade contracts--studies differ on the exact share, but all document a dominant role for the dollar; and
- the use of cash currency outside of a nation's borders--the Federal Reserve estimates that roughly 2/3 of all Federal Reserve notes by value circulate outside the United States.

Many commentators, especially in Europe, have argued that EMU will mean an end to dollar hegemony as an international currency, with unpleasant consequences for the United States.

- We believe that a successfully managed EMU would lead to some gradual erosion in the dollar's role, but it is unlikely that the euro would take over the dominant role currently held by the dollar in the absence of major policy mistakes in the United States.
- The economic cost to the United States of a shift to a more equal role for the dollar and the euro would be relatively minor.

<u>Establishment of EMU and the Dollar's International Role</u>

Most analysts have focused on the effect of EMU on the dollar's reserve currency role, but it is likely that all aspects of the dollar's international role would move together, as they will tend to be influenced by many, but not all, of the same considerations.

Uncertainty about the ECB's monetary policy may discourage a major shift in the private use of the dollar in the opening months and years of EMU. In the longer-term, it is plausible that a successful euro would assume a greater international role than its predecessor currencies. Increased international use of the euro nonetheless presumes several developments:

- adoption of a credible monetary policy by the ECB;
- an effective stability pact that lends credibility to the fiscal policies of EMU members; and
- the development of euro-denominated government securities markets that are broader and

more liquid than any single existing European government securities market.

Dollar Reserve Overhang

Many analyses focus on the possible extent of the "dollar reserve overhang" that will exist following the launch of the euro. While all holdings of EMU member currencies will cease to be foreign exchange reserves when they are converted into euros, some countries may nonetheless tend to have unwanted dollar reserves after 1999.

- Intra-EMU trade will no longer involve currency conversion and thus might be considered interregional rather than international trade. To the extent that desired reserve holdings are based on import levels, the fact that 50% of all EMU-11 trade is accounted for by intra-EMU transactions would provide scope for a significant decline in reserves.

  -- The expected initial membership has about $325 billion dollars in official forex reserves. The exact foreign currency composition is not exactly known, but the majority of this is believed to be in dollars, with DM in second place.

- EMU members will no longer require foreign exchange reserves to defend their ERM parities, further reducing desired reserve holdings.

Non-European central banks may gradually shift an increasing portion of their reserve portfolios into euros. This will depend on the ECB's credibility and the development of broader and more liquid euro government bond markets. It is nonetheless doubtful that the euro would displace the dollar's role in Asia, a region which accounted for an estimated 61% of the reserves held by developing countries in 1996. While Eastern European and possibly African and Middle-Eastern countries may choose to link the their currencies to the euro, this would not involve a major re-balancing of official reserves.

- The Deutsche mark and French franc already accounted for 48% of central bank foreign exchange reserves in Eastern Europe in 1995.

The possible extent of undesired dollar reserve holdings in both Europe and the rest of the world is therefore highly uncertain.

The effect of central bank sales of dollar reserves, should they occur, will depend critically on the market environment. If the official sales occur gradually, are viewed as a simple rebalancing of official portfolios, do not induce a shift in private portfolio preferences, and if U.S. fundamentals remain strong, there is not likely to be much effect on exchange or interest rates. However, if markets are concerned about U.S. fundamentals, including policy credibility, a rapid sell-off by central banks could have a significant further impact on interest and exchange rates. By creating a potentially attractive alternative reserve currency, EMU increases the importance of sound and credible macroeconomic policies in the United States.

- In light of the depth and liquidity of the U.S. bond market and assuming continued strong U.S. fundamentals, even quite substantial sales of U.S. dollar assets by central banks are not likely to have a major impact on U.S. interest rates.

  -- To put this in perspective, in 1992 alone the USG sold \$311 billion in new debt, the Fed bought \$38 billion, foreign central banks bought \$22 billion, and the public bought the remaining \$251 billion.

  -- These sales may come at a time when the U.S. budget is in surplus and the Fed continues normal purchases of Treasury securities. These forces may actually shrink the supply of USG debt available to the public over a 10-year period even if foreign central banks sell \$300 billion of reserves.

<u>The Dollar's International Role and the U.S. Economy</u>

The benefits of the dollar's international role include

- seignorage from the issuance of cash currency;

- lower interest rates due to investor preference for dollar assets, including by central banks;

- more business for U.S. banks and financial firms;

- an easier environment for U.S. exporters and importers; and

- the prestige of the reserve currency role.

The economic value of the last three benefits is difficult to assess, and probably relatively small.

One measure of the value of seignorage is the interest saved by having foreigners hold non-interest-bearing U.S. liabilities. At current interest rates, these savings are worth about \$15 billion per year. However, Latin America and Asia probably account for most of these cash holdings, and they are not likely to switch to euro bills under most scenarios.

Finally, the benefit of holding dollar assets depends on the strength of the preferences. The most plausible analyses of the impact of EMU conclude that the euro will become a much closer substitute for the dollar than the individual currencies that it replaces. This implies that, in the future, investors will view dollar- and euro-denominated assets as close substitutes. On this basis, the medium-term effects on interest and exchange rates are likely to be very small, even for very large asset sales.

Sound U.S. Policies and the Dollar's International Role

Ultimately, the dollar is likely to retain its role as a major international reserve currency as long as U.S. macroeconomic fundamentals remain strong and the dollar is a sound store of value.

- A sound monetary policy with continued low inflation is probably the most important condition for the dollar's international position.

- Sound fiscal policy is also important -- investors must have confidence that the U.S. government will be able to honor its obligations without resort to inflationary finance.

- A commitment to open markets for capital and trade is necessary.

- Structural policies that enable strong growth and attractive investment opportunities in the United States also help to maintain the dollar's international role.

IV.3 U.S. Legal Issues Related to EMU

The proposed introduction of a single currency, the "euro", for participating member states of the European Union (EU), is generating considerable legal discussion both in Europe and New York. Representatives of the NY forex and legal communities have begun an effort to address potential legal issues that may arise in the United States due to the large number of forex contracts and derivatives currently denominated in European currencies and traded in the United States.

<u>Background</u>

On January 1, 1999, the EU is scheduled to introduce the euro as a substitute for national currencies of certain participating countries. From this date through December 31, 2001, there will be a transition period during which both the euro and existing national currencies are legal tender. In practical effect, each national currency will become a denomination of the euro, the value of the participating national currencies being fixed against each other and the euro. Beginning in 2002, the euro will become the sole legal tender in those participating countries, replacing their national currencies.

<u>Legal Issues: "Continuity of Contracts"</u>

The major concern is how to head off legal arguments that could jeopardize the performance of foreign currency contracts denominated in the currencies of participating countries. For example, a rogue party to a disadvantageous cross-currency interest rate swap or currency option contract, entered into before 1999 but which extends past January 1, 1999, might seek to terminate the contract after January 1, 1999, arguing that the introduction of the euro and the resulting fixed value of the national currency were not foreseeable and had frustrated the underlying purpose of the bargain.

Under the legal theories of "impossibility of performance" and "frustration of contract," an English or U.S. court can excuse performance of a contract where the reasonable expectations of the parties have been frustrated or are impossible to fulfill due to circumstances beyond their control -- such as an act of government or change of law. While the chances of a rogue party winning in court on these theories, as a result of the introduction of the euro, may be slim, just the threat of such litigation could affect markets.

The UK legal and financial communities are moving toward the insertion of standard "continuity" clauses into all currency or interest rate swap contracts to address this particular problem. English counsel appear optimistic that if all these steps are taken, continuity of contract will not be a problem in the UK when the euro is introduced.

A committee of interested NY lawyers has considered the risk of a rogue lawsuit in this area sufficiently high to merit changes in standard clauses in U.S. forex contracts as well as a legislative fix to achieve the highest possible degree of certainty. New York, Illinois, and

California have passed state laws to address this issue, and Pennsylvania and Florida are considering legislation. An additional area of legal interest under study is whether these state laws will apply retroactively to forex contracts entered into before the passage of the state legislation. Counsel working on this issue in the United States and in England argue that any new statute or regulation should be flexible enough to allow for parties to draft a contract which specifically does allow for termination if a new currency is substituted. The concept of "freedom of contract" remains valid even if governments and markets favor use of the euro.

At this time there does not appear to be any interest in a federal law to clear up risks in all states.

Future Actions

Treasury's Office of the General Counsel will continue to collect information from legal groups in New York and London which monitor developments related to the euro. It will also work with the Federal Reserve Bank of New York on planning related to the ESF's DM repo contracts, any further consideration of a new NY or federal law, and potential legal problems faced by US clearing houses and other financial institutions.

IV.4 U.S. Federal Tax Implications of EMU

Countries within and without the EU (including the United States) are considering the tax implications of the conversion of participating currencies ("legacy currencies") to the Euro. Some have stated their intentions of issuing special legislative or administrative guidance because the consequences of the conversion are ambiguous or unsatisfactory under their current domestic laws.

The Treasury Department and Internal Revenue Service have issued an announcement soliciting comments on the tax issues raised by the conversion. They are in the process of developing a proposal and expect to issue guidance later this year clarifying the U.S. tax consequences of the conversion.

The primary tax issues identified to date include:

- Treatment of gains and losses upon conversion of positions (such as debt and other financial instruments) currently denominated in a legacy currency under general realization principles;
- Treatment of *currency* gains and losses upon conversion of certain classes of instruments (such as cash, debt, and certain other investments in currency) under special foreign currency rules;
- Treatment of *currency* gains and losses in the unremitted earnings of a branch operating its business in a country with a legacy currency; and
- Tax accounting adjustments such as translation of bases in assets and liabilities, earnings and profits pools, and foreign tax credits that are currently stated in a legacy currency.

The major policy considerations in developing the guidance include:

- Consistency with existing U.S. tax principles and results that clearly reflect income of taxpayers;
- Consequences that are fair to taxpayers and the government;
- Rules that do not provide opportunities for tax arbitrage with the transition rules of other countries and minimize anti-competitive effects;
- Transition rules that are both simple and administrable; and
- A system that does not create an undue tax burden or benefit to taxpayers and avoids the development of tax rules that would impede or deter business transactions leading up to or during the conversion period.

IV.5 Overall Implications of EMU for the United States

It is unlikely that EMU will have major direct effects on the United States and its economy. EMU may, however, have important long-term indirect implications for the United States.

- The United States needs Europe as a dynamic partner to share a world leadership role.
- The United States would benefit from a robust European economy that is an attractive place to invest and is not reliant on export-led growth.

The United States has always supported the general objectives of European integration, while recognizing that the decisions about how to move the process forward are Europe's.

<u>Indirect Effects through the European Political System and Economy</u>

- Critics of EMU fear that this project will move Europe towards an unwieldy and unwanted superstate with a huge, democratically unaccountable bureaucracy.
- EMU's supporters see EMU leading to a democratic, productive, and unified Europe that will permanently banish the threat of another European war.

Whatever decision is made on the level of political unification, the U.S. has an interest in a Europe that is able to act decisively on the world stage in partnership with the United States. In particular, the United States needs Europe to meet the challenge of EU enlargement effectively.

There is also a strong difference of opinion on the economic effects of EMU. The direct effects of EMU will probably be negligible compared to the effects of decisions that must be made on economic and structural reform.

- EMU has clearly provided a spur to fiscal reform as countries have struggled to meet the membership criteria. The Stability Pact is designed to continue this discipline, although some doubts remain.
- It is far less obvious how EMU will affect the process of structural reform. Most analysts agree that EMU will increase the penalties for inaction and may serve as a catalyst to reform. However, there are yet no examples of major structural reform measures being undertaken as a direct result of EMU.
  - -- Most European governments are reluctant to propose controversial and painful reform measures until after they have secured the launch of EMU.
  - -- In the longer-term, the political costs of EMU may force some governments to move in the wrong direction to secure necessary political support. This is

currently the case in France and Italy where governments are currently proposing a reduction in the legal workweek.

Structural reforms are particularly important if Europe is to improve its current unacceptably high unemployment rate and weak investment climate, and to reduce its reliance on export-led growth. The U.S. interest clearly lies in achieving greater progress in these areas.

<u>The Dollar's International Role</u>

It is possible that a successfully managed EMU would lead to a gradual reduction in the dollar's international role, but it is unlikely that EMU could relegate the dollar to a minor role in the absence of serious policy errors in the United States. It is also possible that a poorly managed EMU would serve to increase the dollar's dominant international role.

There is no reason to believe that a gradual shift to roughly equal international roles for the dollar and the euro would impose significant economic costs on the United States.

<u>Implications for U.S. Firms in Europe</u>

There may be some legal and tax implications of EMU for U.S. firms that conduct business in Europe or with European firms. The Administration is monitoring these issues closely, but as of now there is little cause for serious concern.

EMU is expected to reduce accounting and transactions costs for U.S. firms that do business in Europe, but it is important for U.S. firms to make adequate preparations for EMU's launch. In the long run, U.S. firms should be well-placed to take advantage of the unifying effect of EMU on the European market, especially the market for financial services.

TREASURY CLEARANCE SHEET

No.__________
Date: April 8, 1998

MEMORANDUM FOR: ☒ SECRETARY ☒ DEPUTY SECRETARY ☐ EXECUTIVE SECRETARY
☐ ACTION ☐ BRIEFING ☐ INFORMATION ☐ LEGISLATION
☐ PRESS RELEASE ☐ PUBLICATION ☐ REGULATION ☐ SPEECH
☐ TESTIMONY ☐ OTHER ________

FROM: Assistant Secretary Geithner
SUBJECT: European Economic and Monetary Union (EMU)

REVIEW OFFICES (Check when office clears)

- ☐ Under Secretary for Finance
  - ☐ Domestic Finance
  - ☐ Economic Policy
  - ☐ Fiscal
    - ☐ FMS
    - ☐ Public Debt
- ☐ Under Secretary for International Affairs
  - ☐ International Affairs
- ☐ Enforcement
  - ☐ ATF
  - ☐ Customs
  - ☐ FLETC
  - ☐ Secret Service
- ☐ General Counsel
- ☐ Inspector General
- ☐ IRS
- ☐ Legislative Affairs
- ☐ Management
- ☐ OCC
- ☐ Policy Management
  - ☐ Scheduling
- ☐ Public Affairs/Liaison
- ☐ Tax Policy
- ☐ Treasurer
  - ☐ E & P
  - ☐ Mint
  - ☐ Savings Bonds
  - ☐ Other ________

NAME (Please Type)	INITIAL	DATE	OFFICE	TEL. NO.
INITIATOR(S)				
Ken Austin	KA	4/8/98	IMI	622-0174
REVIEWERS				
Joseph Gagnon	JG	4/8/98	IMI	622-0138
Caroline Atkinson	CA	4/8/98	DO/IM	622-0489
Russ Munk	RMG. RLM	4/9/98	DO/GC	622-1899

SPECIAL INSTRUCTIONS

☐ Review Officer Date ☐ Executive Secretary Date

DO F 80-02.1 (04/89)

1998-SE-014431

Exec Sec
98-SE-014431

DEPARTMENT OF THE TREASURY
WASHINGTON, D.C.

UNDER SECRETARY

DEC 23 1998

ACTION

MEMORANDUM FOR SECRETARY RUBIN
DEPUTY SECRETARY SUMMERS

FROM: Timothy F. Geithner TFG
Assistant Secretary (International Affairs)

SUBJECT: The Launch of EMU

As we prepare for the formal New Year's launch of EMU, I would like to bring two items to your attention.

- Tab 1 is a status memo on EMU prepared by EMU Desk Officer, Ken Austin.
  - An important point in the paper is that we could face a conflict with the Europeans early next year if the euro appreciates much further against the dollar. This is particularly sensitive because in the December 8 WP-3 meeting the IMF's Michael Mussa (and others) predicted that the dollar will drop significantly in the next year or two. The Europeans have become increasingly concerned about the effect that dollar depreciation could have on their growth rates over the next two years.
- Tab 2 contains talking points and Q and A's on EMU.

RECOMMENDED ACTIONS: We should use the attached talking points and Q and A's to respond to public and press queries on our position on EMU.

Approve ✓ Disapprove__________ Let's Discuss__________

ATTACHMENTS: Tab 1: Status memo on EMU

Tab 2: Talking Points and Q and A's

Good Job!

EXECUTIVE SECRETARIAT

The Deputy Secretary of the Treasury

January 5, 1999

NOTE FOR TIMOTHY GEITHNER
Under Secretary for International Affairs

FROM: LAWRENCE H. SUMMERS

Good job.

Larry

Attachment

Room 3326 **622-1080**

1998-SE-014431

DEPARTMENT OF THE TREASURY
WASHINGTON, D.C.

December 23, 1998

UNDER SECRETARY

MEMORANDUM FOR SECRETARY RUBIN
DEPUTY SECRETARY SUMMERS

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ATTACHMENTS: Tab 1: Status memo on EMU

Tab 2: Talking Points and Q and A's

KAustin: IMI
December 22, 1998

EMU T-Minus (–) and Counting

KEY CONCLUSIONS:

Markets are convinced of a successful launch of EMU on January 1, 1999. Preparations are essentially complete. However, for the immediate future, EMU is not going to be a significant determinant of European economic performance, either positive or negative.

- At the threshold of EMU, European financial markets seem to be insulated from financial instability in the rest of the world. Markets have not tested the ERM central parities that are intended to be the conversion rates for the predecessor currencies to the euro. On the other hand, exchange rates of European currencies outside the EMU, have been buffeted by turbulence in world markets.

- There appear to be no comparable benefits for the real economy. As European exports slow due to global economic problems, domestic demand does not appear adequate to pick up the slack. The net effect is that Europe's moderate recovery will probably slow next year.

- There are a number of operational and technical issues, rather than policy issues, that could still cause problems when markets open next year. These problems range from computer software problems to the operation of payments clearing systems and are in both the public and private domains.

There have been two major changes that have shaped the development of EMU since the summer:

1) The predicted slowdown of European growth next year which has shifted the burden of risks to recession and unemployment from acceleration and inflation.

2) The leftward shifts of governments particularly in Germany and Italy.

Rather than shaping the economy, Europe's economy has shaped EMU. A continent-wide economic recovery that got underway in 1997 helped qualify every country, except Greece, that wanted to join when the final decision was made in 1998. Although some continued cyclical and inflation divergence delayed the convergence of central bank interest rates, the convergence process gained speed in recent months as consensus emerged that the balance of risks had shifted from inflation to recession.

Economic Policy in 1999

Now slower growth will shape the dynamic of economic policy-making. European governments will have to try to fight unemployment without resort to new spending.

- Monetary policy will soon be in the hands of the ESCB. However, the new German government has shown no reluctance to publically pressuring central bankers to ease.

- Fiscal policy is constrained by the Stability Pact and budget deficits that are still relatively close to 3% of GDP in several countries, including Germany, France, and Italy.

- There appears to be some reluctance, even on the left, to take the step of formally renouncing the Stability Pact.

- Italian PM D'Alema has suggested modifying the pact or its definition of debt to exclude spending on public investment.

• There is no clear momentum for structural change. EMU advocates often suggested that monetary union would accelerate structural reform by penalizing laggards. While there remain some examples of privatization and deregulation, there are clearly examples of regression, such as the 35-hour work week proposals in Italy and France.

- Franco-German proposals for tax harmonization could be a more insidious threat to the process of structural change. These proposals have been taken off the table, at least temporarily, in the face of strong opposition from several EU members. They would have changed the rules on taxation within the EU to make it harder for governments to gain economic advantages via competition on tax rates for savings and corporations. It is clear that France and Germany intend tax rates to be harmonized at higher, rather than lower, rates.

• Exchange rate policy has not been discussed as a policy tool, even though there are provisions for exchange rate arrangements under section 109 of the Maastricht Treaty.

- However, forecasts of slowing growth and the dollar's depreciation against European currencies in late 1998 have focused attention on the exchange rate.

- The dollar's partial rebound quieted some of the calls for target zones and complaints about "volatility." However, markers have been set and Duisenberg has publicly said that the ECB would not follow a policy of benign neglect on the exchange rate.

It is difficult to predict what will happen to €/$ in the first months. Recent DM/$ movements may not be indicative of market valuation of the euro. Because of the previously mentioned operational and technical issues involved in the changeover, many traders and financial institutions are closing out positions and maintaining a high degree of liquidity in case there are any major problems after the new year.

• It is, therefore, quite possible that after these types of problems are resolved, and it is perceived as safe and liquid to hold euro-denominated assets, the euro could appreciate sharply.

- Currently $1 = 1.65 DM = .84 ECU. The "conventional wisdom" is that the ECB has a comfort range of 1.6 to 1.8 DM/$. This translates to roughly .82 to .92 €/$.

- Goldman Sachs is currently predicting that the dollar will break the bottom of this range in six months time, although forward markets do not indicate any significant change from current levels.

- Many analysts believe that if the dollar fell to .75 € for any length of time, there could be some sort of policy reaction, such as additional rate cuts or proposed forex bands, like the recent, unofficial, German target zone proposal.

The French, who seem the most concerned about €/$, have publicly expressed recognition that exchange rate considerations restrict certain macroeconomic policy choices.

- Any significant sales of dollar reserves by the ESCB would clearly put additional, unacceptable downward pressure on the dollar.
- A combination of easy fiscal and tight monetary policies (what the French refer to as the Reagan/Volcker policy mix as opposed to the current U.S. policy mix which they refer to as the Clinton/Greenspan mix of tight fiscal/"easy" monetary policy.)

Monetary Policy and Interest Rate Convergence

The first problem faced by the ECB was the issue of interest rate convergence. At the beginning of autumn 1998, rates in the EMU core were 3.30%, but Irish rates were over 6% and Italian repo rates at 5%. There were some concerns that the peripheral countries would keep rates high until year-end to fight inflation, but concerns about a slowdown in economic growth allowed the process to begin in early October. A surprise cut in all 11 countries on December 3 left all central bank benchmark rates at 3.0%, with the exception of Italy which cut to 3.5%. Most observers expect 3.0% to be the ESCB's beginning repo rate on January 1.

A serious problem that the ESCB faces in running monetary policy is the relatively poor statistical data base for the euro area as a whole. It has limited reliable EMU-wide data, and these data have a limited historical base. The ECSB is expected to rely on an eclectic mix of money supply targeting and inflation targeting.

- The Governing Council (the Council) has decided to use its M3 broad monetary aggregate to define its "quantitative reference value." It will use a "value," rather than a range, to avoid creating expectations of mechanistic reactions to money supply growth.
- The medium-term monetary target for M3 growth is 4.5% y/y (assuming 2-2.5% trend GDP growth, inflation measured by the harmonized CPI at less than 2%, and monetary velocity declining 0.5-1.0% per year.)
- The ECB's primary monetary policy instrument will be weekly repo operations. The ECB has announced that first refinancing operation will take place on January 4.
- The target inflation rate is 0.0-2.0% annually.

The Euro as a Reserve Currency

There is no immediate evidence that third nations intend to begin keeping a large fraction of their central bank reserves in euros over and above conversion of current legacy currency holdings. Most central bank officials who are quoted, indicate that they will consider the euro as a reserve asset over the medium-term based on its performance.

- Duisenberg is resigned to, but not enthusiastic over, the euro's eventual reserve role.

- As mentioned above, Europeans cannot significantly reduce dollar reserves until the dollar begins to strengthen. Ironically, too strong a euro might prompt dollar purchases and increase the dollar's relative role as a reserve currency.

Final Conversion Rates

At 10:30a.m. GMT, at the end of daily central bank indicative fixings on Thursday, December 31, the European Commission will make the calculations of the final irrevocable conversion rates of the original currencies to the euro. These must be based on the market rate of the various currencies to the ECU, although the final conversion rates of the predecessor currencies to each other are based on the ERM central parities. EU finance ministers will adopt the rates and make them public about 12:30 p.m. GMT. At midnight, local time, the rates will take effect and the euro will be born. Thus Finland, the easternmost EMU member state, will become the first to join and Portugal and Ireland will be the last to join.

"Outs"

Currently, Greece, which has been an outlier on the Maastricht criteria, hopes to join as early as early as 2001. Greece is now a member of the ERM and will participate in its successor, ERM-II. Greece expects government deficits to drop below 3% of GDP, beginning this year. Inflation and interest rates are coming down, but it may be difficult to bring them down to required levels next year, although the government has set a 2.0% inflation target.

Sweden and Denmark have been kept out of EMU by popular opposition. Public opinion appears to have shifted in favor of EMU in recent months as a bout of instability in forex markets slammed Scandinavia but spared countries that will join EMU. Many had expected the Swedish Government to wait at least until the 2002 general election to decide the issue, but now some believe that a referendum could come sooner. A similar shift may come about in Denmark, where the political establishment is still recovering over the defeat of EMU in the previous referendum. However, most politicians believe a referendum is unlikely before 2001.

In the UK, the public is still perceived to be hostile to EMU. However, both the Labour government and the business and financial communities believe that it is risky to stay out of EMU if the venture appears to be a success. The Blair Government has pledged not attempt to join EMU before the voters have had their say, either in a referendum or general election. The next election must take place no later than 2002.

London and the Euro Launch

Although the UK is not going to be a founding member of the EMU, the Bank of England and the City of London are at the center of preparations for the changeover. There are two closely related reasons for this 1) London is currently the financial capital of Europe, 2) London would like to remain the financial capital of Europe, even after the introduction of the euro. London has a $1.5 trillion-a-day forex market and the largest stock market in Europe. The BOE expects to have 200 of its staff working over conversion weekend (Dec. 31-Jan 4) and nearly 30 thousand staff are expected to be at work in the City of London. Trading systems and software have been tested, but no one is certain that everything will work properly when billions of dollars in financial assets are re-denominated into euros.

EMU TALKING POINTS

- The establishment of the European Economic and Monetary Union is an historic milestone in the history of European integration.

  - We congratulate Europe on the successful efforts to create EMU. We applaud Europe's success in reducing inflation and budget deficits that has moved this project forward.

  - Support for closer European integration has long been a touchstone of United States foreign policy. Now that Europe has chosen to take this next step, we greatly desire to see its success.

  - Europe still faces challenges to reduce today's high unemployment, revitalize investment, and make EMU work.

  - A successful EMU with dynamic domestic European growth, based on open markets and sound economic and structural policies, will benefit the United States.

IMI: Ken Austin
December 16, 1998

EUROPEAN ECONOMIC AND MONETARY UNION (EMU)
United States' View

Question:

Is the Treasury Department following developments related to EMU closely? Does the United States support EMU? Do you believe that EMU is in American interests?

Answer:

- The establishment of the European Economic and Monetary Union is an historic milestone in the history of European integration.
    - We congratulate Europe on the successful efforts to create EMU. We applaud Europe's success in reducing inflation and budget deficits that has moved this project forward.
    - Support for closer European integration has long been a touchstone of United States foreign policy. Now that Europe has chosen to take this next step, we greatly desire to see its success.
    - Europe still faces challenges to reduce today's high unemployment, revitalize investment, and make EMU work.
    - A successful EMU with dynamic domestic European growth, based on open markets and sound economic and structural policies, will benefit the United States.

IMI: Ken Austin
December 16, 1998

EUROPEAN ECONOMIC AND MONETARY UNION (EMU)
United States' Reticence on EMU

Question:

Is it true that the U.S. Government's reluctance to express specific views on EMU masks deep concerns about the wisdom of the project and the consequences for the United States?

Answer:

- A successful EMU that promotes sustained growth and stability in Europe is very much in our interest, as well as in Europe's. As we have said many times, we look forward to a successful EMU. We have always maintained, however, that the key decisions concerning EMU are an internal matter for Europe to determine on its own.

IMI: Ken Austin
December 16, 1998

EUROPEAN ECONOMIC AND MONETARY UNION (EMU)
EMU and EU Enlargement

Question

What effect do you expect EMU will have on the proposed enlargement of the EU to include several former Soviet bloc countries?

Answer

- We are very interested in the success of EU efforts to admit new members in Central and Eastern Europe and hope that EMU will complement that project, and not distract attention from EU expansion.

IMI: Ken Austin
December 16, 1998

EUROPEAN ECONOMIC AND MONETARY UNION (EMU)
Role of the Dollar

Question

Will the euro replace the dollar as the world's primary international currency? Is the U.S. Government concerned about the consequences of such a development?

Answer

- Reserve money status depends on a variety of factors.
- It is difficult to know the degree to which the euro, over time, will take on a greater role as a reserve currency.
- What is important for the United States is that we continue to ensure that U.S. macroeconomic policies earn the respect of world markets.

IMI: Ken Austin
December 16, 1998

EUROPEAN ECONOMIC AND MONETARY UNION (EMU)
Will the Euro be a Strong or Weak Currency

Question:

Do you believe that the new euro will be a strong currency or a weak currency?

Answer:

That depends on a broad number of factors. What is important for the success of EMU is the degree to which it leads to a credible macroeconomic policy regime, structural reforms, and successful establishment of a more dynamic economy.

IMI: Ken Austin
December 16, 1998

EUROPEAN ECONOMIC AND MONETARY UNION (EMU)
Suggestions for a Possible Common Currency in the Americas

<u>Question:</u>

Is there any movement toward creating a common currency, like the euro, for the Americas?"

<u>Answer</u>:

No, the situation on this side of the Atlantic is very different. Such a common currency would neither practical, nor desirable, for the foreseeable future.

IMI: Ken Austin
December 16, 1998

SENSITIVE: HOLD CLOSELY

THE G-7 AND THE EUROPEAN ECONOMIC AND MONETARY UNION (EMU)
United States' View

Question:

What is your reaction to the European proposal on the representation of the euro area in meetings of G-7 finance ministers and central bank governors?

Answer:

Obviously there are fundamental changes happening in Europe. Any changes in the G-7, which has been a small and informal process, will require the agreement of all of the participants, including both European and non-European members.

Administration

Decisions about informal meetings at the ministerial level are best left to the ministers themselves to decide.

Treasury

We will be discussing this issue with our G-7 partners over the coming weeks. The United States strongly values the informal nature of the G-7, which depends critically on its small size and the familiarity that develops among participants.

IMI: Ken Austin
December 16, 1998

EUROPE

Withdrawal/Redaction Marker
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002. memo	Robert E. Rubin to POTUS re: Visit of French President Chirac (2 pages)	01/26/96	P5

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96-154586

DEPARTMENT OF THE TREASURY
WASHINGTON, D.C.

UNDER SECRETARY

ACTION

MEMORANDUM FOR THE SECRETARY

THROUGH: Deputy Secretary Summers

FROM: Under Secretary Shafer (International Affairs)

SUBJECT: Letter to the President: Meeting with French President Chirac

ACTION FORCING EVENT:

French President Chirac will meet with President Clinton at the White House on February 1. We expect you will be invited to attend the expanded discussion. President Chirac is expected to press two issues of particular concern to you: IDA replenishment and his views on proposals for enhancing "international monetary stability".

FIXED FX

RECOMMENDATION:

That you sign the attached memo.

__✓__ Agree ________ Disagree ________ Let's Discuss

BACKGROUND ANALYSIS:

The French are well aware of Congressional hostility to Administration proposals to meet U.S. obligations to IDA and other MDBs. Nevertheless, they feel that the U.S. administration's commitment to these agencies, particularly IDA, which provides major financing to France's former dependencies in Africa, is waning. On the issue of international monetary stability, we believe it is important to put on the record our opposition to proposals for greater fixity in exchange rate regimes.

We are also preparing background notes on both issues for NSC staff.

Attachment: Memo to President Clinton

EXECUTIVE SECRETARIAT