Lecture 7

Stability of exchange rate the most important factor in establishing a closer European economic community

Why was the Euro created?

- Instability affected both private and public policies
- Influenced inter-regional transactions
- Does this instability justify creation of a united currency?
- Several justifications for the creation of the Euro
    - Adjustable fixed exchange rate regime became very unstable, especially after the European governments decided to cancel capital control programs; instability in exchange rate; vulnerable to growing speculative financial transactions
    - During 1992 European currency crisis; put European governments face to face with 2 options
        - In order to maintain the **perfect capital mobility system** and **exchange rate stability** and **autonomy on national monetary policy** they would have to give up their national monetary policies
            - Not possible to achieve objectives at the same time with the same currencies. Called the **impossible trinity of open macro economics**
            - Have to give up one to achieve the other 2
            - Creates the Euro to ensure stable exchange rate and perfect capital mobility system
        - Objective was to prevent any future shocks in the exchange rate

        - New influence of new classical monetary theorists, influenced governments to create monetary union. Encouraged policy makers to give up their control over domestic monetary policies.
        - Belief that united currency will lead to more stable and more efficient monetary and economic policies in general.
        - Promote equality
        - Better job opportunities lower the rate of unemployment
        - New system will lower domestic interest rates; encourage private investment and economic growth
        - Lead to more stable fiscal policies; budget imbalances will be reduced
- Decision was to abandon autonomy over monetary policies
- United monetary policies to be created

<u>Is this system superior?</u>

- One school of thought
    - Better option to control prices and to achieve price stability; low inflation rate
    - Will automatically adopt anti-inflation policies of the German Central Bank which was successful in this period.
    - Newly created European Central bank mandate
        - Ensure price stability
        - Ensure low rate of inflation
        - Zero inflation rate policies

      <u>2nd Mandate</u>

        - Limit maximum level of budget deficit and public debt
    - Creation of Euro will eliminate the possibility of devaluating individual national currency; a more stable system in terms of labor, fiscal, monetary policies

- Against the new system
    - Will encourage the deregulation movements in European countries; these will lead to more imbalance of wealth and income distribution; wealth transferred from public to private sector
    - Result in cutbacks in all welfare and social programs; will make low income groups worse off
    - Creation of Euro will impose several constraints on member nations' ability to reduce unemployment; reduce their ability to improve conditions for labor sector
    - The actual costs of the new system will be bore by the low income groups

Political Factors in Creation of Euro

- Presents serious challenge to US power and foreign policies
- End inter-European conflicts; positive cooperation
- End conflict between US and European community

Optimum Currency Theory

- There are costs and benefits for creating an optimum currency union; micro and macro costs and benefits
- If benefits are greater than the costs, both social and economic, this country should join a currency union.
- If costs are greater, then the country shouldn't.

Today, there are different regions in the world; there are certain countries that would benefit.

- The Americas: US, Canada, Latin America
    - 1999: serious and active debate among policymakers on establishing a currency union that would be based on the US dollar

- 2001-2: two Latin American countries adopted the US dollar their domestic national currency. El Salvador and Ecuador
- Supporters
  - Creating this project will generate price stability and will lead to sustainable economic growth in Latin American countries;
  - Protect region countries from negative effects of speculative financial flows
  - Attract foreign investment
- Critics
  - Will push individual countries to give up one of the most important and powerful tools in macroeconomic policies; namely the domestic monetary policies and control over exchange rate determination.
  - Social and economic costs associated with this project:
    - Clear in Argentina
      - Central bank managed its policy through a currency board which was tied to the US dollar
      - By 1995; Argentina's current account experienced deficits
      - No option but to accept deflationary policies
      - Generated 2 problems: massive unemployment and large decrease in government expenditure; created social crisis of 2001-2002
  - Adoption of US dollar will make Latin American countries dependent on the US economy and the strength of its dollar. They will affected by any change in the value of the dollar and the US economy
  - While the member countries will accept the US dollar as their currency, they will have no role in any decision making

related to the dollar value or the Federal Reserve policies. US policymakers made it clear that no consideration will be made to countries that adopted the US dollar when making decisions

- Will provide no monetary or financial assistance
- The only thing they offer is to share some of the benefits some of the revenues that the US earned from circulating the dollar.

- Former French Colonies in Central and West Africa
- South-east Asia
- Caribbean countries

The Global role of the US Dollar

- What is the dollar's future role as the world's main currency?
  - When the dollar was de-linked from gold, it did not really affect the dollar
  - Still the most usable currency in international transactions
  - Still the most common currency held by governments as their foreign exchange reserve
- Politics play important role in maintaining US dollar as most common world currency
  - Most of the countries' government hold their reserves in US dollars, especially those countries that have a positive relationship with the US; use US dollars to complete financial transactions
  - US financial markets are still the most liquid markets compared to other financial markets. Attractive to investors, short and long term
- Challenges to the US dollar
  - Most important challenge to the global role of the US dollar is the Euro

    - One of the main reasons for the creation of the Euro was to challenge the dominance of the US dollar and the US' international position, to improve European power.
    - Can the Euro challenge the US dollar in terms of an attractive alternative for making financial transactions
        - Some argue yes; eventually the Euro will be attractive enough as an international currency; backed by strong European Central Bank and strong European economies.
        - But premature to judge whether or not it will be a serious threat.
- Japanese Yen
    - Japan trying to promote their currency as a leading international currency; positive growth in this movement
- Some raise concern about the declining role of the US dollar
    - Consequences of decline
        - US will lose benefits that it has thrived on from broad circulation
        - Will lose international prestige which came from issuing the dominant world currency, will lose some of its foreign policy power.
        - Effects on international monetary system's stability
            - These imbalances will affect world economy
        - BUT: Others argue the opposite; competition between currencies will create more balance, more stable conditions than a system dominated by a single currency