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The anticipated and concurring effects of the EMU: exchange rate volatility, institutions and growth☆

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Abstract

Reduced exchange rate volatility and higher and less heterogeneous quality of institutional rules and macroeconomic policies are two of the main (anticipated and concurring) effects expected from a currency union.

In this paper, we measure the magnitude of these two effects for the Eurozone countries looking at real effective exchange rates (REER) and at different indicators of quality of institutional rules and macroeconomic policies (QIRMP). We find that the first effect is much stronger than the second when we compare relative changes for Eurozone countries and the rest of the world in the relevant period.

We further evaluate the impact of both effects on economic growth on a larger sample of countries. Our findings show that both have significant impact on levels (more robust) and on rates of growth (weaker) of per capita GDP.

Keywords: EMU; Quality of institutions; Exchange rate volatility

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1. Introduction

A nice synthesis of the challenges posed by global integration is in the formulation of a well known trilemma (Summers, 1999). The trilemma synthetically expresses the difficulties, or the impossibility, of pursuing at the same time the following three goals—greater economic integration, proper public policy management and national sovereignty—against the possibility of pursuing any of the two at the expenses of the third. The three potential alternatives left for the partial solution of the trilemma are resumed as being those of: (i) "traditional conservative economists" (according to Summers definition) pursuing economic integration and national sovereignty at the expenses of freedom on public policy management; (ii) modern protectionists advocating limits to economic integration to favor "free hands" on public policy management and national sovereignty and, finally, (iii) advocates of Monetary Unions intended as means to promote economic integration and proper public policy management at the expense of national sovereignty (Summers, 1999).

In this perspective, the rise of Monetary Unions appears as one of the possible responses to the trilemma which makes compatible the first two goals at the expense of the third.

Originally, within the more general approach of the optimal currency areas (Mundell, 1961), one of the most sound economic rationales for the EMU came from the theoretical observation that simple fixed exchange rate parities could not be enough for the partial solution of the trilemma given that, in absence of a common currency, exchange rate stability cannot coexist with divergences in fiscal and monetary policies (Giavazzi and Pagano, 1994; Obstfeld and Rogoff, 1995). In this framework, a country whose monetary policy is relatively more expansionary than that of the fixed exchange rate partner is likely to suffer from an appreciation of real exchange rates. This appreciation worsens its relative competitiveness and therefore makes necessary a devaluation, thereby generating further currency instability. The awareness of such problems led economists and policymakers in the eighties and nineties to affirm that "*fixed exchange rates now seem much less effective as means to price stability than many of us thought before. Therefore, monetary stability and credibility has to be built at home with other means*" (Svensson, 1994: p. 467).

On the basis of this theoretical pillar, the EU started a process of convergence in fiscal policies, inflation and institutions which was going to prepare the introduction of a common currency.

One of the undiscussed advantages of the process leading to the common currency was the elimination of exchange rate volatility among members (Buiter et al., 1998; Devereux et al., 1999). This was generally considered a beneficial effect given the perception that "*unpredictable volatility can inflict damage...*[and that]... *Although the associated costs have not been quantified rigorously, many economists believe that exchange rate uncertainty reduces international trade, discourages investment and compounds the problems people face in insuring their human capital in incomplete asset markets*." (Obstfeld and Rogoff, 1995).

Since exchange rates are a forward looking financial variable whose movements are driven by expectations and anticipate the occurrence of real events,