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Exchange Rate Arrangements for a Multi-Speed Europe

CHRISTOPHER TAYLOR

EUI Working Paper RSC No. 95/35

European University Institute, Florence

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I The questions

The prospect of a small-group EMU by the end of the century raises important questions for exchange rate arrangements in the wider EU. Furthermore, the additional prospect of a new echelon of states joining the EU by early in the next century raises related questions for the rather longer term. The key questions are:

1 How will exchange rate arrangements work between the various groups, advancing at different speeds ?

2 How will the multi-speed EU handle its exchange rate relations with the rest of the world, especially the USA and Japan ?

The basic issue is - how far will there be a role for formal arrangements to stabilise exchange rates between the different EU groups, and between the EU and ROW, and if so what form should they take? In principle there is a wide spectrum of possibilities, ranging from unilateral targeting to bilateral or multilateral schemes for pegged-but-adjustable rates like the ERM or a successor. (Arrowsmith [1995b] gives a menu of alternatives). And there are numerous subsidiary questions. If there is a role for fixed-but-adjustable rates, how adjustable should they be ? What obligations should there be for monetary authorities to intervene in foreign exchange markets? Or to change domestic policies? Should there be provisions for short-term financial support? And/or for medium-term support ? If formal arrangements do not suit some currencies, what are the alternatives and who will pursue them ? Those alternatives comprise free or managed floating and various kinds of informal targetry - shadowing, unannounced ('quiet') target ranges, etc. They might involve arrangements for policy co-operation, ranging from a general 'code of behaviour' through more detailed policy surveillance to IMF-type conditionality with balance-of-payments assistance. In any stabilisation approach, formal or informal, some EU States might prefer to focus on a non-EU currency, such as the dollar, or a composite like the SDR, rather than an EU currency.

The Maastricht Treaty provides that monetary policy for the EMU group will be conducted centrally by the European Central Bank, while non-participants' monetary policies will be left in national hands. The EMU group's external exchange rate policy is to be decided by the EMU members of the Ministers' Council (ECOFIN), in consultation with the ECB,[1] which will be responsible for its execution.[2]

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[1] Treaty, Article 109.

[2] Protocol on the Statute of the European System of Central Banks and of the European Central Bank, Article 3.1.

However the Treaty says very little about exchange rate arrangements for non-participants. There is an implication that the EMS will continue in some form, because countries with an opt-out or derogation seeking to join EMU will still have to meet the exchange rate criterion (which requires observation of the 'normal band' of the EMS for two years previously); and the General Council of the ECB will take over functions of the European Monetary Institute which have to be performed in Stage III[3], which could include administration of the EMS. But the question is left very open.

II Considerations affecting the answers

The answers will depend on a number of considerations:

1 Membership of the respective groups

By around the year 2000 the EMU group (call it 'Group I') is likely to comprise between five and nine countries which have met the convergence criteria and have moved to Stage III in accordance with the Treaty blueprint and deadlines. They are likely to include at least the 'hard core' of five (Germany, Netherlands, Luxembourg, Austria and France), and additionally perhaps Belgium, Denmark (if willing), Finland and Ireland. A Group I of nine would leave six of the EU-15 in the second group ('Group II'): the UK (assuming it opts out of EMU), Greece, Italy, Spain, Portugal and Sweden. In time they might be joined by several new, relatively industrialised, members - the remaining ex-EFTAns Norway, Iceland and Switzerland - making an EU of some 18 western European States.

Furthermore, the EU may be augmented in the longer term by a third group of mainly less-industrialised countries (call it 'Group III') situated on its periphery. They could comprise principally the 'Visegrad 4', (Hungary, Poland, and the Czech and Slovak Republics), plus eventually the three small Baltics and several central/eastern European states (Bulgaria, Romania, and possibly Slovenia and other independent states emerging from the conflicts in ex-Yugoslavia); and they could be joined by several Mediterranean states - Cyprus, Malta and possibly Turkey. Group III might conceivably comprise upwards of 12 or so countries by the early years of the next century, implying an EU, including associates, of around 30 or more States thereafter. However, most of this group, especially the CEECs, are likely to remain in an associate status for some considerable time into the next century, as the Visegrads are now. Although there might be few economic problems in granting the smaller economies full EU membership, the larger ones would be difficult to absorb because of the costly implications for the EU budget, as Baldwin

[3] ESCB Statute, Article 44.

(1994) has shown. This means that few in Group III would be candidates for EMU in the next ten years, or have voting rights on EU decisionmaking bodies. They might nevertheless participate in its exchange rate arrangements, depending on how these evolve.

2 The relative economic strengths and bargaining power of these groups.

Within the EU-15, a Group I with nine States and a Group II with six States would be fairly equal in terms of population, but Group I would be about 50% larger in terms of GDP (see Table 1 for basic country data). Group I's external trade would also be larger, and it would be much less reliant on trade with Group II than Group II would be on trade with Group I, as Arrowsmith (1995a, Table 5 and 1995b, Figure 6) shows. Group I's voting power in the Council would also be larger, although it would not command a qualified majority there, as Arrowsmith also shows: both groups would comfortably hold a blocking minority in the Council and this would be unlikely to change as a result of changes in voting weights or qualified majority requirements which may be agreed in the forthcoming Intergovernmental Conference (Arrowsmith 1995b, p.3). The addition of three further small developed members to Group II would not change the balance of economic or political power greatly. Neither would the development of Group III for many years, for although it will include some populous economies like Poland and (perhaps) Turkey, per capita incomes there will remain relatively low for some time and, without voting rights, EU Associate States will have little influence over its policies.

3 The economic characteristics of Groups II and III as potential members of an optimal currency area based on the core group

According to the theory of optimal currency areas, countries should be wary of locking their exchange rates together if there is low mobility of factors of production between them, and/or they are closed economies or produce only a limited range of goods and services (see Taylor [1995] for a review of the literature). In fact, most economies in Groups II and III exhibit rather low international mobility of labour, for cultural/linguistic reasons, and most in Group III have also traditionally experienced low international capital mobility, for political and institional reasons, although this is now changing. On the other hand, many in Groups II and III are small open economies (as the final column of Table 1 suggests), and most have fairly diversified production structures. It therefore appears that a number in both groups will have a strong interest in fixed exchange rates for trading reasons. On these grounds alone, regardless of others, it seems plausible to expect that many countries among Groups II and III will be looking to join Group

I in due course, although for structural reasons few members of Group III might be serious candidates for EMU until well into the century.

4 Their macroeconomic and political objectives

As regards their national macroeconomic and political objectives, Group I States are, virtually by definition, likely to be fairly uniform, at least in the context of EU integration, whereas the aims of Group II and III States will be relatively heterogeneous and this is likely to be to their disadvantage in relations with Group I.

(i) Group I will have some interest in arrangements to provide for exchange rate stability within the larger EU. Reduced exchange-rate volatility would enhance the benefits from the Single Market, cet. par.; core States will wish to avoid sustained devaluations by EU partners which give them a competitive advantage against the core, already seen by some as a major threat. Their political objectives point mainly towards an expanding EU, provided it does not impede closer economic and political integration for those that are ready and willing. The Treaty provides opportunities to access EMU for all who meet the convergence criteria, including the exchange rate criterion (which is nevertheless ambiguous in its reference to the 'normal' fluctuation band, and appears less demanding of newly-acceding States, which do not have to be formal ERM members). However, other arguments will point against exchange rate commitments for this group. Group I States will not wish to incur heavy costs through exchange market intervention, or otherwise put in jeopardy the price stability objectives of EMU just to facilitate convergence by less-disciplined States. Neither will they wish to incur heavy transfer payments to cushion the effects of closer integration in exposing structural weaknesses among the other two groups.

(ii) In contrast, Group II will have disparate economic policy objectives, not least in the exchange-rate field. As noted, for some their exchange-rate strategy will be fairly clear, being small open economies aiming to move closer to the core in terms of their structures, performance, and economic policies. They will therefore have a strong interest in linking their currencies more or less closely to Group I's currency, and will see little in the way of monetary independence to lose. This sub-group might include (in addition to Belgium, Finland, Denmark and Ireland), Sweden, Portugal, Iceland and Switzerland. However, for a few - Denmark, Switzerland possibly - political objectives may pull against full EMU membership, suggesting an interest in intermediate currency arrangements on their part, or at least arrangements which fall short of full EMU. For others, being larger economies, with some industrial similarities to the core but peripheral characteristics too - UK, Italy,

Spain and possibly Norway -their prefered economic linkages with the core group will be less clear. Generally, their economic interest in exchange rate stability against Group I is likely to be less compelling. But among them, Italy and Spain will continue to be strongly motivated towards closer political union, and therefore keen to join Group I in due course for that reason; whereas the UK will probably be much less enthusiastic about political union (as may Norway), and therefore chary about EMU on political grounds. Nevertheless all will have to respect the Treaty injunction to treat their exchange rate policy as a matter for common concern (Treaty, Article 109m); and all will probably wish to keep open their options to join EMU if they can be preserved without major sacrifice - and will therefore try to meet the exchange-rate criterion, especially if it evolves to give less emphasis to formal ERM membership.

(iii) Most Group III States will presumably have aspirations to join Group I eventually, but this is likely to be a relatively remote ambition and their main economic priority immediately will be to maximise their access to the Single Market and derive the maximum economic benefit from it. Most of them will therefore have a a strong interest in exchange stability against the core for trading reasons, in addition to having domestic price stability and other convergence objectives which will propel them in that direction. Close links with a strong external currency may well seem preferable to domestic targetry in countries whose own central monetary institutions are perceived to lack policy credibility. Finally, significant protective barriers affecting trade, payments and capital movements (quotas, tariffs, exchange controls) are likely to survive for some time among this group and this will facilitate exchange rate targetry as their policy focus.

5 The feasibility of pegged-but-adjustable regimes

Even before the troubles that hit the ERM in the present decade, it had become the accepted wisdom that fixed exchange rates are not compatible with free trade, open international capital markets and independent national monetary monetary policies - the well-known 'inconsistent quartet' (Padoa-Schioppa 1988). This perception was reinforced by the upsets in and around the ERM in 1992-3 and the first half of 1995, especially affecting currencies of Member States which continued to pursue independent monetary policies. However, pegged-but-adjustable exchange rates may still have something to offer in the liberalised market conditions confronting most EU currencies, if countries have similar inflation objectives and adopt broadly consistent monetary policies, but wish to retain flexibility to adjust to asymmetric shocks or structural divergences, while not wanting to be exposed entirely to market forces, which may produce 'bubbles and bandwagons'. Devices like broader bands

with soft edges, temporary suspensions of central parities, frequent small-scale adjustability of central rates, etc, as suggested by Williamson (1992,1993), may contribute an element of stability without inviting destabilising speculation. And, as noted, exchange controls and trade restrictions will help mitigate speculative pressure on the affected currencies. But, basically, successful pursuit of exchange rate stability requires freedom from major asymmetric shocks (including domestic shocks), or at least widely-diversified industrial structures and flexible labour markets. And countries which try to peg rates must be prepared mainly to subordinate domestic inflation/monetary objectives to pursuit of the external target, or follow domestic targets which are consistent with the anchor country's monetary target. National choices in this respect will turn on the relative efficacy and credibility of domestic versus external targets; this may depend in part on whether their central bank is politically independent or not.

6 Countries' approach to use of fiscal policy

Successful pursuit of formal ER stability also requires willingness to subordinate other national macroeconomic policies, especially fiscal policy, to monetary policy in the medium-long term, while putting a premium on use of fiscal policy as tool for stabilisation in short-medium term. This raises issues about rules versus discretion and autonomy versus co-ordination in fiscal policy field which are beyond the scope of the present paper.

III The succession to the ERM

The above considerations suggest that in all three emerging EU groups there will be majorities of States with an interest in developing a scheme of pegged-but-adjustable rates which would reform or replace the EMS, although such a scheme will not appeal equally to all States. Membership of the Single Market and acceptance of common convergence objectives will pull in favour of exchange-rate stabilisation, and formal arrangements are likely to be seen by many as desirable to provide adequate incentives and sanctions among such a large and diverse collection of States.

As compared with the status quo, the balance of power within any such scheme would inevitably shift to the core group, whose monetary policy would be dedicated virtually exclusively to internal price stability: and the 'new Ecu' (when it is finally adopted as Group I's currency) would become the anchor currency, much as the D-mark is now in the ERM. Experience suggests that if such a scheme is to be credible, there would have to be some provision for assisting countries that wish to peg to the new Ecu, at least to the extent of providing very short-term assistance with exchange market intervention when their currencies come under

temporary speculative pressure. More ambitiously, there could be a demand for longer-term assistance among countries required to make strong convergence efforts. This could take the form of medium-term balance of payments credits, which would appear a more appropriate form of response to cyclical problems or temporary asymmetric shocks than permanent transfers through the EU structural funds.

Several crucial differences can thus be envisaged from the EMS as it traditionally operated, ie. before the radical relaxation of August 1993:

1) Stability would be expressed with reference to one or more fluctuation bands around the new Ecu. These would define the positions at which intervention would take place. The present bilateral grid would disappear for formal policy purposes.

2) Fluctuation margins would be more flexible. A number of devices might be considered: target zones, softer edges, temporary suspensions of central parities, etc. One innovation that merits serious attention would be to introduce averaging of exchange rate deviations over periods such as a year or longer, as suggested by Johnson (1994). This would permit moderate temporary deviations beyond target bands, provided appropriate action were taken to correct them, and would leave market speculators with a less precise target to aim at than hitherto.[4]

3) Given the problems encountered by the Bundesbank as the principal VSTF creditor during the recent ERM crises, and the ECB's prospective concern with price stability, it seems unlikely that the EMU group would agree in such a scheme to finance obligatory unlimited intervention using the new Ecu, even for currencies which are at their floor against the latter. Assistance might have to be more akin to the limited, short-term, currency swaps which have long been available between central banks via the BIS. Currencies at or near their margins of fluctuation would qualify for such swaps, but only if their central rate in the scheme had been formally agreed by other participants by weighted majority vote, and judged on that basis to be sustainable in periodic reviews; and borrowers would defray lenders for any exchange losses incurred (in the event of devaluation).

4) Medium-term balance of payments assistance would be available, but conditional on a policy programme agreed with the lenders. Arrangements for

[4] Averaging would reduce but not necessarily eliminate the need to provide for exchange market intervention, because there may be shocks (for example, national elections or major strikes) that do not call for corrective policy action but have effects that do not wear off within the averaging period.

assessing policy conditionality and for drawing up, approving and monitoring borrowers' adjustment programmes would accompany the scheme.[5]

In other words, there would be a greater resemblance between the new scheme and the approach to currency stabilisation traditionally practiced by the IMF. The EU could even set up its own European Monetary Fund with functions resembling those of the IMF; the ECB might administer such a Fund, although it could not contribute its own resources because of the Treaty prohibition on direct lending to governments. The scheme would be open to all EU Member States and Associates, but membership would not be obligatory.

The advantages of such an arrangement would be several-fold. Firstly, it would recognise the reality of the new situation, in which the EMU Group would be the dominant economic and trading area, with much less emphasis on policy symmetry; secondly, it would give less of a one-way bet to currency speculators in periods of tension; thirdly, it would avoid the onus of assistance with intervention falling exclusively on the strongest-currency State; instead, the obligation to help with intervention would be shared more evenly, perhaps through some sort of quota arrangement, reflecting participants' relative economic size; fourthly, it would embrace the principle that exchange rates would be defended if they were judged by peers to be sustainable, and formalise the decision-making process in that respect. And fifthly, it would strengthen the element of medium-term financing available through the system, for which the Treaty makes some explicit provision (Article 109h) during Stage II. This Article will continue to apply for non-EMU participants during Stage III, for whom some balance of payments financing may still be needed in support of strenuous convergence efforts. Without continuing provisions of this kind, the potential burden on EU transfers to assist countries in transition could be significantly greater.

Countries would have the option of relating to the new system in one of several ways. They could choose to peg to a central rate against the 'new Ecu' within something like the old narrow band (of +/- 2 1/4%); or within a wider band (10%?). Some might choose to average deviations over a period of, say, 12 months, using either the mean or standard deviation. Some could pursue an announced target rate against the new Ecu, but without fluctuation bands; and some could float, while pursuing an announced objective of 'broad stability' against the new Ecu. Those with announced bands would qualify for short-term swaps, which could be rolled over if the recipient's central rate continued to be judged sustainable in the light of

[5] The underlying policy advice might be commissioned from the IMF, via a Fund programme according to the established IMF routine. Alternatively, policy advice might be provided by a special EU secretariat convened for the purpose, staffed jointly by the Commission and the ECB, which could provide the necessary technical expertise.

its policies; all would be potentially eligible for medium-term credits, subject to adopting and performing under agreed stabilisation programmes, much as now under IMF rules. All would be required to subscribe to an agreed code of policy behaviour (which would include consultation on both monetary and fiscal policies), on which both full and associate EU membership would be conditional. Such a code would help to focus the processes of economic policy consultation and surveillance provided in Article 103 of the Treaty.

Redefining the Treaty criterion

Inevitably for countries with ambitions to join EMU, the exchange rate criterion governing eligibility for Stage III will continue to be an influential factor affecting their exchange rate strategy. As it stands the existing criterion, agreed in the Maastricht Treaty, is unsatisfactory because its meaning is highly unclear, it does not suit the post-ERM crisis situation, and it does not apply equally to old and new members. The meaning of the 'normal band' of the ERM has been ambiguous since the major relaxation of August 1993, and States joining the EU after the Treaty was originally signed do not have to be formal members of the ERM to be eligible for EMU. Assuming that some exchange rate criterion is retained, it should be reframed to make it clear and relevant to the new situation.

Consistency with the thinking above suggests that the criterion should be recast after the formation of EMU to require broad stability against the EMU bloc for a minimum period (two years?). Stability should be defined as maintaining a root-mean-squared-deviation from the mean exchange rate against the new Ecu of not more than, say, 2.25%, measured weekly over a rolling 12-month period. A periodicity of 12 months for the calculation would give time for temporary shocks to be absorbed and for adjustment policies to work in response to more permanent shocks. A weekly 'stability index' might be calculated and published for each EU currency, so that the market would always know how currencies were performing against the criterion. The 'stability index' would become the standard exchange-rate indicator for convergence assessment.

IV Relations with the other major currencies

(a) External exchange rate objectives for the main EU Groups

As in the case of intra-EC arrangements, the various groups of States in a multi-speed EU will have somewhat different interests with regard to their exchange rates with the outside world. Group I States will be collectively less open to ROW than now, and so less interested in stability against an external currency on that account; and they will be very conscious of the internal price stability target and the ECB's commitment to it. Accordingly they would doubtless resist any commitment

for pegging to an external exchange rate, although they would have some interest in external stability as beneficial to trade provided it did not trespass on their price stability objective.

However, assuming the creation of a successful, low-inflation, EMU and the smooth adoption of a single currency, Group I States could well encounter nominal exchange rate appreciation, caused by shifts in international portfolio investment behaviour responding to the formation of EMU, and by disposal of surplus reserves of third currencies owned by participants. Although the bulk of these capital flows seem likely to be in the nature of stock adjustments rather than permanent flows, they could be quite large and protracted. The consequence could be a sharp appreciation in the new Ecu after Stage III, as has been noted in the EMU literature (Commission 1990, pp. 188-90.) Given also that Germany and several other candidates for Group I are likely to start EMU with uncomfortably high labour cost structures vis a vis most of the external world (see below), a real appreciation of the new Ecu would be a serious problem. They will therefore have a strong interest in minimising and if possible avoiding it.

Meanwhile, States in Groups II and III will remain as they are, in many cases very open trading economies, and more open to trade outside the EU, although not uniformly so. Most will have a stronger interest in exchange rate stability for trade purposes than Group I States, and as noted, several may wish to focus on links with a strong external currency for price stabilisation purposes. Others, (the UK, Norway, Switzerland possibly), may aim to retain significant domestic monetary independence, but will probably attach importance to stability in their overall 'effective' exchange rates, including the US dollar or other major currencies, reflecting their traditional trading and investment relationships. Thus although Group II and III States will be mindful of the case for exchange stability against Group I, not all of them will wish to focus on the Ecu exclusively, especially if it means greater instability against other major currencies.

Group II and III countries will be particularly reluctant to peg to the Ecu if it means appreciating against major external currencies. Like the EMU group, although to a lesser extent, some of them suffer from unsatisfactory competitiveness against third countries (see also below); and poor competitiveness is more of a problem, the more open an economy is to trade. A link to an appreciating Ecu would tend to worsen that problem, especially if Group II and III countries are less successful in stabilising their domestic prices than the EMU group. If given a free choice, some in Groups II and III might prefer to stabilise against the dollar rather than an appreciating Ecu, hoping thereby to minimise competitiveness losses against Japan and the rapidly-industrialising economies of South-east Asia. However the pressures on them to peg against the Ecu are likely to be strong, for economic (Single Market competitiveness) as well as political (EU integration) reasons.

This constellation of factors suggests that there will be incentives for cooperation on external exchange rate strategy between the various EU Groups. All will have an interest in minimising the appreciation of the new Ecu after the formation of EMU; and the more closely other currencies are linked to the Ecu, the less prone it will be to appreciate against the dollar when market sentiment moves against it. Even though Group I will be larger (in output terms) and less open, and therefore less economically dependent on the rest of the EU, its members will have a strong interest in persuading the other two groups to stabilise against the Ecu rather than against third currencies.

(b) A concerted strategy for the larger EU?

If a concerted exchange-rate strategy for the enlarged EU is possible, it should no doubt concentrate on achieving broad stability for the new Ecu and its linked currencies against the other two major global currencies, in the sense of avoiding large, unpredictable, movements not justified by major shocks. However, such a strategy should be subject to two qualifications. Firstly, the real exchange rates between the key currency blocs should be broadly stable (apart from responses to permanent shocks). With nominal rate stability, this implies either that inflation in the US and Japanese blocs should, ideally, match the price stability which the EMU bloc is assumed to achieve, or at least that the inflation differences between major blocs should be small in the long run, so that exchange rates between them can adjust in a smooth and predictable way.

Secondly, the real exchange rates thus established should be sustainable in the long run, ie they should imply rough parity of common-currency unit production (essentially labour) costs between the tradable sectors of the major blocs. To the extent that this is not the case, the EU should seek adjustments to bring costs into closer alignment, allowing for the possibility of feedbacks on domestic inflation. The evidence suggests that 'European' costs are at present competitive on average against Japanese costs, but uncompetitive against US costs (see Table 2, and Taylor 1995, Chapter 7). This reflects the yen's massive appreciation against the dollar in recent years. The EU's position against the two key currencies combined is less clear but, since Europe does more trade with the US bloc than the Japanese bloc, the EU as a whole is probably uncompetitive in 'effective' (trade-weighted) terms overall. If so, it will be in the EU's collective interest to encourage an appreciation of the dollar against the yen in the short-medium term, while contriving some depreciation of the EU currencies against the dollar, until relative costs are more closely matched. It has been shown that concerted, well-publicised, intervention by the major central banks has been effective from time to time during the past 15 or so years in correcting misalignments between the dollar and other major currencies, but only if policy stances in the relevant economies are supportive (Catte et al., 1992). Fundamental adjustments in Japanese and US trade policies, and probably in

their fiscal policies, would be a necessary ingredient for lasting correction of the existing imbalance between their currencies, and the EU should certainly throw all its negotiating weight behind international efforts in that direction.

(c) Implications for international consultative arrangements

The advent of a 'small-group' EMU and the emergence of other groups in a multi-speed EU will almost certainly mean some reconsideration of international arrangements for exchange rate consultation and cooperation. Within the EU there will be pressures, boosted by enlargement and the consequent proliferation of numbers, for States to align themselves into groups for purposes of currency negotiation; logically these alignments should match the three groupings described earlier. The major economic powers outside the EU are likely to wish to deal primarily with Group I collectively rather than the European majors individually because of its economic strength and because the new Ecu will be regarded as a global currency on a par with the dollar and yen. (As can be seen from Table 1 Group I's GDP is not far short of Japan's GDP when measured at market exchange rates, and might be larger if measured at 'PPP' exchange rates). These developments may well have implications for arrangements in the principal global exchange rate fora - the G-7 and IMF - and possibly in other organisations such as the OECD.

As explained earlier, in Stage III the formulation of external exchange rate policy for the new Ecu will be a matter for finance ministers from the EMU Group, whose decisions will be by qualified majority. Non-participants in EMU are specifically excluded from this function; any influence they can exert on exchange rate policy for the new Ecu, and on the EU's other exchange rate arrangements, will presuambly have to be brought to bear within ECOFIN. This will obviously put non-participants at a considerable disadvantage in negotiations between EU States and the ROW on currency matters; non-EMU participants will not have a formal locus in such negotiations. This will create pressure on Group II and III States to concert among themselves on currency issues, and subgroups could emerge, meeting before, or on the fringes of, ECOFIN plenaries. (Corresponding subgroups could emerge in the Economic and Financial Committee, the officials' committee which will replace the Monetary Committee when Stage III starts.)

The importance of the Ecu as a global currency and the polarisation of groups within ECOFIN will almost certainly raise questions about the format and even the continuation of the G-7 as the premier forum for consultation on exchange-rate and related matters between the major economies.[6] One approach would be to convert the G-7 into a smaller forum, the 'G-3', encompassing the dollar, yen and new Ecu,

[6] The G-7 comprises the USA, Japan, Germany, France, the UK, Italy and Canada.

the latter being handled by representatives from Group I (presumably a finance minister from one of the EMU States in rotation, and the president of the ECB[7]). This would mean Germany and France merging their representation with that of the other Group I States; and Italy, the UK and Canada losing theirs altogether.

An alternative which would be less unattractive to the UK and Italy would be to replace the G-7 by a G-4 forum, with the fourth 'seat' going to the non-EMU EU States. This might be justified on the basis of their economic importance but, to carry conviction, the members of those groups would have to demonstrate true ability to concert their policy interests in the exchange rate field. No doubt Canada would feel aggrieved at being excluded from such a forum but unless and until the membership of the rest of the NAFTA grows to include, say, additional Latin American majors in an enlarged 'Free Trade Association of the Americas' it would hard to make a case for Canadian representation on a remodelled forum of the major currencies.[8]

The implications of a multi-speed EU for arrangements in the IMF and OECD can be expected to be less far-reaching in the foreseeable future because they are large and relatively inflexible organisations, where changes in patterns of membership and representation happen fairly slowly and require the consent of more than just a few major countries. For example, none of the EU majors which presently have separate seats on the IMF Executive Board (Germany, France and the UK) could be expected to give them up without a considerable struggle, and the voting majorities needed to remove them might be hard to put together, despite the changes taking place in global economic power balances. Even so, after EMU is launched, these international organisations will probably feel impelled to seek effective links with the EMU bloc as a single entity, without which it will be difficult to hold meaningful Article IV-type consultations or other surveillance exercises. This could lead to some rationalisation of the consultative arrangements operated by these organisations, such as G-10 meetings in the case of the Fund and Working Party 3 meetings in the case of the OECD. Re-modelling would probably move in the direction of amalgamating the representation of the EMU group, and this in turn might well imply some streamlining of the representations of other major currencies, including those of EU States outside EMU.

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[7] The ECB president's position as the 'permanent' EU spokesman representing the ecu should mean that he has more influence on the new forum's proceedings than central bank governors presently have in the G-7.

[8] At present the combined GDP of the rest of NAFTA (ie. Canada and Mexico) is less than that of Italy or the UK individually).

In that case, a key challenge for those States after Stage III would be to seek adequate representation on the re-modelled fora that emerge, whether successors to the G-7, G-10, WP3, etc. This might not be easy, as Group I States are unlikely to be sympathetic, and neither is the Commission: multiple EU representation would cut across the objective, enshrined in the Treaty, to present a common policy front externally, in part so as to maximise negotiating influence, and in part because unity is thought essential to the exercise of 'Community competence'. Furthermore, there is the danger that diversity of economic and political objectives among Groups II and III States will detract from their bargaining influence; States which are keen to join Group I are not likely to be solid supporters of exchange rate flexibility for others. Nevertheless, without some form of diversified representation in rationalised international fora, external exchange rate policy for a multi-speed Europe is likely to be conducted exclusively in the interests of the Group I States, and this should provide a strong incentive for those outside EMU to sink their policy differences.

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Table 1: Basic Economic Indicators

Country	Population million, 1993	GDP US$ bn., 1994(a)	Per capita GDP US$bn., 1994(b)	Exports of goods and services % of GDP, 1993(c)
EU core-5				
Austria	8.0	196	19.8	38
France	57.7	1327	19.5	23
Germany	81.2	2041	19.3	22
Luxembourg	0.4	14	30.1	86
Netherlands	15.3	329	18.2	51
Subtotal	162.5	3907		
(% of EU-15)	(44.0)	(53.4)		
Other EMU probables				
Belgium	10.0	227	20.4	69
Denmark	5.2	145	20.3	35
Finland	5.1	97	16.4	33
Ireland	3.6	52	14.9	68
Subtotal	23.8	522		
(% of EU-15)	(6.4)	(7.1)		
EU 'periphery'				
Greece	10.4	78	11.1	22
Italy	57.1	1025	18.5	23
Portugal	9.9	87	12.2	24
Spain	39.1	483	13.8	19
Sweden	8.7	196	17.3	33
UK	58.2	1016	18.1	25
Subtotal	183.3	2884		
(% of EU-15)	(49.6)	(39.4)		
EU-15	*369.7*	*7313*		
Possible ex-EFTAn candidates for EU				
Iceland	0.3	6	20.0	33
Norway	4.3	109	20.3	43
Switzerland	6.9	260	23.9	36
Subtotal	11.5	375		
(% of EU-15)	(3.1)	(5.1)		
Mediterranean candidates for EU				
Cyprus	0.7	8*	10.4*,**	47
Malta	0.4	3*	8.0*,**	94
Turkey	59.5	126	5.1	14
Subtotal	60.6	135		
(% of EU-15)	(16.4)	(1.9)		

(Continued)

Table 1 (continued):

'Visegrad Four'				
Czech Republic	10.3	32*	7.6*	55
Hungary	10.2	38*	6.0*	30
Poland	38.3	86*	5.0*	19
Slovak Republic	5.3	11*	6.3*	67
Subtotal	64.1	166		
(% of EU-15)	(17.3)	(2.3)		
Other possible CEEC candidates for EU				
Estonia	1.6	5*	3.1*,**	57
Latvia	2.6	5*	5.0*	67
Lithuania	3.7	4*	3.1*	71
Bulgaria	8.9	10*	4.1*	50
Romania	22.8	26*	2.8*	23
Slovenia	1.9	10*	6.5*,**	63
Subtotal	41.5	61		
(% of EU-15)	(11.2)	(0.8)		
North American Free Trade Association				
Canada	28.8	544	20.5	30
Mexico	91.2	376	7.1	13
USA	257.9	6650	25.6	10
Subtotal	377.9	7571		
(% of EU-15)	(102.2)	(103.5)		
Japan	124.7	4582	20.8	9
(% of EU)	(33.7)	(62.7)		

Notes

(a) At current prices and market exchange rates.

(b) At current prices and 'purchasing power parity' exchange rates.

(c) Exports of goods and non-factor services (ie, including c.i.f., travel, etc., but excluding interest, investment and labour income), as % of GDP at current market prices.

* 1993

** At current prices and market exchange rates. (PPP rates not available.)

Sources
OECD, Main Economic Indicators, March 1995; World Bank, World Development Report 1995 and World Tables 1995.

Table 2: Relative unit labour costs in manufacturing, selected industrial and developing countries[1] (Europe = 100)

Country	1990[2]	Oct. 1992[3]	Oct.1995[4]
France	100.3	103.9	102.4
Germany	107.3	125.1	124.6
Italy	93.7	78.5	77.6
UK	101.5	92.3	92.6
Belgium	93.4	91.5	89.3
Netherlands	84.3	94.4	91.5
Sweden	102.4	77.5	79.8
Europe[5]	100.0	100.0	100.0
USA	69.9	73.1	
Japan	77.3	121.3	
South Korea	32.3	34.4	
Taiwan	54.9	59.4	

Source

Taylor (1995), Table 7.7

[1] Average hourly compensation in manufacturing industry divided by output per man hour, valued in a common currency at purchasing power parity exchange rates. Relative to average for 'Europe'.

[2] Estimates for 1990 (year) and Oct. 1993 from Turner and Van't dack (1993), Table 15, rebased to give 'Europe' = 100.

[3] Estimates for 1990 (year) and Oct. 1993 from Turner and Van't dack (1993), Table 15, rebased to give 'Europe' = 100.

[4] Author's projections, derived from EC Commission forecasts of changes in whole economy unit labour costs, adjusted for relative trend productivity growth in manufacturing. Assumes no overall change in exchange rates, Oct. 1993– Oct. 1995.

[5] Weighted average of above seven countries, using PPP-valued GDP weight in 1990 (see Turner and Van't dack 1993).

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