

# **EMU : the First Four Years**

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**Abstract** The Economic and Monetary Union (EMU) has been in operation since 1 January 1999. This paper offers an assessment of the European Central Bank's policy in this period of nearly four years and reviews the problems with fiscal policy that have recently erupted in the Eurozone. It also looks at developments in financial markets in this period.

## **1. Introduction**

By any standards the creation of the EMU<sup>1</sup> and its institutions was a remarkable event. The founding countries' political commitment to the project has confounded the scepticism of many hard-boiled economists. Nor - despite a number of apprehensions - has practical experience of a single monetary policy for the countries of the Eurozone yet led to obvious disasters, missed opportunities or drastic tensions among the member countries.

Indeed, the perceived success of the Union probably helps explain the current fashion for similar arrangements such as currency boards, 'dollarisation' and 'Euroisation'.

Nevertheless, it has to be said that conditions so far - though not without some testing shocks - have been relatively favourable. Only quite recently has a less favourable environment emerged, and some strains are showing in the Eurozone's fiscal framework. The hoped-for long run benefits of monetary union in Europe- in terms of more productive investment, faster growth and more complete financial markets meanwhile, are hardly yet in sight. Concern can be voiced at the lack of flexibility of EMU institutions. Built to carry forward the Bundesbank's successful fight against inflation, they may be ill adapted to conditions of threatened deflation.

We begin by noting the immediate background to the formation of the Union, the early favourable experience of the transition period and the clarifications that were made regarding the policy targets of the European Central Bank (ECB), its operating strategy and operating instruments. In the subsequent section we will briefly summarise the experience of ECB monetary policy in the period since the introduction of the common currency. Then we turn to some of the contentious issues; those of transparency and accountability; and of policy coordination with the fiscal authorities. Finally, we look at the evidence that some of the long run benefits of monetary union in Europe may be coming about.

## **2. The Beginning**

The membership of the European Monetary Union was determined at the meeting of the Council of Ministers in May 1998, in line with the criteria outlined in the Treaty of European Union (Treaty of Maastricht) and in the line with the injunction in the Treaty that the formation of monetary union should not be delayed beyond 1999. The criteria were applied in a flexible fashion, especially in respect of the criterion referring to the debt/GDP ratio.

That criterion specified that a country's debt/GDP ratio should not exceed 60% 'unless the ratio is sufficiently diminishing or approaching the reference value at a

satisfactory pace'; in fact only three countries (not counting the UK) had debt/GDP ratio less than 60% (these being France, Luxembourg and Finland), some had ratios in excess of 100% (Italy and Belgium) whilst Germany's ratio was rising, not falling. Nevertheless, in respect of other criteria – the conformity of inflation and long-term interest rates for example, and the ratio of the budget deficit to GDP – all the countries were in the clear, with the exception of Greece. (Greece was to qualify later and joined the EMU in 2001).

Except in the case of a negotiated opt-out, the Maastricht treaty is designed to *oblige* a country to join if it satisfies the criteria; accordingly, the UK and Denmark exercised their opt-outs whilst Sweden deliberately failed to satisfy the exchange-rate criterion by not participating in the Exchange Rate Mechanism (ERM) of the European Monetary System.

Having determined the composition of the Union, the Council of Ministers also determined that by the end of the calendar year 1998 the cross exchange rates of these countries should be at the level prescribed by their central values in the ERM arrangement. It might be argued that Ireland should have again appreciated its currency, but it either did not want to do so or was dissuaded from this course of action. One result, as noted below, is that Ireland was plunged into a weak exchange rate, low interest policy at the start of EMU with a resultant increase in inflationary pressure. Germany, arguably, launched into EMU at an overvalued exchange rate and has suffered relative stagnation as a result. Given the decision, the ECB had to orchestrate a phased reduction in the initial quite wide dispersion of policy rates among the Central Banks concerned, in a way that maintained the credibility of the exchange rate commitment given that by the beginning of the following year (1999), there would be a single common policy rate.<sup>2</sup> Some sophisticated observers maintained a scepticism about whether this could be done, almost to the end (e.g. Obstfeld, 1998). But it was. There was no resort to any defensive intervention arrangements. Speculators supported the authorities in their targets.

In addition to managing this transition, the ECB took the opportunity to clarify its operating targets, strategy and method of working. The Treaty governing the ECB gives it a mandate: its 'primary objective' is to maintain price stability; subject to this, it is encouraged to support the general economic policies of the Community. Price stability has to be defined: the ECB defined it as an increase of the level of the Euro-Area harmonised consumer price index (HCPI) of not more than 2%, to be realised 'over the medium term'. This ceiling is a very little more than the index bias induced by the fact that quality improvements are undervalued in measured price indices. The 'medium term' qualification seems to be very important. Dependent upon its definition it could be maintained that a 2% ceiling might be too low to accommodate the operation of Balassa-Samuelson effects in developing countries of the union without inducing deflation in leading countries; and might be too low to be optimal in economies that exhibit substantial downward rigidities in wage and price behaviour. In practice, there have been many months from March 2000 on, in which HCPI inflation has exceeded 2 per cent- in fact, in almost every month until June 2002 when inflation dipped below 2 per cent again.

The Treaty does not expressly envisage the optimality of a low rate of inflation and, instead, directly specifies the objective of price stability; with the additional flexibility of the 'medium term' horizon, the ECB could be argued to have interpreted the treaty in as flexible a way as is reasonably possible. The Treaty goes on to allow that, without prejudice to the achievement of its primary objective of price stability, the

ECB should assist in the realisation of other Community policy objectives. There has been no public discussion by the ECB of this secondary objective.

The ECB's statement of its monetary strategy has been found less than adequate by a number of critics, although the criticisms themselves are inconsistent. In what can be seen as an attempt to 'inherit the mantle of the Bundesbank', the ECB set out its strategy as consisting of 'two pillars'; the first of these, known as the 'monetary pillar', consists of 'a reference value' for monetary growth, and the second an open-ended list of inflation indicators. The complaint against this is that it gives a separate role for monetary growth and fails to specify what will happen in the event of a clash between the indications given by money growth and those given by other indicators; at the same time, those observers who want a stronger role for monetary indicators are also dissatisfied because the monetary pillar does not specify a target for monetary growth but only a reference value. In the event, the ECB has frequently allowed overruns of its monetary growth referent (as it has of the 2% price inflation ceiling), which seems to disarm the potential criticism that the monetary indicator could be misleading but adds to a lack of clarity. Whether the lack of clarity in total is significantly greater than attaches to the policy of the Bank of England, the Federal Reserve or other Central Banks, is debatable, even if market comment sometimes – even frequently – suggests otherwise. It is clearly impossible and undesirable to replace discretion by a pre-formulated rule and all the more so in a situation in which major features of the economy are 'new'.

### **3. The Monetary policy Record**

The main tool of the ECB is its 'main refinancing rate'. Its path is shown in Figure 1, where it is compared to the analogous 'federal funds rate' of the Federal Reserve. Figures 2, 3 and 4 show the outcomes for growth and inflation in the Euroland economy as a whole and in the individual member countries. The figures shown for 2002 are based on recent forecasts from the National Institute of Economics and Social Research (*National Institute Economic Review*, September 2002).

The history is a simple one to summarize. The ECB began full operations against a background of concern about the effects on the world economy of the South East Asian foreign exchange rate crises. The refinancing rate finally set for the start of operations, at 3%, was already well below the figures that market participants and analysts had expected during the course of 1998. The continued concern about the outlook for the world economy resulted in a further cut in April 1999; this cut took place after the resignation of the controversial German Finance Minister Oskar Lafontaine and some speculate that the cut was postponed until this time because of a perception that it might otherwise have appeared as a concession to his well-ventilated demands for such a reduction. Whether the cut was really necessary is, however, unclear, since the case for increasing the main refinancing rate soon became well-established as evidence grew of resumed output growth and inflation. This promoted a series of interest rate increases throughout 1999 and 2000 that did not begin to be reversed until May of 2001 after which further cuts were made through the remainder of that year. The rate has so far remained unchanged throughout 2002.

The outcome is shown graphically in Figs. 2, 3 and 4. The arrows shown in these figures have their origin in the base year (e.g. 1999 in Fig.2) with the point of the arrow showing the second year position (e.g. 2000 in Fig.2). During 1999-2000, there was strong output growth throughout the Euro-area, accompanied by a rise in inflation. The position of Ireland was clearly particularly anomalous, but Finland, Spain and the Netherlands also stand out on the 'up-side' of the European expansion.

In 2001, inflation showed somewhat whilst output growth fell quite substantially. This decline in output growth, again with some decline in inflation, persisted throughout 2002. The global shock that initiated this period of output growth decline in 2001 evoked a sharper fall in the federal Funds rate than in the ECB's Main Refinancing Rate: see Figure 1. This provoked the suggestion that the ECB was reacting in more laggardly fashion than the Fed. A group of authors reporting for the CEPR, however basing themselves on Uhlig (2001), drew the conclusion that the two different interest rate tracks could have been produced by the same reaction function. The sharper Fed reaction, in other words, was due solely to the fact the deflationary shock was sharper and bigger in the US than in Europe.

The less enjoyable conditions of 2002 have been more evenly experienced across the Eurozone than the more buoyant conditions of 2001. As a summary measure of the convergence in macroeconomic conditions in the Eurozone we have computed the "Taylor-rule-indicated" interest rate for each country and then calculated the variance and coefficient of variation of these interest rates. Figure 5 shows the position in 2002. The dispersion clearly shows the contrast between the stagnant economy of Germany and the still-buoyant Irish economy. Still, the Taylor-rule is not being invoked here so much as an optimal rule as it is a weighting for output growth and inflation. In this light, the evaluation of the dispersion of the Taylor-rule-indicated interest rates could be regarded as marking the progress of convergence among the economies. Figure 6 and Table 1 show the variance and coefficient of variation of the Taylor-Rule -indicated interest rates from before the formation of the EMU to the present time. It stands out clearly that a process of convergence was strongly reversed in 2000, perhaps partly due to the 'Procrustes' effect of the introduction of a single monetary policy<sup>3</sup>. Figures for 2003 rely on forecasts from the OECD and the National Institute for Economic and Social Research in London.

The main feature of the first 2-3 years' experience is that of the 'upside deviation': the experience of growth faster than sustainable and inflation faster than the desired 2% is not an unpleasant one and the countries experiencing these combinations most strongly have been relatively small ones. They cannot influence the ECB's policy that is set for the Euro-area as a whole, but at the same time they probably do not feel outraged by ECB 'neglect' of their situation. In this sense, the underlying conditions were favorable to the reception of the ECB's policies and no notable tensions between countries then emerged. There has been a marked change in climate since the global IT shock of 2001, where – as reflected in Figure 4, Germany has suffered from comparative stagnation, whilst the fiscal policy framework has shown clear signs of tension, as discussed below in section 5.

Most discussions of ECB policy hitherto have devoted some space to the behaviour of the Euro exchange rate (Fig. 7 shows the course of the Euro/\$ exchange rate). The initial decline proved hard to explain (see Koen *et al.* 2001) and the more recent recovery has proved no less simple to rationalize – except, as the overdue reaction to a prolonged period of undervaluation. The causes of this deviation are not easy to pin down. Some of the explanations proffered have been used as sticks with which to beat the ECB (and the EU more generally). For example, it has been argued that the lack of a single fiscal authority is a key weakness, or that the observed flow of investment from Europe to the US is a reflection of Europe's failure to reform itself – and so on. These arguments are unpersuasive but so also have proved the more

traditional ‘fundamentals’ arguments. The persistent decline in the Euro through 1999 and 2000 was, however, something of an embarrassment to the ECB and led to some tergiversation in policy. Initially, strong claims were made that the correct policy was one of benign neglect and that intervention in the foreign exchange market could, in any case, do nothing useful. Then there came bouts of intervention, some multilateral and some unilateral in September and again in November 2000. These appeared to leave little permanent mark whilst their execution and explanation left much to be desired (Koen *et al.* 2001). Altogether, the episode did not redound to the ECB’s credit: though it may not have done much harm.

#### **4. Transparency and Accountability**

The constitution of the ECB specifies a large amount of independence from national governments and Community institutions: in the small academic industry of ‘Central Bank Independence (CBI)-scoring’ (e.g. Berger *et al.*, 2000; Cubierman *et al.*, 1992) the ECB comes out as the most independent of Central Banks. This, of course, is no accident. The design follows the fashion in academic investigation of inflation control and, more important, the example of the Bundesbank. Not surprisingly, though, it seems that CBI-scoring and accountability-scoring are generally inversely related (Berger *et al.*, 2000). Since Central Bank power is so important, it seems deeply unsatisfactory that its control should be so far removed from democratic institutions: this is the problem of the ‘democratic deficit’. In fact, it is not so easy to see how this deficit can be satisfactorily removed in current European conditions: in principle, a credible European parliament could provide the basis for accountability but this institution’s own credibility has yet to be assured. Inviting national governments to assume a position of power over the ECB would, on the other hand, run clean against the thrust of CBI-advocacy.

Susanne Lohmann has emphasised in various writings (but see Lohmann, 1995, in particular) that economists’ notions of what makes Central Bank independence can be over-formal and that successful central Banks need a constituency of support in order to operationalise their independence. From this point of view, the ECB’s independence still remains paper-thin. Whilst there is nothing it can do alter the formal statutory position, even if it wanted to do so, the ECB can substitute transparency for accountability and, to an extent, has done so. In particular, the ECB has decided to publish the *Monthly Bulletin*, offers frequent press conferences and has made a point of cultivating the European Parliament and uses hearings before that institution’s Economic and Monetary Affairs Committee as a forum at which to explain itself. At the same time, as explained below, it has been able to use the Stability and Growth Pact as a shield against interference from national governments. However, its gestures towards accountability have been treated as insufficient by some (see Buiter, 1999, in particular) and the ECB has refused to offer topical release of the minutes of meetings or an attributed voting record. Pressured by the Economic and Monetary Affairs Committee of the European Parliament to produce its inflation forecast, it finally did so with what looks like an ill grace, in that the forecasts are formally attributed to the ‘staff’ and stated not to be a decision tool. All of these alleged backslidings can be defended in one way or another. It is not clear that releasing the voting records would contribute to better decision-making when the composition of the Governing Council (the governors of the national Central Banks and the members of the Executive Board) reflects so strongly national differences and it is also not clear that the publications of the minutes in these circumstances would do more than drive ‘the real discussion’ underground. The analogue of the Bank of

England's procedures and its monetary Policy Committee is less helpful than it might seem, since the composition of that committee is not designed to reflect the vested interests of the day but rather a spread of expertise. Nor is it clear that 'the inflation forecast' is a useful concept: that it might be so gains currency from Svensson's (Svensson 1997) characterization of this forecast as 'the intermediate variable' of inflation targeting. The ECB would, and does, deny that it is an inflation targeter; in any case, the intermediate variable function can only be served by a forecast that is unconditional (i.e. incorporates the Central Bank's own reaction to the events foreseen) and is perhaps not best produced by the Central Bank itself.

The ECB has, however, been roundly criticised by several authorities and institutions (see for example, Koen, 2000 and OECD, 2000) for weakness in its communication strategy. It is certainly possible to identify a number of occasions when communication has been less than perfect (the foreign exchange market intervention issue identified above is only one of them). Still, the bottom line is whether or not the results of the policies pursued have been broadly acceptable; there is no substitute for a good track record.

## **5. Fiscal Policy, the SGP and Policy Coordination**

The European Central Bank can help set the overall macroeconomic environment in Europe but when it comes to individual country adjustment relative to the average, there is nothing that it can do: this burden falls on individual country adjustment policies, principally fiscal policy. A 'coordination' between fiscal and monetary policy seems to be an obvious requirement since the two are close substitutes. The Stability and Growth Pact (SGP), indeed, provided a form of 'negative' or 'rule-bound' coordination. Under the terms of the SGP, countries agreed to continue (as they had under the terms of the Maastricht Treaty) to observe a maximum of 3% in their deficit/GDP ratios. To this was added a formal procedure for notification of default, leading eventually to the imposition of a fine in the event of continued default. In addition, the countries agreed to aim for a medium term position of 'balance or small surplus'.

In the first three years or so of EMU, the SGP – despite initial misgivings (e.g. Allsopp and Vines 1998) seemed to work well. Yet countries failed to take advantage of the 'good times' to pay off their debts and consolidate a strong budgetary position. As a result, in the weaker conditions of 2002, the SGP has begun to cause frictions. Portugal has been revealed to have violated the 3% budget deficit ratio ceiling, whilst Germany is on the verge of doing so. France, Italy and Germany all demonstrated an inability to hit the medium term target originally laid down for 2004.

It is clear that the SGP in its current form cannot last. For one thing it is so evidently a stop-gap, negative, measure that it cannot measure up to the inclination of governments for some positive policy coordination measures, between themselves and vis-à-vis the ECB. The ECB has not publicly opposed such moves but it has equally not sponsored any. There must be more than a suspicion that the ECB would view moving beyond the SGP with hostility, and as abandoning an effective and credible protection for the (possibly false) promise of a 'positive co-ordination'. The kinds of argument that might appeal to the ECB in this context are in fact put forward in the recent CEPR publication in its series '*Monitoring the ECB*' (Alesina *et al.*, 2000). The report downplays the extent of externalities in Euro-area fiscal policies, and plays up the dangers to the ECB of being overwhelmed by the combined weight of politically untrustworthy Euro-area governments. The strong likelihood that there will, in fact, be

a move in the direction of positive policy coordination suggests the realism of the ECB taking, in fact, a less hostile stance than the one recommended in the CEPR report. It is also important to recall that one of the lessons of the post-Plaza Accord international coordination effort was that positive differences about objective matters (the signs of policy multipliers, the base forecast) were just as important, if not more so, than differences in ‘tastes’. The comparison and reconciliation of opposing forecasts, for example, could be a fruit of a positive coordination of policies, which could protect the ECB from damaging criticism stemming from technical mistakes.

## 6. The European Financial System

What of the larger effects of the creation of the European Monetary Union? It has been argued that the creation of a monetary union in Europe would considerably enhance the consequences of the formation of the European Union for trade and output (see e.g., CEC 1990). There are some more recent contributions to the literature which argue for very large effects of the creation of monetary unions for trade between the participating countries (e.g., Rose, 2000) but it is not clear how representative the results in question could be for the European economies. In any case it is too early to be able to detect and attribute to the formation of the EMU any effects on trade as such. But one might hope to be able to detect such effects more rapidly in the financial markets. The significance of such effects could moreover be quite substantial. Two particularly significant effects can be mentioned.

First, so far as concerns the possible international role of the Euro, it has been argued that a *sine qua non* is the presence of a large liquid market in sound paper, such as that provided by government bonds (McCauley 2000). From this point of view, it is a source of gratification that the Euro government bond market is larger than that in the US. Moreover, the enlargement effects have spilled over to the commercial bond market; probably the large bond issues associated with bidding for the UMTS licences would not have been feasible in Europe before the advent of the Euro (though this has obviously been a mixed blessing). However, the follow-on effect for the establishment of an international currency role has not yet been observed and the more bullish of these appreciations (e.g., Portes and Rey, 1998) have, to date, been disappointed.

The second important effect that might be hoped for is a considerably enhanced ability of the financial markets in Europe to offer a means of risk-spreading and income insurance. Work by Oved Yosha and various colleagues (e.g. Yosha and Sorensen (1998)) has drawn attention to the potential importance of integrated capital markets for the execution of these functions. The creation of a more integrated capital market would make less troublesome the evidence of continuing inhomogeneities in the stochastic experience of the member countries of the EMU, providing a source of insurance which could in principle be performed by fiscal mechanisms which in the European context have not been adopted.

In practice the experience has been curiously diverse. In the bond markets, integration was quickly achieved, in the retail banking market progress has, if anything, been negative. The equity markets are “in between”. The negative progress in retail banking markets is possibly temporary. A comparative absence of cross-border banking mergers has been accompanied by an increase in intra-border mergers; these may have a defensive connotation, and to that extent simply betoken a later increase in cross-border merger activity. But there is reason to be sceptical: in

Europe the assignment of responsibility for the maintenance of competition and for bank supervision often effectively falls to national Central Banks which naturally tend to “look after” their domestic constituency of banks. Domestic mergers may be promoted for reasons of efficiency and to deter foreign cross-border mergers. Meanwhile, it has taken regulatory intervention by the Commission to ensure that cross-border clearing charges are not more onerous than intra-border charges – something which naïve expectations had expected to be produced by competition. If the story from the banking market is far from satisfactory at least in the equity markets the frustration of expected gains has led to the setting-up of the Lamfalussy Commission which has examined the myriad of small and large differences between stock exchange regulations in different countries and made positive suggestions for their removal.

## 7. Conclusions

The European Monetary Union has worked better than many expected. And the period has not been without some significant shocks – from the fall-out from the South-east Asian foreign exchange rate crises to start with, to the IT shock of 2001. Shortly there will be needed an adjustment to the enlargement of the European Union to embrace ten more countries from further East. A significant component in the continued success of the EMU must be a reform in, and a reaffirmation of the credibility of, the Eurozone’s fiscal framework. This may require a constructive role on the part of the ECB, which it has been shy of demonstrating so far. Critics are prone to add a further caution. The set up of the EMU and the statutes and the operating procedures of the ECB demonstrate an overriding concern with the control of inflation; the ECB’s independence, the monetary pillar and the (by international standards) conservative inflation target all point in this direction. Yet there is a danger of deflation lurking ‘in the wings’, a possibility at least that output growth needs more attention. Critics hold that the institutional design of the EMU may not be adequate to this challenge. But, this may be yet another case where critics of the ECB got it wrong – as they have done before.

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## Notes

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<sup>1</sup> Strictly speaking the mnemonic EMU stands for Economic and Monetary Union, but it is natural, as well as common, to think of it as standing for European Monetary Union.

<sup>2</sup> This wide dispersion guaranteed that the individual member countries could not be similarly served by a common monetary policy.

<sup>3</sup> According to legend Procrustes was an inn-keeper who reduced or lengthened his guests by force to the length of his single available bed.



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