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Euro-zone, Emerging Markets and Global Economic Integration – A Study of Opportunities and Threats in the Context of the Current Financial Crisis

Abstract

The introduction of Euro as a single currency was expected to achieve significant competitive advantages for the member countries and far reaching financial strategic implications to the emerging market world including India Inc. On January 1, 1999, the euro was introduced for non-cash settlements, while on January 1, 2002 euro cash was issued in to circulation. Much as the great competitive gains were placed in the euro before its introduction, the euro-zone market performance has been not all that impressive as expected on account of the structural rigidities and global financial conditions. At the same time euro has its impact on global economy, international capital markets and the prospects of emerging market world. Further its impact on firms in emerging markets and their financial and business strategy has been enormous. And it makes imperative to study the Euro-zone market dynamics in the context of the current global financial crisis.
Accordingly this paper is divided into five sections. The first section gives an account of European integration and its impact on Emerging markets such as India and its business and industry. The second section is an attempt to analyze the possible implications to foreign trade, investment flows and growth prospects. The third section examines the impact of the European integration and macroeconomic policies pursued by EU on emerging markets, and how that impact may evolve in the future. The fourth section examines the mega-implications of the European integration and macroeconomic policies pursued by EU to global economy, equity and bond markets in Europe and the rest of the world. More importantly, the paper also critically examines the progress made by the union towards true market integration and its resilience in a situation such as the current financial crisis and the regional down-turn, apart from providing summary and concluding remarks.

Keywords: *Euro-zone, emerging markets, global economic integration, threats, opportunities, crises.*

Current Financial Crisis and Global Economic Integration

The European Union (EU) is the association of countries formerly called the European community (EC) and prior to that known as the European Economic Community (EEC). The EEC became the EC when the issues handled in common moved from mainly economic and trade matters to include social and political aspects. EC became the EU when common tariff levels were applied by all members to outside countries and tariffs among the member countries were removed[1] – EC transformed into a Customs Union (Levi D. Maurice, 1996).

The European Union (EU), which came into existence on 1st January 1993, is a major event in international political and economic relations and has caught the attention of the world. The collapse of the erstwhile USSR and the dramatic turn of events in Eastern Europe have significant bearings

on North-South Relations as the countries of South undergo fundamental changes. Against this backdrop, the construction of the EU and its impact on developing economies in the context of changing North-South relations provide an interesting agenda for research, which is beyond the scope of this particular paper.

"The process of construction of the Union involved radical changes in the economic, commercial, trade and external policies of the EU. These changes, although mostly internal, would have significant implications for all other countries in relation to the Community, the issues in contemporary North-South relations and trade prospects of emerging economies at large" (Giri D.K, 2001) [2].

The EU facilitated the transition of European currency (€) from a notional accounting measure to its acceptance as legal tender in twelve member states from January, 2002
– with this EU transformed into a Currency Union. How big a deal is a currency union really? It is tremendous, say economists and analysts. A currency union goes much beyond a free trade zone or customs union like the North Atlantic Free Trade Zone (NAFTA) and does away with the very notion of fluctuations across currencies and exchange risk involved. The main objective of such arrangement being: To create a unique European common market and bring-in the benefits of enhanced market competition and integration.

Such European Integration will have far-reaching implications to emerging markets such as India in terms of foreign trade, capital inflows and growth prospects. Since the fifteen member European Union is India's major trading partner and source of investment and aid, ahead of Japan and the U.S. It is in this context, this paper is an attempt to address some of these issues from the point of view of emerging challenges and opportunities for emerging markets in general and India in particular.

The paper is divided into five sections. The first section gives an account of European integration and its impact on India's business and industry. An attempt is made here to assess the implications to exporters and importers, exchange rate movements, currency risk and hedging prospects and the relevant strategic considerations for Indian companies. The second section is an attempt to analyse the possible implications to India's foreign trade, investment flows and growth prospects. The third section examines the impact of the European integration and macroeconomic policies pursued by EU (for example, European Central Bank's monetary policy) on emerging markets, and how that impact may

evolve in the future. The fourth section examines the mega-implications of the European integration and macroeconomic policies pursued by EU (for example, European Central Bank's monetary policy) to global economy, equity and bond markets in Europe and the rest of the world; and trade and investment flows into India. Also it critically examines the progress made by the union towards a true integration, apart from providing summary and concluding remarks.

1. European Union, the Euro and Indian Business

The implementation of European Monetary Union (EMU) and the introduction of the Euro has had significant impact on the way business is done by companies, at both strategic and operational level. Though the Euro represents new business prospects, the companies must develop new skills and capabilities to tackle and effectively manage the changes in the areas of accounting, information technology, tax, treasury, legal and most importantly the financial and other information systems. Further, inadequate preparation to deal with the Euro may adversely affect the companies' very existence.

Some Issues Related to Business and Industry

Some of the challenges that the Euro has posed to the Indian companies are mainly with regard to the following, including an assessment of corporate strategies. Most companies are already trying their best to adapt to the changing scenario.

i) Invoicing and Pricing: Initially problems in pricing and invoicing occurred when a company has to quote its products / services both in euro and the legacy currencies (or in-currencies). While one-fifth of India's foreign trade is with Euro land, less than 10 per cent is invoiced in the EMU currencies. The immediate effect of the EMU will therefore was of moderate, though there may be pressures from counter-parties and banks to switch-over to the Euro. Besides, it will be necessary to assess pricing and marketing policies followed by firms. As currency barriers completely vanished by July 2002, transparency and efficiency gains for the markets will be enormous. Euro land contributes nearly 17.5 per cent of world trade (compared to 15.9 per cent of the U.S) and synergies will only improve their share in the world trade. With the rupee trading at

new lows against the euro and gaining on the greenback in recent period, Indian exporters are increasingly shifting their billings from dollars to euros.

ii) Risk-monitoring and hedging: A common currency does effect transaction costs at the margins and influence trade and capital flows between India and Euro-zone economies. It means Indian and European exporters and importers as well as European investors now need to hedge risk in one currency only, the Euro instead of a multiple currencies like the DM and FFr. This clearly reduces the cost of foreign exchange risk monitoring and hedging. Further, given the share of India's trade with Euro land, rupee exchange rate vis-à-vis Euro, and invoicing practices as mentioned above, the magnitude of this effect has been gradually increasing and is likely to be significant.

iii) Effect on Rupee: There is not likely to be any significant impact on the rupee. We expect the U.S dollar to retain the 'intervention currency' status for the foreseeable period. However, as invoicing shifts to the Euro and its importance increases, the Euro-Rupee rate will be monitored more closely. For instance immediately after the introduction of Euro, during 1st Jan 2001 to 15th January 2002 , the rupee has gained by Rs. 0.72 and the U.S dollar by about $ 0.05 against euro [3]. The result is that the weakening of the Euro against the dollar has reduced the export competitiveness of Indian firms from the rupee's depreciation against the dollar (Rohit, 1999)[4]. In recent period the Rupee has appreciated about 8 to 10 per cent against the euro during July – August 2008 to touch Rs 63.46 to a euro today compared to about Rs 68.17 earlier. While this could theoretically make life difficult for Indian exporters to the Euro Zone, Indian IT services companies seem unruffled by the development.

iv) Dollar-Rupee Risk Diversification: The majority of Indian firms have at least 80% of their foreign exchange transactions in US $s. This goes very much against the basic tenets of prudent risk management and diversification. For, during mid-June to 11th August 2002, US$-Rupee rose 2.35%. An importer with 100% exposure to US $ saw its liabilities rise from a base of 100 to 102.35. Over the same period, when Euro-Rupee fell 4.63%, an importer with 25% exposure to the Euro saw its liabilities rise from a base of 100 to only 100.60. During 2002-05 corporate India's uncovered

risk in currency market was estimated to be $ 20 billion. By diversifying into a more liquid market such as Euro-Dollar, the risk arising from the structure of the Indian rupee market (which is small, thin and illiquid with wide spreads) can be hedged. Trends in one strong currency, say US $, can be hedged by offsetting trends in another currency, say Euro.

v) Macro-environment, Forecasting and Budgeting: It is very essential to understand the economic impact of the Euro to enable intelligent forecasting and to have an understanding of the overall economic performance of Euro-15 rather than individual economies. Euro involves following a single monetary policy and a largely similar fiscal policy across the member-economies; and also merging of capital markets.

The Euro's performance on the foreign exchange markets mainly depends on the underlying strength of the euro-zone economy. During the three years, 1999-2001, the US has been a better place to invest because its economy has performed well. Capital over flowed into the U.S from Europe in 2001 because most investors thought the U.S economy would recover from recession more strongly than the Euro-zone's. Consequently the dollar continued to strengthen against Euro, even though the Euro-zone did not show it as quickly as the U.S. However, the sub-prime crisis and the continuing record rise in oil prices resulted in significant decline in dollar. This essentially reflects the role played by 'perceptions' of the market players about the macroeconomic fundamentals of respective economies within the region.

vi) Corporates - Size and Business Strategy: A currency union like the EU overcomes the trade barriers and the so-called 'home-country bias'[7]created by exchange rate risk and facilitate a truly integrated market. The trade and investment flow within the region pick-up with firms and countries competing purely on the basis of competitive strength [8].

Firstly, the Euro will greatly enhance sales and procurement opportunities as currency related barriers to the movement of merchandise, services and factors of production within EMU region will cease.

Second, the Euro region has already transformed in to an attractive investment destination as it may serve as access points to all the member

countries and also the newly emerging markets of Central and Eastern Europe.

Third, selecting a right business location in Europe will be easier for Indian forms as exchange rate related concerns no longer matter for the choice of a right business location. Firms could concentrate on other critical parameters directly related to the main concerns of the company such as production cost, technology, and proximity to market centers and infrastructure.

Fourth, for banks the process of integration brings a bit of bad news with good. The most significant impact for the Indian banks operating abroad is the elimination of exchange rate risk across the EMU region, which will encourage branches to buy / sell securities across the borders on a massive scale.

With the introduction of Euro, the notion of domestic currency become redundant taking away with the captive markets for foreign banks *on par* with domestic banks. The activity of M& As and restructuring that one can see in the European banking sector and their ramifications for their Indian subsidiaries (and also for Indian banks operating there) reflects this adjustment to a level-playing field.

Fifth, Indian firms with already established sales and production networks in Euro-zone will face more strategic challenges – in terms of the pricing of product and services. While on the one hand it will lead to larger local markets, on the other the companies will come under pressure from newly emerging competition, as in the case of European banking sector, within the region. The increased price transparency in this market will have an impact on price discrimination and the prices charged by a business for its goods and services in different markets in the region. This in turn might impact on existing packaging and labeling of products and on new product development. Thus, cost-cutting and innovation will be pre-requisites for competitiveness and the future market position in an evolving business scenario.

2. Euro-zone, the Euro and Indian Economy

The implications of Euro on India can be analyzed in terms of its effect on trade, foreign aid, external commercial borrowings, FDI and portfolio flows, banking related issues and technology.

Prospects for Foreign Trade

The EU is India's biggest trading partner and source of investment and aid exceeding the contribution of both Japan and the U.S. Nearly 25% of India's exports go to the region and imports from there make-up for about 30% of the total [9]. Apart from the direct favorable impact on exchange rate risk monitoring and related costs (as mentioned in the above section), there is no immediate impact of Euro on India's exports and imports to, and from the Euro-zone.

However, going by the trends in European corporate sector, it is quite possible that European firms will become more and more competitive as they would rationalize, streamline and become cost-efficient competitors. Further, the evolving markets of a gigantic size as Euro land would enhance market access and open up new opportunities for commercial ventures. This would imply that Indian firms have larger opportunities to be proactive and competitive. Sectorally, there could be more scope for software exports to the Euro zone. As the experience in recent past shows Indian software companies are already able to access and diversify exports to Euro-zone countries.

Trade Invoicing

Indian exporters and importers were invoicing nearly 80% of its total trade in US$s. Switching over to invoicing in euro by Indian firms depend on a number of circumstances. For example, POL products and fertilizers, which account for a major chunk of our imports, are denominated in US$s which is an international practice. Similarly, exporters and importers in other countries may still continue with US $ denomination. However, the European companies which were earlier invoicing in US $s prefer to shift to Euro. Indian firms would keep a watch on international practices, preferences of their trading partners, possible natural hedge opportunities and their own considerations in such a shift in invoicing from US $ to Euro.

Foreign Direct Investment (FDI) Flows

The Euro zone accounts for nearly 12 per cent of the total FDI in India. Newly introduced Euro is unlikely to have an impact on existing investments, which are denominated in rupees. The investor can remit the funds in any convertible currency of his choice including euro. As the

physical arrival of the Euro will encourage Euro-zone governments to push-through much needed structural reforms and a broader and deeper Euro market would make the euro more attractive to investors.[11]

External Commercial Borrowings

The introduction of euro has opened up new avenues of financing opportunities for Indian firms who have been so far largely tapping the markets abroad in U.S $s in the form of bonds and syndicated loans. With Euro becoming attractive, competition between US $ and euro would become more intense and result in possible marginal reduction in spreads for Indian firms. Moreover, Indian borrowers will now have greater access to euro-zone markets in view of the larger investor base and a common financial market. For long-term financing, those firms which have natural hedge in euro now find it attractive to borrow in euro and take advantage of lower costs. Also, there is scope for raising dollar denominated and euro loans in Euro zone markets now

Legal and Information Technology Issues

There are no difficulties as such in Indian legal system regarding continuity of contracts *per se*. Under the existing foreign exchange regulations, Reserve Bank of India (RBI) has notified euro as a permissible currency and hence settling payments in Euro is legal.

With regard to information technology, existing computer systems are already modified to recognize Euro, carry out and record relevant business transactions in the Euro. The modified systems must be able to provide a link between the in-currencies and the euro as all the in-currencies are connected through euro (at least till July, 2002, when all in-currencies will be phased out). Thus, the systems needed to handle orders in both the currencies which will require a thorough understanding of user interfaces with other linked sub-systems and ledgers to ensure consistency throughout the financial information system. The businesses may also require a system functionality to match in-currencies / euro receipts with national currency unit invoices.

Overall, the influence of the Euro and the underlying monetary union on the global economy, asset markets and the structure of international banking are anything but moderate. However, there are effects which

Indian firms, government and the banking sector need to monitor to explore the opportunities, given the size of the Euro-zone market.

3. European Union, the Euro and World Financial System : The Underlying Macroeconomics and Policy Implications

Going by the experience of the past few years, it would be too premature to be able to assess accurately how important the euro will become in the international economy and financial system, more particularly in view of the major currency realignments that are taking place. It would take some more time for analysts, policy-makers, borrowers, investors and other financial market players to understand the euro and its relative importance. However, one can assess the possible advantages and implications of the Euro and the underlying macroeconomics and policy.

First, going by the experience the impression among market analysts is that the euro would become a more attractive currency for bond issuers. In fact, in the first month of its introduction in 1999, the euro was the most popular currency for bonds issued in the international markets. It accounted for nearly 55% of the volume of new bond issues compared with 40% for the US $. This was mainly due to initial euphoria about euro-denominated instruments.

Second, with euro, the notion of domestic currency has become redundant and the dominant strategy for European banking heavy weights has been to increase market share in the par-European market. Thus, the persisting trend of M & As and consolidation is likely to continue in future more intensely. Size does matter, especially when domestic banks are loosing captive markets in the wake of Euro's introduction.

Third, indications show that the Euro is likely to become more attractive for the investment of Central Bank's official reserves. Currently, the US dollar is by far the most important reserve currency world over. It is reported that well over half of official reserves are held in US $ denominated assets while about one-fifth were held in EMU currencies. Some major Central Banks may decide to keep a larger part of their reserves in euro. The People's Bank of China, the Bank of Japan, the Central Bank of Taiwan, and the Bank of England have all indicated that they may now divest part of their reserve holdings by acquiring the single currency[12]. The shift to euro assets by Central Banks around the world would be motivated by its strength vis-à-vis US dollar, its increasing use as a

transaction currency and the more liquid and deeper bond markets, among other factors. And there are indications of supporting factors that should help boost the euro currency's value over both the medium-term and long-term. The euro zone's 'basic balance' – i.e. the sum of its current account balance plus long-term capital flows – is growing significantly past few years and this indicates that the Euro might appreciate further[13]. However, other factors are also very important affecting prospects of euro: like international oil prices, global inflation rates, and acquisitions of euro-zone companies by foreign institutions.

Fourth, the emergence of Euro, and the underlying EU will have far-reaching implications to major currencies (and the much-touted benefits of globalization) more particularly to the US dolar. Indeed, considering regional trading arrangements (RTAs) – such as NAFTA, EU, Mercosur in South America and ASEAN, more and more of international trade is occurring within regions. Statistics show that between 1982 to 1998, the proportion of U.S trade with countries in North, Central and South America increased from 29.31 per cent to 37.1 per cent, while Japan's trade with other Asian nations increased from 19.7 per cent to 34.6 per cent; and Germany's trade with other European countries which was already at a record high of 64 per cent has increased to 77.6 per cent.

This trend toward regionalization of trade has important currency implications, making it of paramount significance to international financial management. The Euro currency (earlier it was DM which played a dominant role in Europe) is likely to become more dominant as the settlement currency in Europe, with the same being true for Japanese Yen in Asia. It is quite possible that the euro could also emerge as an important anchor currency for other countries, particularly among countries in Central and Eastern Europe by virtue of their geographical proximity and possible economic linkages. Some of these countries may find it useful to peg their currencies formally or informally to the euro or a basket of currencies with euro carrying large weightage. As a result, the role of US $, which has been the dominant global currency for price quotations and settlement of international payments, likely to be diminished outside the Americas [15] in future.

Fifth, experience has shown that the euro is likely to become an alternate currency for invoicing next only to the US $. Approximately 50% of the world exports is invoiced in US $s, almost four times the share of US in world trade. While nearly 20% of world exports are invoiced in EU currencies and 5% in Japanese Yen. In the long-run, it is possible that euro

would become an important alternate currency for the invoicing of international trade.

Sixth, firms are already finding euro as a preferred currency for financial transactions. Trade finance could be more easily accessible to firms in India and abroad as the European banks compete purely on their competitive strength and able to extend loans at attractive rates. Further in the case of long-term financing those firms that have natural hedge in euro may find it advantageous to borrow in euro and take advantage of lower costs.

Also, with the elimination of exchange risk and the emergence of a single currency market, the scope for sector-specific funds expected to be more attractive. Therefore, raising funds for sector-specific projects like financing of infrastructure projects become easier with the single currency.

Last, but not least, issue is with respect to the underlying macroeconomics and policy implications of the euro on world trade, output and investments flows. With the advent of euro, national central banks of the member countries have ceded monetary control to the European Central Bank (ECB) – based at Frankfurt. The German Bundesbank heavily influences the ECB's 'monetary stance' with inflation control as the prime target. However, this is often at the cost of the real economy and its growth prospects. In spite of clear signs of global and European slow-down since the middle of 2000, the ECB foiled an interest rate cut till May 2001 – its second cut since inception and it remained rigid during the later period, while the Bank of England resorted to interest rate cuts thrice during the same period[16]. For the Global economy in the long-term this kind of 'tight' monetary stance would imply that there would be an upward pressure on interest rates and consequent tightness in liquidity. This would dampen both the equity and bond markets in Europe and the rest of the world. For the world economy as a whole, it could mean that expansion in output would be more moderate. This bound to affect trade and investment flows into India, and hence its growth momentum.

Thus, the implication to the global economy though difficult to assess accurately, the general perception is encouraging. How important is the role euro would continue to play and how fast it would impact on the global macro-economy hinges on a variety of factors. More importantly, it would depend on how the expected benefits and risks evolve for all the players, and more particularly for the Euro zone economy itself, as examined below.

4. The characteristics of the Global Financial Crisis

The crisis started at the core of the international economy with the US based multinational financial institutions in the first half of 2007 and the contagion quickly spread beyond the US. Initially the crisis affected the developed economies in the first half of 2008, and then the emerging economies in the second half of 2008 and early 2009. This makes its mechanics and the direction of spillover similar to the great depression of 1929-33 and the 1972 US dollar crisis, so the spread is from developed market financial centers to those of emerging market and under developed financial centers. The spread is quite opposite of 1997-99 series of emerging market crisis which started in their own economies but then spread to the advanced market financial centers, adversely affecting some global financial institutions which were excessively exposed to these crisis ridden economies.[22]

Roach, SS (2009) in his book *A Lethal Shakeout* argues that the current global financial crisis has preceded and caused by an overheating of world economy, which laid, among other things, to the buildup and subsequent of several asset bubbles which resulted from a buildup in: 1) the housing and commercial property market in US and several European countries such as Ireland, UK, Iceland, Spain, Greece and Baltic countries, 2) the stock market in the US and over the world,

3) the global commodity markets started with oil followed by metals, agricultural commodities and food products.[23]

Europe's response to the crisis: potential threats to the Goal of Single European market:

Euro-zones 's response to the crisis came quite late and not always in a well coordinated way. In its first phase (until the late summer of 2008), the danger of systemic financial crisis was downplayed by most policymakers. The periodic liquidity squeezes on the inter-bank market were considered a temporary contagion effect imported from the US. The main policy concerns were the appreciation pressure on the Euro (generated by a depreciating US dollar), the weakening US demand for EU export, the continuing inflationary pressure and the decline of the housing market in some EU countries. The breaking point came with the Lehman Brothers bankruptcy in mid-September 2008. This dramatic event triggered a far-reaching contagion effect on world financial markets and global financial disintermediation. The policy responses were quite chaotic and mostly on

the national level, in spite of their cross-border consequences. Because most of them involved either explicit or implicit fiscal consequences, they had to be taken by national authorities, due to the limited, in fact almost non-existent, fiscal capacity at the EU level. The attempt to coordinate national anti-crisis policies came late and was not always efficient or successful. The main factors which greatly complicated policy coordination were the various speeds and strengths of cross-country financial contagion, the uneven exposure of individual economies to shocks, the uneven capacity and resources to provide rescue, the sometimes hasty and nervous reactions on a national level and the temptation to free ride, maintains Marek. D.

Strengthening EU fiscal capacity – An IS-LM Frame-work:

The global economic downturn has renewed interest in a counter-cyclical fiscal policy going well beyond the automatic fiscal stabilizers(see e.g. IMF, 2008). The IS-LM frame-work is central to the macroeconomic analysis and the central banks' monetary accommodation of the fiscal stimulus. Even if the importance of fiscal stimulus recognized at the national economy-level the required monetary stimulus is contingent upon the proactive involvement of ECB which is unlikely in this case. This is on account of the uniform policy stand applicable to all the member countries whereas the required dose of fiscal stimulus differs depending on the specific level of shock to which they are vulnerable. Hence such interventions bound to be ineffective in achieving any such fiscal and monetary objectives in times of crisis.

Apart from the above, coordinating the national fiscal stimulus packages has limited effectiveness for several reasons, as argued by Marek D below:

1. Fiscal decisions remain within the prerogatives of national governments and national parliaments. None of the EU governing bodies (the Council, European Commission and European Parliament) has the formal power to force a member state to participate in a joint fiscal stimulus package and deliver on given promises. In fact, smaller member states may face the temptation of free riding, i.e. benefiting from a stimulus offered by larger partners while remaining reluctant to contribute to a common pool.
2. On the contrary, all EU member states are subject to limits in their fiscal deficit (3% of GDP) and public debt (60% of GDP on gross basis) imposed on them by the Treaty and the Stability and Growth Pact (SGP). As most of the countries have run cyclically adjusted deficits over the last decade, they do

not have much, if any, room for countercyclical fiscal policy. So it was not surprising when shortly after agreeing on an EU-wide fiscal stimulus package, the Commission initiated the "excessive deficit" procedure against six member states (France, Greece, Ireland, Latvia, Malta and Spain)8, which had breached the 3% of GDP deficit ceiling in 2008 and which appeared likely to have expanding deficits in 2009 and 2010. Looking ahead, this kind of schizophrenia will not enhance the credibility of any voluntarily agreed upon fiscalstimulus package. Rather, it further undermines EU fiscal surveillance rules and thus has hardly built a culture of fiscal constraints on national level.

3. In addition, at the start of the current crisis, individual EU member states started to face highly uneven public borrowing constraints determined by many factors, the fiscal prudence past track record probably being the most important one. The atmosphere of collective safety provided by a common currency in the first ten years of its existence is gone (probably for good). To address this issue the long discussed idea of common Eurozone bonds (e.g. Giovannini et al., 2000) became a policy interest again (EurActive, 2008, Sept. 25; 2009, Feb. 18). However it has little chance of being approved both by EMU countries with a lower risk rating (who are reluctant to pay more for their treasury securities when the risk will be shared at the EMU level) and those member states which remain outside the Eurozone (who are afraid of being crowded out from the sovereign debt market – see below).

4. Borrowing constraints are of particular concern for those EU member states (especially among the NMS) which remain outside the Eurozone. Neither the EU nor even EMU membership is considered an effective insurance against sovereign default by financial markets. As a result, the room for fiscal maneuver for at least half of the member states is also highly limited for this reason.

5. Furthermore, even if one assumes that for the reasons elaborated in the three previous paragraphs that the national contributions to a joint fiscal stimulus package must remain asymmetric, (i.e. mostly provided by countries which have room for maneuver under the SGP and lower borrowing costs, which does not seem likely for domestic political economy reasons – see below), this could cause a further crowding out of resources available for countries with poorer credit ratings.

6. Because of the expected lack of solidarity in fiscal stimulation9 caused by the above mentioned policy and institutional constraints, the national fiscal stimulus packages will be maximally targeted to domestic economies and

will disregard potential adverse cross-border effects. This can be easily understood from a political economy point of view. If a government wants to spend more of its taxpayers' money (most likely at the cost of burdening future generations of citizens with additional debt), why should the benefits of such policies be shared with other nations? This is the main source of "economic nationalism" which may seriously undermine the Single European Market and trigger a dangerous wave of a new kind of protectionism worldwide.

The global financial crisis and the role of Euro-zone Economy:

The crisis is truly global in character, so the policy response should also be global. There are serious macroeconomic adjustment issues as discussed earlier and even the most comprehensive and adequate decisions within the EU (which is, unfortunately, not always the case as argued in the previous sections) would remain ineffective without broader policy coordination with the other major players. Further, as one of the major economic power houses, the Euro-zone bears a special responsibility for global crisis management. The following sections deals with some of the key policy issues and policy dilemmas facing the EU as a global player and the underlying issues.

5. The Euro-zone and Prospects : Summary and Concluding Remarks

The primary objective of introducing a single currency is essentially to create a unique European common market and bring-in the benefits of enhanced market competition and integration for the Euro-zone economies. But the new currency has not really achieved the targeted objectives. In spite of its initiation and experimentation over the years not really contributed to transform Europe into a vibrant economic entity. The governments resist to introduce structural or microeconomic reforms and industries are still protected from competition. Moreover, Europe's product and labor markets are highly regulated, which renders the very process of European Integration incomplete.

Coming to the macroeconomic management issues of integration, the reality is that different economies within the euro zone are at different phases of business cycle and therefore ECB's uniform monetary policy proves, sometimes, inadequate to tackle the basic issues of low growth and unemployment (which are country-specific) in a desired manner.

Especially since membership of the Union also comes with tight 'fiscal discipline' enshrined in the Maastricht criteria which sets upper bounds on government budget deficits and hence the ability to revive their flagging economies by pump-priming will be muted. The ECB refuses to lower interest rates and the member nations cannot raise public spending either since it might violate the Maastricht norms. In 2001, Ireland faced a similar situation. Its attempts to raise budget deficit attracted a severe reprimand form ECB. The Irish opposition did not loose the chance to criticize the government against the perceived 'loss of sovereignty'. The IMF advised the ECB to got a bit easy on fiscal targets[17].

Another problem lies at the heart of Europe: Germany which is struggling to keep its budget deficit below 3 per cent of GDP, in spite of impending recession. This is to adhere to 'the stability and growth pact' norms. The Pact, adopted at Germany's behest, provides that any country breaching the 3 per cent ceiling could be subject to fines as big as 0.5 per cent of GDP. Though there are let-out clauses for deep recessions, but Germany looks unlikely to qualify for such relaxations.

There are indications of imminent financial problems in the wake of the U.S. sub-prime crisis and the fall-out. The housing bust across the Atlantic was the trigger for the ongoing credit crunch. Figures released on August 14th 2008 showed that the euro-area economy shrank at an annualized rate of 0.8 per cent in the second quarter, the first such reverse since 2001. Further, a closely watched survey of purchasing managers in manufacturing and services slumped in July 2008 to its lowest level since 2001. Business confidence has turned down sharply in all of the three biggest economies in the euro area: Germany, France and Italy. Even the Germany experiencing the economy's deterioration, in spite of the fact that this was one of the few financially vibrant economies that skipped the global house-price boom[18]. Stronger wage growth and high commodity prices have squeezed profits of companies, and exports were adversely affected.

Is there a way out of this crisis-driven model of integration? [19] Many eminent European leaders and policy-makers could come out with several solutions including a whole new round of political integration. One popular idea, promoted by both Lionel Jospin, then the French Prime Minister and Romani Prode, the head of European Commission (EC), is the appointment of Mr. Euro who could represent the entire euro-zone in various international economic forums[20]. Other suggestions include the harmonization of corporate and other taxes and the creation of a bail-out

fund to help countries in economic trouble. Because options open to countries with a national currency, notably devaluations and an independent monetary policy are no longer open to members of the euro-zone. Hence Mr. Prodi suggests that the Union should greatly increase its central budget (implying that members pay taxes into a central pool), so that if a country hit by a shock specific to itself, then some of it could be transferred to help it tide-over the crisis [21]. This federal fiscal structure is considered as the key to the success of the U.S, often touted as the oldest and the most stable currency union.

Though many eminent European leaders think that the logical end to the integration process is that of a closer 'political union', but that is not to say that Europe must now proceed to closer political union. On the contrary, the union has a common currency to reckon with and a daunting task of adhering to the stability pact norms. In case if the breach of the limit norms went unpunished, the down-side risk is that the new currency could suffer a credibility loss in addition the economic woes. And the problem is that the stability pact, far from creating more of flexibility, actually creates less and out of the reach of a member country, as in the case of the German experience.

The true flexibility and endurance that Euro-zone economy badly needs at this juncture can only come from removing remaining barriers to competition and further deregulating product and labor markets. More importantly, the governments including Germany's must go ahead with the structural reforms to make their economies more vibrant and contribute to the very process of heightened market competition and integration.

Appendix: 1 - What is the Euro? The Construction

With the arrival of the European Monetary Union on January 1, 1999 the European countries have begun replacing their national currencies with the euro, transforming the European Union (EU) into the world's largest single currency trade group. The union poses both challenges and opportunities to businesses which will now be be operating in an open and transparent market.

Out of 15 nations which comprise the European Union (EU), only 11 (and later 12) adopted the euro in January 1, 1999. The EMU is the largest single currency zone in the world with a GDP of eight trillion dollars. The new block will be an economic might accounting for 19.4% of the world GDP and 18.6% of the world trade as compared to the US which accounts

for 19.6% of world GDP and 16.6% of the world trade and Japan which contributes only 7.7% of world GDP and 8.8% of world trade. Also, the unification is expected to bring an additional growth in GDP (for the 11 member countries) of about 0.5-1% thus overtaking the US.

Key statistics

	Area	**People**	**GDP**
1998	**(000 km2)**	**(mn nos)**	**(mkt pr)**
EU-15	3191	376	7495
Euro-11	2364	292	5774
USA	9373	270	7592
Japan	378	127	3327

Apart from this the formation of EMU will rake in many other benefits such as:

- Lower business costs with a single currency
- Rise in competition may reduce prices benefiting the consumers and making countries more competitive in the international markets
- Centralized fiscal and monetary policy will provide interest and inflation rates which are stable and under control
- Which will in turn encourage corporate investment

Starting Jan 1 ’99, the currencies of member countries (11 countries which joined the EMU include Austria, Belgium, Finland, France, Germany, Ireland, Italy, Luxembourg, Netherlands, Portugal and Spain) has been linked to the euro with a fixed conversion rate. The local currency and the euro will co-exist until July 2002 at the latest, after which the local currency will be replaced by the euro.

Entrance criteria: The European Commission (EC), the EU’s administrative body, has set up entrance criteria to ensure the countries that joined EMU had a reasonable chance of succeeding in a single currency zone. These "convergence criteria" focused on stabilized inflation, exchange rate stability, sustainability of public finances and the ratio of public debt to GDP.

Qualification test for EMU members

Inflation rate should not exceed 1.5% above the average of best three Countries.

- Long term interest rate not more than 2% higher than the average rate of 3 member Countries with the lowest inflation rate.
- Budget deficit to be maintained within 3% of the GDP
- Public debt not exceeding 60% of the GDP.

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[3] Many currency strategists now believe that the coming 12 months could see more strengthening for the euro, as it recovers ground lost since its launch as an electronic, accounting currency on Jan 1, 1999. Measured on a trade weighted basis, the Euro has declined every year of its existence – by 12% during 1999, 1% during 2000, and 2% in 2001. David Fairlamb (2002): 'A Real Currency with Real Impact', *Business Week*, Jan 4, 2002.
[4] Rohit(1999): 'Where do we go?' *Business India*, July 11, 1999
Economists at Credit Suisse First Boston in London now predict that the single currency will rise by 10% during 2002.
[5] It is a synthetic (cross) rate, say between € and US $, calculated from the rates of these two currencies against, a third currency, say Pound Sterling ₤. It gives lower and upper limits on the direct quotes / rates between, say € and US $.
[6] Jon Bowen (1999): 'What the Euro means for Indian Business' , *The Hindustan Times*, Jan 17, 1999, New Delhi
[7] It is the tendency on the part of firms and households to invest more in domestic assets and buy more from domestic producers in the face of foreign exchange rate risk and related costs.
[8] In the case of European Currency Union (ECU), the impact of this has been quite significant. In the second quarter of 1999, just three months after the introduction of Euro, cross-border mergers and acquisitions (M & As) in euroland increased by 43%, a trend that persisted since then. The rise of the Euro has also deepened the pan-European debt-market and increased the available risk instruments significantly.
[9] Of these, the UK is the most significant but does not belong to the currency union (the Pound sterling, ₤ continues to exist). Excluding U.K. the Union's rank drops by a couple of points, but remains significant.
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[17] This box item text is summary of a section from Opcit note no. 16.
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