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Editorial

Overview of the special issue on the euro five years on

1. Introduction

The debate on the effects of EMU has entered into an important second phase. The earlier phase was mainly dominated by logical arguments and theoretical analyses aimed at highlighting expected advantages and disadvantages of the proposed common currency. Among the most debated issues where the costs and benefits of a unified monetary policy in the presence of potential asymmetric shocks in member countries, the need for increasing coordination of fiscal policies, the impact of economies of scale generated by the common European market, and the direct effects of the abolition of bilateral exchange rates.

One obviously cannot investigate the effects of an event that has yet to happen. The only available exercise was that of simulating these effects on the basis of the observed *ex ante* structural characteristics of European economies and their higher or lower capacity for harmonization. Now after several years have passed since the actual introduction of the common currency, a second phase of investigation has begun. The focus here is not just on the expected effects of the event, but on the first measurable results of its realization.

This is the motivation for the work that has led to the eight contributions collected in this special issue. Seven of these papers are refereed versions of papers presented at the Twelfth International Tor Vergata Conference on Banking and Finance, held at the University of Rome, Tor Vergata in December 2003. The sessions at which these papers were presented were sponsored by *JIMF* in conjunction with the Frank J. Petrilli Center for Research in International Finance at Fordham University and the Faculty of Economics at the University of Rome, Tor Vergata. The eighth paper, "The European Union currencies and the U.S. dollar: From post-Bretton-Woods to the euro," by María-Dolores Gadea, Antonio Montañés and Marcelo Reyes had been previously submitted to *JIMF* and is included here because of its relevance to the central topic of this issue.

2. The Eight Contributions in Brief

In the paper, "Rethinking the role of NCBs in the EMU," Russell S. Boyer investigates the effect of unified monetary policy on policy making powers of the

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EMU member countries. Using a model of a small open economy which manages its exchange rate, he asks what freedom of action a national central bank (NCB) gives up when its traditional functions are absorbed by a supra-national central bank, like the ECB. Interestingly, the paper finds that very little power has been yielded by an NCB beyond what was already relinquished in the decision to fix exchange rates at permanent values. The paper reports that different policy initiatives are observationally equivalent under the fixed exchange rate system and in this case all policy initiatives have identical consequences up to a factor of proportionality. Therefore, if NCBs have an initiative that sets interest rates, they continue to have the same freedom to act as they did before. The trade of domestic bonds for international bonds is the avenue that allows NCBs to accomplish this task. Boyer concludes that as long as the strains from the seignorage division can be withstood, a currency union should benefit its members through the efficiencies that are gained from the use of a common unit of denomination. He concludes further that this gain does not come at the expense of loss of independence.

The paper "Learning and the monetary policy strategy of the European Central Bank" by G.C. Lim and Paul D. McNelis examines the welfare implications of alternative inflation targeting proposals for the monetary policy of the European Central Bank. The authors compare the current asymmetric inflation targeting with alternative targeting strategies, e.g., a fully symmetric inflation targeting that incorporates a learning mechanism for the central bank. By using a nonlinear solution method incorporating shocks from productivity, exports, and foreign prices, the authors find only small welfare differences between an "asymmetric" and "symmetric" targeting strategy, and between targeting overall CPI inflation or domestic inflation. On the basis of their results, the authors conclude that there is little urgency for the ECB to modernize its strategy, remove the ambiguity, and explicitly and transparently adopt flexible inflation targeting. They claim further that a switch from asymmetric to symmetric targeting may cause higher interest rate variability.

Bill B. Francis and Delroy M. Hunter examine how the introduction of the common currency affected the risk exposures, risk premia, and the cost of equity of the banking industry in "The impact of the euro on risk exposure of the world's major banking industries." The authors argue that with the introduction of the euro, there are likely to be two offsetting results on interest-rate risk. One is a significant increase in the interest-rate-risk exposure of the banking industry; the other is that given the pursuit of a single monetary policy there may be a decline in interest-rate risk exposure. Using 11 euro-zone countries, five non-euro-zone European countries, and three non-European countries, they employ a multi-factor asset pricing model to investigate the extent to which various risk premia in the cost of equity have changed after the introduction of the euro. The authors find a significant and economically large decline in the cost of equity of the banking industry across the three groups of countries following the introduction of the euro. They find that although there are increases in both the market and currency exposures after the euro, the decline in the cost of equity arises from a large decline in the currency premium. Contrary to what has become a standard argument, the

authors find no evidence that increased banking competition arising from the legislative changes accompanying the introduction of the euro has resulted in an increase in the overall risk premium of the banking sector.

Michael J. Sager and Mark P. Taylor examine the systematic patterns in the euro vs. U.S. dollar foreign exchange market on days when the Governing Council (GC) of the European Central Bank announces its interest rate decisions. In "The impact of European Central Bank Monetary Policy Committee announcements on the foreign exchange market: A microstructural analysis," the authors use 5-minute data in 2002 and 2003 and apply a Markov-switching model to investigate whether there is a positioning prior to the announcement and news effects after the announcement. They find that the probability of switching into a high-volatility, informed trading state rose significantly on GC meeting days when interest-rate decisions were announced and that the probability of remaining in the low volatility state was found to fall significantly at the same time. The authors report that there is a significant news effect related to the noon announcement. The authors also find significant evidence of an increase in the probability of being in the informed state beginning an hour before the interest rate announcement is made. They argue that this result is due to dealers' closing out positions in order to minimize their risk exposure immediately before the announcement rather than due to information leakage concerning the policy decision.

In their paper "The anticipated and concurring effects of the EMU: exchange rate volatility, institutions and growth" Michele Bagella, Leonardo Becchetti, and Iftekhar Hasan argue that the positive effects of a common currency must be evaluated starting from the beginning of the convergence process leading to the euro. The authors measure the magnitude of both anticipated and concurring effects for the euro-zone countries by looking at real effective exchange rates (REER) and at different indicators of the quality of institutional rules and macroeconomic policies (QIRMP). They measure two main effects based on the two-step approach. They first compare real effective exchange rate (REER) volatility, with the level and variance in the quality of institutional rules and macroeconomic policies (QIRMP). They then evaluate the impact of these variables on economic growth. They find that while the effect of REER volatility reduction on the euro-zone countries is strong and significant, the positive change in quality of institutional rules and economic policies is not higher than that in non-euro-zone EU and in other (non-OECD) countries. The authors conclude that the convergence to a common currency has resulted both in a reduction in the volatility of real exchange rates as well as an increased quality of institutional rules and economic policies.

In "Purchasing power parity and the euro area," Kees G. Koedijk, Ben Tims, and Mathijs A. Van Dijk examine the impact of the introduction of the euro on the behavior of real exchange rates by testing the PPP hypothesis for a panel of real exchange rates within the euro area over the period 1973-2003. The authors provide evidence supportive of PPP for the full panel of European real exchange rates, but argue for the importance of accounting for cross-country differences in behavior. They go on to investigate PPP between the "synthetic" euro and a number of other major currencies over the period 1979-2003. The authors find support

for the PPP hypothesis for this panel viewed as a whole, but again show substantial differences in behavior across the various real exchange rates. On a country-by-country basis, in fact, they find strong support for PPP only in the case of the euro vs. the Swiss franc. They conclude that the process of economic integration in Europe has accelerated convergence toward PPP within the euro area, but that the process has varied by country.

María-Dolores Gadea, Antonio Montañés and Marcelo Reyes in "The European Union currencies and the U.S. dollar: From post-Bretton-Woods to the euro," study the behavior of European real exchange rates vis-à-vis the U.S. dollar over the period 1974-2001. A major focus of their empirical analysis is on the effects of long-lived shocks to real exchange rates, which they model as shifts in mean. Allowing for such shocks, they find evidence supporting the mean reversion of real exchange rates for the period ending in 1996, but little or no support for the hypothesis when they extend the sample period to 2001.

In "The effect of the euro on country versus industry portfolio diversification," Thomas J. Flavin examines the relative benefits of industrial versus geographical diversification in the euro zone before and after the introduction of the common currency. By using monthly total returns and market capitalizations on 1,193 companies across the eleven original members of the euro zone, he finds that there has been a shift of importance from country diversification to industrial diversification. In the early years of this sample, the results are consistent with the other literature, which shows that the majority of diversification benefits stem from international rather than industrial diversification. However, this result is reversed after the introduction of the common currency. Here he finds that industry effects outweigh country effects implying in turn that industrial diversification is more likely to grant a better portfolio performance. Flavin's finding is consistent with increased integration between euro-zone markets after the adoption of the single currency, thus corroborating earlier findings. Using a group of non-EMU European countries, Flavin shows further that this result is not just confined to the euro zone. He concludes that the shift in the importance of country and industry diversification effects may not be due to the introduction of the common currency *per se* but simply may be part of a global phenomenon.

3. Conclusions

Only a scant half decade has passed since the fixing of exchange rates that preceded the full-fledged introduction of the single European currency. Despite the paucity of data over this short period, the authors of the empirically-oriented papers collected in this issue have managed to come up with a variety of interesting findings concerning this event. These show features of European financial markets that to varying degrees coincide with what had been expected before the fact. The two primarily theoretical papers in this issue provide new insights with regard to EU policy.

The empirical findings include evidence of a somewhat heightened convergence toward PPP within Europe, of a shift of importance from country to industry diversification, reduction of the currency risk premium in the cost of equity, of convergence in institutional quality and of a reduction in real-effective-exchange-rate volatility. Whether these developments can be attributed solely to the introduction of the euro is somewhat problematic. In one instance – equity market integration – they appear more likely the result of other concurrent events, in particular, the strengthening of links among such markets more generally.

The two theoretical papers challenge prevalent views with regard to the conduct of European monetary policy and changes in the degree of policy independence in the individual European countries following the introduction of the euro.

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