LESSONS FROM MONETARY UNION IN EUROPE FOR NEW ZEALAND

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Abstract

Experience over the last few years in closer monetary integration in Europe suggests that some of the accepted ideas relating to the possibility of monetary union for New Zealand might be updated. In particular, the governance structures in Europe suggest that there are ways of structuring asymmetric unions between unequal partners. These governance issues extend beyond the institutional arrangements for monetary policy to fiscal and other policies that affect the macroeconomic prospects of the partners. Secondly, changes in the behaviour of members since the convergence process began in earnest in 1997 suggest that computation of expected costs/benefits might need revision. Lastly, using the examples of Finland and Ireland, the paper illustrates that monetary unions can amplify the benefits from favourable asymmetric shocks and hence can form part of wider development process as being experienced by the accession countries.

There has been an upsurge in interest in currency unions following the experience of the EU in creating the euro area. The spectacular collapse of the Argentine one-to-one currency board with the US dollar has tempered this but there does seem to be a range of cautiously favourable evidence. Recently (Frankel and Rose 2000) have suggested that there seems to be a favourable relationship between membership of a currency union and trade and output. The results have been substantially criticised as being based on atypical examples but seem to stand up well to sceptical attack (Melitz 2001). The present paper seeks to offer three further suggestions, drawn from European experience that might encourage small countries to consider entering a tighter monetary relationship with a much larger country or group of countries.

1 Asymmetric Unions

Economic and Monetary Union in the European Union has taken place among some very unequal partners in terms of GDP and population. The smallest three partners, Luxembourg, the

Irish Republic and Finland each form less than two percent of the total euro area (less than one percent in the case of Luxembourg). It is clear that even though the Governors of their central banks each has one vote in the Governing Council of 18, there is no way in which they are going to have any noticeable effect on the policy of the area as a whole simply because of any specific problems they may have that are not common to the area as a whole.

However, not only do they not expect to have any impact on euro area monetary policy for these reasons from a practical point of view but the Eurosystem does not take decisions on that basis – ie by summing the monetary policies that are in the interests of the individual member states. Policy is aimed at the benefit of the euro area as a whole. There are no discussions in the Governing Council of the circumstances in individual countries except where that may be some indication of emerging euro area trends. The whole structure of the policy-making framework tries to discourage any such national approach. The ECB collates the information from the national central banks (NCBs) together with information it has compiled itself and presents this in the briefing papers to the Governing Council. In the meeting itself there is a presentation by the Chief Economist followed by a general discussion at the end of which the policy decision is taken. Unlike the FOMC there is not a round of taking information from the members on the perspective from their region. The approach is highly centralised.

The difference between the members of the Governing Council over what to do is explicitly in terms of what the effect will be on inflation in the euro area, as measured by the Harmonised Index of Consumer Prices (HICP), not about some unstated implicit concern for the impact on the particular Council member's home country. Disagreements are about issues such as, what various indicators imply, how the euro economy actually works and the tactics of applying policy conclusions. Thus it is possible to distinguish between the members of the Governing Council at a technical level – how they view the role of monetary indicators or the extent to which various measures of core inflation give a better view of the underlying trends – rather than by which country they come from.

Of course, since the proceedings are confidential we will not find out which member holds which view except insofar as it is obvious from their public pronouncements. Similarly up till now decisions have been taken by consensus so there is little said about the nature of any disagreements along the way. Although one might argue that ending the confidentiality would enable the members of the Governing Council to demonstrate by their actions that they are not voting along country lines, one of the main arguments advanced for the confidentiality has been that it enables the members to vote according to their best judgement, without any fear that their home countries can pressure them.

What we have in the Eurosystem therefore is an unusual asymmetry. The Governor of each NCB has the same single vote irrelevant of the size of the country they come from even though that can represent a difference of the order of 100. The simplicity of the calculation is complicated by the existence of the six members of the Executive Board, who also have votes. While four of the initial members come from each of the four largest countries, the President is from the Netherlands and the remaining member from the third smallest country, Finland. From any view point this does not represent choices based on size. Indeed the French Vice-President, Noyer, was replaced by the Governor of the Greek central bank, Lucas Papademos, in June and not by another Frenchman. However, it is widely anticipated that the next President, whose term will start in July 2003, will be French, as the result of the debate over the appointment of Mr Duisenberg in 1998. No doubt the appointment of the Bundesbank chief economist as chief economist of the ECB could tend to result in a reflection of that tradition in ECB policy preparation but this is not a requirement and could readily change with the next incumbent. Despite the fact that the Executive Board members are clearly chosen by the member states so as to get some sort of balance across the EU, it would be misleading to assume that they can be treated as second representatives for their particular member states in deciding about monetary policy (or other issues).

The nature of the balance among the countries in the membership of the Governing Council stems from an interesting combination of factors. First of all, traditionally in the European Union each member state has had its office holder on joint bodies. Each member state has a seat at the Council of Ministers, each member state has a Commissioner, a member of the European Court of Justice etc. Secondly the structures of the Eurosystem are heavily influenced by the fact that it was the central banks themselves that had the major input in the design. Lastly the EEC started with a small group of countries (six), If the number had been much smaller, particularly if one country dominated, or much larger then the nature of the institutions might well have been different. One might for example look at the case of the US, where the initial number of states was twice as large.

It is therefore very difficult to assume that any other monetary union would be a replica of the Eurosystem. Just as the Eurosystem itself is not a replica of the Federal Reserve in the US and has very different dynamics of operation. The Federal Reserve was created some 150 years after the Union, not after less than 50 years. The Eurosystem itself can be expected to change as the number of members increases. The number of members could increase by three within a couple of years or so, if Denmark, Sweden and the UK decided they wished to join. The first group of ten applicant countries are hoping to be able to join the EU in time to participate in the 2004 parliamentary elections and most have expressed a wish to move to joining stage 3 of EMU as

soon as possible thereafter, which in theory could be 2006. At some point it could become difficult to run an effective decision making body for monetary policy as the number of members increases. (Buiter 1999) has expressed strong views about the inoperability of large groups but the practice is yet to be revealed.

1.1 One Person One Vote.

A second issue of size relates to the relationship between those voting in favour of a proposition and the proportion of the Union their central banks cover. Although the Governing Council currently operates by consensus on most issues, as the number of members increases so one can expect that they may have to vote if decisions are to be taken promptly. The current rules require a simple majority. In theory a measure could be passed by the six members of the Executive Board plus the Governors of the central banks from the three smallest countries (reflecting less than 5 percent of the total population) as there are 18 members and the President could use his casting vote.[1] With everybody acting in the spirit of the arrangements this would still present no problem. However, it could become more of a problem if some strong dividing factor were to emerge or if the debate were to appear more politicised in some way. It is fairly easy to think of issues that could divide. Price stability is not defined by the Treaty, as time goes on the broader international consensus could disappear and new views of what is optimal arise. With strongly differing rates of economic growth across the euro area, a 'high inflation interest group' (or low inflation for that matter) could develop. What is an issue and what creates problems in such groupings is clearly context dependent.

There are some exceptions to the one person one vote and a simple majority rule. Issues which relate to income or to the capital of the ECB are decided by votes that are in proportion to the capital that the member states subscribed to the ECB when it was set up. Those shares were based on GDP and population.

The message we can take from this is then two-fold for other monetary unions. First of all it does seem to be possible for decision-makers to consider monetary policy issues in terms of the general benefit and not simply from a national viewpoint. Secondly it is possible to separate out different issues and vote on them using different structures. Thus when it comes to capital, for example, national interests can be protected. It is therefore possible to devise a system where the objectives are agreed beforehand and sufficient of the proceedings are transparent that the

[1] Indeed a quorum is only two-thirds of the members, so again in theory, in the extreme case, a measure could be passed even if no central bank governor supported it.

participating states can be clear that there joint benefit is being pursued and not just that of the dominant members.

1.2 Other Asymmetric Monetary Unions

The EU is not the only example of a voluntary asymmetric monetary union among European countries. Belgium and Luxembourg operated a monetary union up to the time that the euro was introduced. Indeed Luxembourg had to create a central bank as a result of the terms of the Maastricht Treaty. Previously, although separate coins circulated in Luxembourg (but of identical size and composition to their Belgian equivalents) monetary policy was in effect decided in Brussels. Similarly the UK and the Irish Republic operated a monetary union from the time of the Irish Free State in 1923 until 1979 when the Irish government decided to join the ERM separately from the UK when it was set up. Technically the arrangement was a currency board. While the two currencies traded one to one and the coins were also of identical size and composition they were not legal tender in the other country. They therefore had to be exchanged through a bank,

There is no single recipe for currency boards.[2] Some like Argentina operated their currency one for one with the US dollar but with clearly different notes and coins. The Estonian currency board, which celebrated its 10th anniversary in June 2002, first based its currency on the deutschmark and now on the euro but not one for one. This difference is the norm. If New Zealand were to enter monetary union or some looser arrangement with Australia or any other monetary area for that matter it too would face a range of choice over how to set up the decision-making body and whether the currencies should merge, as in the euro area, be interchangeable as in Belgium-Luxembourg, be one to one with the same specification for coins as in the UK and the Irish Republic, one to one with different designs as in Argentina or just to have a fixed exchange rate but a different parity and currency.

The choice over the decision-making body and over the currency itself reflects the nature of the relationship that is being chosen even though there may be little to choose in practical terms between them. Clearly if there is enormous physical traffic between two countries it is unnecessarily unhelpful to make use of the currency in the other country directly over the counter difficult. However, perhaps the simplest example of very substantial integration with different notes and coins is the monetary union between England (and Wales) and Scotland, where Scottish banks issued their own bank notes. Bank of England notes were accepted throughout Scotland but people in England were generally rather unwilling to accept Scottish

notes in payment except where such transactions were commonly requested near the border. Coins were and are interchangeable. One pound coins may be English, Welsh or Scottish and indeed there are other designs for the face, although the head is the same in all cases.

Clearly for either New Zealand or Australia to contemplate some form of monetary union they would have to expect to get something out of it. Since it would not necessarily be considered on its own, it is not a requirement that both countries should gain out of monetary union per se, merely that including monetary union would increase the overall benefit to both parties. As trying to decide what the other features might be is an unnecessarily speculative exercise we need only focus on what might make the arrangement unacceptable to Australia.

The obvious objection would be that monetary policy might be different and hence less appropriate for Australia or simply that it would be more costly. In the case of a New Zealand currency board or dollarisation it is difficult to see this argument as neither requires the Australian authorities to bear any regard for the impact on New Zealand. For dollarisation there would be a gain in seignorage for Australia. The question would then be whether New Zealand could do anything in other policies that might affect the system to the disbenefit of Australia. The obvious possibilities are irresponsible fiscal or financial policies. These could drive up interest rates within New Zealand. Even though the currencies would be the same there is no requirement that the debt of the partners would be rated the same or attract the same rates of interest. There could be some contagion if investors thought that there might be some feedback from difficulties in New Zealand onto Australia. Otherwise the danger of default would be priced into the loans themselves. There would be some impact on the exchange rate when New Zealanders are trying to buy or sell Australian dollars net. In a crisis some people might try to exit altogether but in general it would be like facing any other major default.

This issue of concern for related policies is one of the key features of monetary arrangements. The worries in EMU in Europe are to do with the constraints on member state governments through the Stability and Growth Pact, not about the monetary side of union itself. Hence the constraints on government debt ratios, deficits and the structural planning of their budgets form the heart of the discussion. Given current legislation with the 1994 Fiscal Responsibility Act, it might seem that Australia had little worry about with respect to New Zealand. Unfortunately, given the structure of democracy in New Zealand that it is not strictly true as a government with a majority can rapidly overturn any legislation. There are no requirements for supermajorities or a second house to slow the process down. However, such a change without any context would be difficult to understand. A government suggesting that it was going to ease the rules on responsibility would find itself paying a cost on government debt before it even tabled the

[2] (Frankel and Rose 2001) consider a wide range of arrangements including many with former colonial powers.

legislation. The need would have to be very great to make such a cost worthwhile. In any case the legislation is phrased in such a way that it can cope with the borrowing necessary to finance even a severe crisis.

However, it remains the case that the New Zealand government, voters and international financial markets would make the decisions and the Australian government would have to threaten credible sanctions in other fields to offset it. Given WTO rules there are limits as to what these might be. While systems have to be able to have plausible means of coping with crises the main determinants of their credibility is what is expected to happen in normal times.

In forming some sort of monetary grouping with Australia, New Zealand would clearly be of very limited concern in determining the overall policy. Indeed events would have to be dramatically different for them to have any noticeable effect. A 2 percent inflation differential for even 15 percent of GDP of the area as a whole would still only raise area-wide inflation by 0.3 percent. It would have to be persistent to have much effect over the medium term.

2 Some Unexpected Results?

Most of the focus in the literature is on the possible impact of adverse shocks under monetary union. Very little attention is paid to the consequences of favourable shocks. The process is, of course, largely symmetric. If a favourable asymmetric shock strikes the economy under monetary union then the domestic monetary authorities can no longer act to head off any incipient inflation. The real impact is thus greater than it would have been without the union.

If the inflation then actually occurs this will worsen competitiveness and the net gain may evaporate. However, this implies that the economy behaves in exactly the same way in both circumstances. Since firms and their employees will appreciate that an inflationary response under EMU may harm their future, it may be that their behaviour will in turn be less inflationary. This very much seems to be the experience of Finland in the period since deciding to participate in Stage 3. At around the same time as economic and monetary union started Finland was witnessing a major favourable asymmetric shock in the form of rapid growth in the ICT sector, particularly in mobile telecommunications. Over the period 1995-9 GDP grew by about 6 percent a year of which 2 percentage points were accounted for by the ICT sector. The effect on exports has been even more striking. Nokia's share of exports alone has risen from around 7 percent in 1995 to over 25 percent in 2000. Although the ICT boom cannot be regarded as a country-specific shock, it was an asymmetric shock for Finland as a part of EMU simply because the sector was far more important for Finland than for the euro area on average. With its own currency, a floating exchange rate and inflation targeting, the country would most likely have

witnessed a strong appreciation of the currency against the Euro, although not necessarily against the US Dollar, in 1999 and early 2000, as well as higher interest rates. It is unlikely that such a substantial current account surplus as shown in Figure 1 could have been maintained with an adjustable exchange rate. Similarly a growth path as high as that shown in the figure would ultimately have been forecast as inflationary.

There would probably also have been a reversal in 2001 when the prospects of the ICT sector were written down by financial markets, implying sharp effective depreciation of the markka in tandem with the decline in Nokia's share price. If these changes had occurred within the ERM (or ERM2), the tendency toward appreciation might have invited speculation about a realignment (revaluation) attracting more capital inflows and raising liquidity. In 2001 the country would most likely have experienced speculation in the opposite direction.

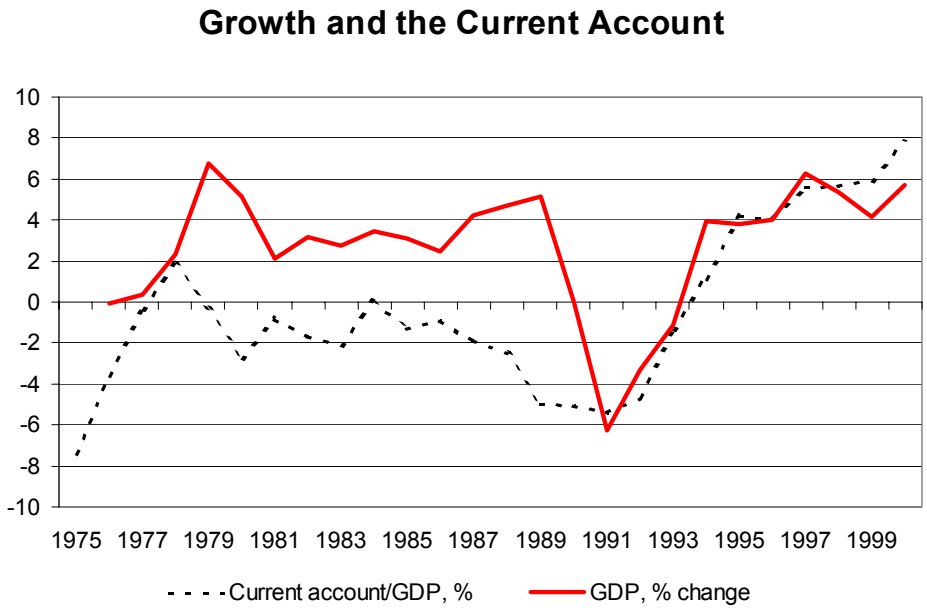

Figure 1

It is fair to conclude that the membership in the EMU has stabilised the Finnish economy in the face of a favourable asymmetric shock, at least compared to a (counterfactual) situation where the country would have faced a similar shock with its own currency, old institutions and old behavioural patterns. While in the past both domestic demand and inflationary pressures have, for a number of reasons, reacted strongly and procyclically to swings in exports, the growth of domestic demand has been remarkably stable over the past 4 or more years. This does not mean that membership of EMU as such would have contributed to the smooth development of domestic demand despite important changes in exports. Rather it is changed behavioural patterns, which account for the observed stable development. It is, however, too early to say

whether the institutions have changed sufficiently in order to promote smooth domestic development in the face of other types of asymmetric shocks in the future.

Finland was not the only country in Europe that faced a favourable ICT-related asymmetric shock. Sweden faced a similar shock, although the ICT-sector's relative importance in total exports is smaller than in Finland. The overall development in Sweden has been favourable and equally stable. The major difference has been the evolution of the exchange rate. The Krona appreciated effectively throughout 1999 up to the spring 2000. The appreciation, which took place hand in hand with Ericsson's share price was particularly strong against the Euro. The reversal started in mid-2000, whereafter the currency has effectively depreciated at the same time as Ericsson's share prices have declined. The sharp depreciation impacted inflation at the same time as growth slowed down, thereby providing an offset. These observations suggest that Sweden's non-membership has hardly had any negative impact on the economy. But it is equally difficult to prove that the non-membership has brought any economic benefits either. The emerging inflationary pressures arising from currency depreciation reveal that stabilisation of the economy by monetary policy is not an easy task. (Sweden was the first OECD country to raise interest rates again after the September 11th disaster.)

To some extent membership of EMU has changed the behaviour of Finnish institutions, particularly in the labour market – but the favourable development of the economy has meant that many hard choices have been avoided. In many respects institutions have changed more in Sweden where economic conditions have not been so favourable. The shock approach to inducing institutional change may therefore be yet to come in Finland. Perhaps the current downturn with unemployment still around 10% will provide the necessary stimulus. Investment behaviour on the other hand has changed markedly and firms have adopted a strategy that has clearly altered the development of productivity in Finland (Figure 2).

There is a clear change in the behaviour of the Finnish economy after the recession. With the decline in markets in the former Soviet Union there was considerable scrapping of capacity but thereafter capital investment remained almost 10 percentage points of GDP below its previous levels. The striking increase in the rate of growth of output therefore was accompanied by a fall in the level of capital input. Some of this change is undoubtedly due to the change in economic structure but unlike many OECD countries Finland has not had such a strong swing into services. Manufacturing remains considerably more important that in the US, UK or France for example. Labour productivity between 1995 and 1999 while still rising at over 2.5 percent a year was rising rather more slowly than in the 1980s (4 percent a year). However, aggregate figures mask

annual growth rates in excess of 10 percent in Machinery and equipment, Finance and insurance and Post and telecoms (OECD, 2001). According to (Maliranta 2001) real total factor productivity in Finnish manufacturing industry had reached the level of the US by 1999. Some of this increase is undoubtedly due to a simple catching up process but the increase in R&D to levels similar to that in the US (and 1 percentage point above the EU average) will also have helped (Forsman 2000). Wage rises have been moderate despite the rapid rates of output and productivity and real wages have risen less than productivity, helping to maintain Finnish competitiveness. Since Finland has relatively centralised wage bargaining this is likely to represent overt constraint on the part of the parties. Wage dispersion among production workers has changed little since the late 1980s, which further suggests co-ordination, exploiting one end of the Calmfors-Driffill 'smile'.

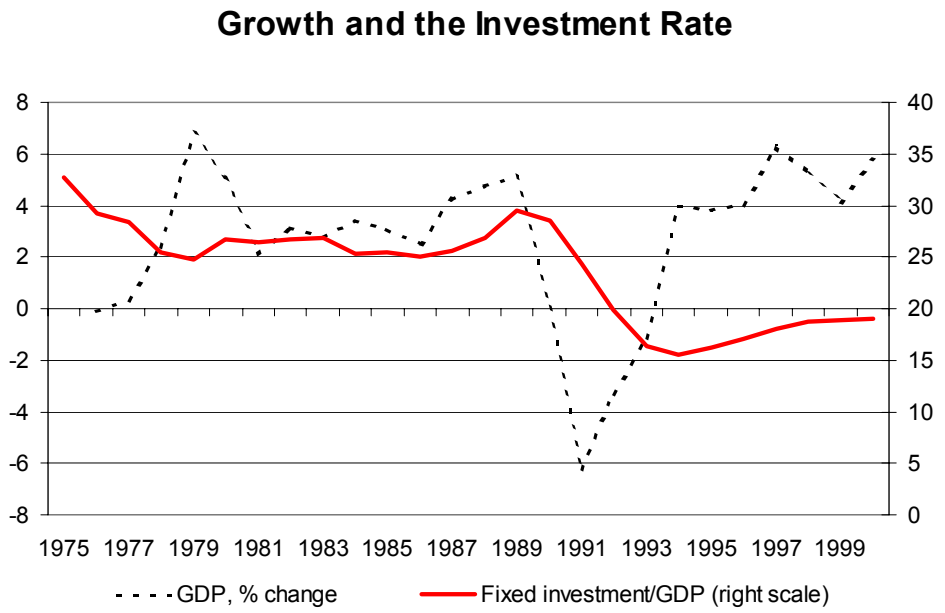

Figure 2

It is difficult to attribute this structural shift to EMU membership as such, as it starts beforehand, but it is not incompatible with it. However, the changes do fit in much more closely with the improvement in the credibility of monetary policy that occurred in 1993.

One of the imponderables posed in the context of membership of Stage 3 is the impact on the flow of foreign direct investment. (Heikensten 1999) suggests that Sweden may have been losing out in two respects, first because the euro capital market is larger and second because both Swedish and foreign firms would have invested more in Sweden. It seems difficult to get any

clear evidence in Finland whether this effect has occurred and if it has whether it is quantitatively important. There has been substantial outward investment by Finnish firms, particularly in North America. Large firms, like Nokia have been able to tap non-euro markets for finance and the New York market in particular has been important. It is even difficult to trace through the exact logic. Closer integration may increase the importance of production in the most favoured sites in the EU close to the main markets (Fujita et al. 1999). Being part of Stage 3 might actually decrease the incentive to be located in peripheral locations like Finland and Sweden. There is no reason for foreign companies to have some local production as part of a hedge against future currency shifts.

Similarly some of the other gains in transaction costs, such as the avoidance of currency risk and the increased transparency of pricing have remained gains that are to be quantified with any great credibility. As for the question of influence over policy, this is even less tangible. No doubt all of those participating in Eurosystem committees from the Governing Council downwards believe they are having an impact on policy. However, once organisations develop strategies and make major decisions it is difficult to relitigate them. Subsequent joiners of Stage 3 will to a large extent be faced with a fait accompli. There are two issues worth considering in this hypothetical discussion. The first is that Finland, Sweden and the UK were following very similar independent monetary policies before Stage 3 began. Hence that interest group would have been larger inside the Eurosystem if all three countries had joined. The second is that both Finland and Sweden are small countries in economic and financial market terms in the context of the euro area. The same is not true of the UK. Assuming policies would have been the same with or without Finland or Sweden is likely to be true at the margin. The same cannot necessarily be said for the UK. There thus remain some difficulties in trying to compare actual behaviour in Finland in the euro area with likely behaviour outside or behaviour inside had other countries also joined.

We need to be rather cautious in extrapolating the Finnish experience to other countries as Finland's favourable experience thus far in Stage 3 of EMU is overlaid by other special factors. The ground work for credible monetary and fiscal policy was in place before Stage 3 became a political reality. Much of the Finnish economic success was due to a combination of long-run factors relating to investment in the ICT sector and the human skills required for it and the shock of the crisis of the early 1990s where drastic responses were required by both firms and employees to recover; see (Björksten and Meriluoto 2002), for example. The movement in the exchange rate first downwards and the upwards were essential parts of that recovery process. Had the crisis struck when Finland was inside Stage 3 at an overvalued exchange rate then the

consequences would have been even more severe. Stage 3 clearly poses problems for adverse asymmetric shocks but by the same token it helps magnify the consequences of favourable asymmetric shocks.

This gives two rather trivial messages. The first is that if there are good reasons for thinking that a harsh adjustment needs to be made, it is helpful to have some nominal flexibility in undertaking it. In this way one can understand that the Swedish authorities felt they needed one more bout of adjustment before entering Stage 3. The second is that a country needs to undertake a credible reform of monetary and fiscal policy anyway if the circumstances demand it. However, it is easy to see that in some circumstances, being able to find an external source to 'blame' for the changes may be politically helpful in undertaking what will inevitably be unpopular in the short run because many people are adversely affected. The UK government 'blamed' the IMF in 1975 for changes it needed to make in a similar manner. Finland needed no such external constraint. The crisis was sufficiently deep and obvious that difficult choices were politically possible. There are, however, great difficulties for small countries in establishing credible macroeconomic regimes. The 'peso' problem, graphically illustrated again in recent months will always tend to exist. The very freedom that having an independent exchange rate offers for a flexible response to asymmetric shocks also offers the possibility, albeit very small, that the regime will change. That possibility gets priced into interest rates. There are indications of this effect in the comparison between Finland and Sweden. Similarly the very fact that the discussion about the advantage of that freedom is conducted in an asymmetric manner, focusing on the downside, suggests it may be over-rated. The effect of favourable shocks from natural resource discoveries on exchange rates can be mitigated by government transactions, particularly when they can appropriate much of the revenues themselves. It is more difficult to do the same when the favourable shock lies in the private sector. If the private sector transfer of resources abroad takes the form of direct investment then the shock will be made more transitory. Nokia has contributed as much as 4 percent of taxation in its most profitable year but there are limits to how successfully a government can hope to share the benefits across society in this way when capital is mobile. (A point the CEO of Nokia has not hesitated to make in public.)

What is interesting is that behaviour induced by crisis in Finland has been maintained. Here one might want to look to EMU for a reason and not just to the favourable asymmetric shock from the ICT sector. However, as is so often the case there is really insufficient information to make a full judgement. Having at least one complete cycle will help. Unfortunately these data are being generated at present. The Finnish economy has experienced a rather sharper downturn than many of its partners, with industrial production having actually fallen for more than the

requisite two quarters to record an output recession. Nevertheless consumption seems to have pursued a relatively smooth path through the cycle. Spending did not respond to the strong cycle in both stock market and house prices – with it strong exposure to ICT and to just one company, Nokia, in particular, the Finnish stock market has been among the most volatile in western Europe. It may be that the crisis is still too deeply etched on people's memories and they have been more cautious on the way up this time round. Certainly bank lending to the company sector has been very muted, although lending to the household sector has developed quite rapidly. There is material here for both points of view.

3 Concluding remark

It is not the purpose of this paper to argue for or against participation by New Zealand in any monetary union, whether with Australia or elsewhere. It is merely the intention to draw attention to the existence of some relatively favourable experience in the EU, which has not necessarily been taken into account heretofore. In the first place there are variety of arrangements that can be followed that accommodate the fact that one partner in the union is a great deal smaller than the other. It is not necessary to have a single currency nor even to set up a joint decision-making body. There is no need to lose seignorage. Such arrangements have endured for over 50 years and can be replaced by tighter or looser economic links. Secondly there is a tendency to focus on adverse shocks in worrying about the loss of freedom of action under monetary union.[3] By the same logic favourable asymmetric shocks can generate a redoubled benefit under the constraint that monetary union stops monetary policy from responding. Thirdly, it is likely that behaviour will change under the impact of the change in regime. Not only do economies tend to grow more alike so that the asymmetry is reduced but shocks that would previously have been inflationary can become less so. There is, for example, clear evidence from Finland that both of these last two effects have come into play in the last 8 years, differentiating the consequences from its near neighbour Sweden, that has not benefited so much from relatively similar impulses.

Any such factors need to be added to the well-researched gains from lower real interest rates, reduced risks and lower transactions costs.[4] They might alter the balance of the assessment against the equally well-known disadvantages stemming from the reduced ability to offset

[3] (Coleman 2001) in his interesting comparison of Queensland and New Zealand in a monetary union with the rest of Australia shows that the constraints may be of limited importance. He also points out the gains for Australia from increased trade and deeper capital markets.

[4] The gains to be reaped from lower real interest rates in New Zealand seem to be particularly large. (Plantier and Scrimgeour 2002) suggest that the 'neutral' three month real rate of interest stabilised somewhere round 5 to 6 percent in the mid-1990s. This compares with a rate of around 2.5 percent in Finland and the euro area.

unfavourable asymmetric shocks (Drew et al. 2001). Optimists might also wish to consider the possibility of substantial gains from increased trade in a currency union suggested by (Melitz 2001) and (Frankel and Rose 2000). However, no such assessment can be based on the likely monetary policy regime alone. There are also recent examples of clear failures, assisted by inappropriate fiscal and regulatory policies. Indeed the progress towards Stage 3 of EMU was nearly halted at its outset with the virtual collapse of the exchange rate mechanism of the European Monetary System in 1992/3.

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