Executive Summary

This paper discusses the proposed European Monetary Union (EMU), a landmark event for Europe and world financial markets, and draws out some of the implications. First, the basic framework of EMU and its associated institutions is reviewed, along with the Maastricht criteria for economic convergence. The economic characteristics and implications of a currency union are discussed. Then, in the remaining three sections, the implications for Europe, the international financial system, and for Canada are examined.

While there is considerable debate about the economic benefits and costs of EMU, the underlying motivation is seen to be largely political. Monetary union is viewed as a major step in promoting the integration of Europe. It will also provide a framework for a pan-European approach to monetary policy. The paper concludes that EMU is achievable, but that the economic benefits may be exaggerated. Much of the popular discussion about the benefits of EMU appears to confuse the benefits of a *customs union*, which entails important trade and investment effects, and which the European Union has been for many years, with those of a *currency union* (EMU), which is about monetary policy and exchange rates. Currency unions are best studied through the theory of optimal currency areas. In this context, it is concluded that European economic performance under EMU would be enhanced if Europe tackled the difficult issues of improving labour and product market flexibility.

The transition to EMU involves both a plan for economic convergence for the participating countries based on the Maastricht criteria, and a complex process for the constitution of a new central bank and introduction of the single currency. From a financial economist's point of view, EMU will start with a "big bang" when exchange rates among participating currencies are locked and the new central bank begins operations, the most likely date being January 1, 1999.

With respect to the implications of EMU, the paper concludes that:.

- For Europe, the quantifiable economic benefits of EMU are likely small. However, it could provide the impetus to improve product and labour market flexibility, changes that will enhance the operation of the European economy under monetary union. It may also accelerate the harmonization of securities markets and banking regulation.

- For financial markets in Europe and abroad, the impact should be positive if the transition goes smoothly. Deeper and more liquid markets should enhance the efficiency of financial market intermediation, and financial product innovation may increase as markets mature and become more competitive. The new currency will find a place in official reserve portfolios of non-participating