Governing EMU

Economic, Political, Legal and Historical Perspectives

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* Francisco Torres, Amy Verdun and Hubert Zimmermann were the editors of these proceedings while Chiara Zilioli was one of the four initial conference organisers.

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Preface

These proceedings collect many of the contributions to the first European University Institute (EUI) Alumni conference held in Florence at the Badia Fiesolana on 3/4 October 2003. This volume is also the result of the first collaborative academic work of EUI alumni as such, and represents the four disciplines taught at the Institute: economics, political science, law and history.

Since launching the idea of organising an interdisciplinary conference on Economic and Monetary Union (EMU), we have counted on the continuous support and help from the Alumni Association and its Executive Committee, especially from Annette Bongardt and Carlo Spagnolo and, since last year, also from Milica Uvalic and Amy Verdun.

It was quite an ambitious task to organise such a conference on the occasion of the traditional alumni weekend in Florence. The conference programme was carefully designed and adapted over almost one year. There was a conference organiser for each discipline: Amy Verdun (political science), Chiara Zilioli (law), Hubert Zimmermann (history) and myself (economics). To look for fellow alumni who might be interested in contributing to the subject as well as for discussants and chairpersons for the conference was a demanding job but a rather gratifying one.

Many alumni came and participated in the conference without presenting and/or discussing a particular paper. Many others could not make it in October 2003 although they had very interesting contributions on the topic. Others were not prepared to contribute to this particular topic but were very keen on participating in future alumni conferences. Some others managed to come and deliver quite interesting presentations but did not find the time to write and/or revise (edit) their papers. We are grateful to all of them, especially to all those – listed as contributors – who came to the conference to present or discuss a paper, and successively undertook revisions of their contributions in the following months.

The organisation of the conference was possible thanks to grants to the European University Institute from the European Central Bank and the European Investment Bank. We are grateful to both institutions and to alumni Chiara Zilioli and Eric Perée, working at the ECB and the EIB respectively, for having suggested such a possibility.

We also very much thank Paul De Grauwe who accepted to deliver the keynote address to our conference and EUI faculty, namely Helen Wallace,

Colin Crouch, Bruno De Witte, Rick van der Ploeg, Arfon Rees and Mike Artis, who acted as chair persons, and Stefano Bartolini, also an alumnus, Neil Walker, Martin Rhodes, Giancarlo Corsetti, David Andrews and Philippe Schmitter, who agreed to be paper and panel discussants, as well as Jürgen Kröger from the European Commission, for participating in the conference and in the panel. For some of these people, this meant making a significant effort to be present and to participate in the conference activities.

Throughout the entire project we benefited from the institutional support of the European University Institute and in particular of its president, Yves Mény, who opened the conference and actively supported this project with much personal commitment and many excellent suggestions. We also received invaluable help and advice from the EUI Administration, namely from Andreas Frijdal, Brigitte Schwab, Kathinka España, Roberto Nocentini, Bobbie Rawle, Alex Howarth and, last but not least, from Valérie Coppini, who helped us carry out the entire project with tireless dedication and enthusiasm. We would also like to acknowledge the help of Jakub Kubicki in transforming many papers with different styles into a single word document and of Signor Pandolfi, in Florence, who patiently made the necessary changes to the manuscript via long telephone calls and took it to press.

Amy Verdun and Hubert Zimmermann were exceptional co-editors. Thanks to them and their remarkable skills and experience as editors and to all contributors – that make for the contents of this volume – it was possible to publish these proceedings and to envisage pursuing this interdisciplinary project in the near future.

Francisco Torres

Chapter 1

Introduction

By

Francisco Torres, Amy Verdun and Hubert Zimmermann

The Enlarged European Union (EU) is facing challenging times. The EU is simultaneously expanding its geographical scope and revisiting existing policies. It has taken on board eight new Central and Eastern European Countries (CEECs) and two small Mediterranean countries. It is likely to take on Bulgaria and Romania in 2007 and later perhaps even Turkey and countries of the Former Yugoslav Republic. In order to enlarge successfully it needed to rethink its institutional structure and reformulate a number of important Community policies, such as agricultural, structural and cohesion policy. The 2001 Treaty of Nice laid the foundation for the enlarged EU. Subsequently, the 2002-2003 Convention dealt with some of the outstanding issues not settled at Nice and ventured into others that emerged when rethinking the raison d'être of the EU. These discussions led to proposing a draft Constitutional Treaty in July 2003, which was eventually adopted with a few changes at the European Summit in June 2004. Though many policies were reviewed during the Convention meetings, one policy area remained almost untouched: Economic and Monetary Union (EMU). The EU's single currency project which has had a chequered history, but eventually became an important cornerstone of European integration, appeared an uncontested area of EU governance. But was it really? Let us first reflect briefly on its immediate past, and then turn to the main questions that this book addresses.

Though EMU was already conceptualised in the 1960s and 1970s it entered into the EU legal framework only with the Treaty on European Union (TEU), signed at Maastricht in February 1992. When it was first discussed in the European Community (EC) it was not possible to generate sufficient support, nor was it the time for economic collaboration on this scale. However, even though EMU was incorporated into the TEU it was still not at all sure that a single currency within a decade would be feasible. Though the TEU entered into force on 1 November 1993, the crisis in the Exchange Rate Mechanism (ERM) in 1992 and 1993 had wrecked havoc with the EMU project. Many wondered indeed if EMU would materialise at all. However, by the mid-1990s the process regained some momentum. Particularly many of the Southern Member States managed unexpectedly to consolidate their public finances and perform well on the 'convergence criteria' that set out the criteria for entry. These criteria referred to performance in the area of exchange rates, interest rates, inflation rates, public debts and budgetary deficits (with the latter turning out to be the main stumbling block). Economists pointed out that once Member States were members of EMU they could more easily free-ride on the 'good performance' of others in the eurozone, so that it might well be necessary to have clearer rules. As a consequence, all would perform well and unsound policies would be discouraged.

In November 1995, the German government took the initiative to develop stricter rules for sound public finances for what was known as 'stage 3 of EMU' (that is, once the single currency would have been introduced in financial markets). The result was the creation of the Stability and Growth Pact (SGP) that stipulates that Member States' budgets be 'close to balance or in surplus' and in any case budget deficits should not exceed three percent of Gross Domestic Product (GDP). Otherwise, sanctions could be imposed. The SGP, agreed to in Amsterdam in June 1997 and firmly embedded in the Treaty on European Union (articles 99 and 104), consisted of two regulations and a Council resolution. At this time, macroeconomic collaboration was also further developed in the form of Broad Economic Policy guidelines and discussions about the creation of an informal Eurogroup that would discuss coordination in EMU.

When the euro was introduced in financial markets on 1 January 1999 many acclaimed North American economists predicted that it would never survive the test of time. Some had even gone as far as to say that the single currency would bring Europe to the brink of war. However, when euro banknotes and coins started circulating in the twelve officially participating EU Member States (and beyond, for instance in Kosovo and Montenegro) on 1 January 2002 no such doomsday scenarios emerged. Indeed, the euro seems to have fared quite well in the first 4.5 years of its existence. Though it had lost thirty per cent of its value vis-à-vis the US dollar by late October 2000 (down to 0.83 from 1.17), it was still considered a respectable currency in these first years. In fact, by the spring of 2002 it started to appreciate steadily so that by the spring of 2003 it even passed its original introduction rate. At that point, commentators were arguing that the euro was too expensive! Little more than a year later, in February 2004, the euro peaked at 1.29 against the US dollar. The fear was that an expensive euro might impede the weak economic recovery that seemed underway in Europe. The success of the euro is not only to be measured by the market reaction to the euro. Its main guardian, the European Central Bank (ECB), was perceived as a solid new institution in these first years. Its policies more or less secured price stability (defined by itself as no more than two per cent of GDP in the medium term – although it did frequently go above that target in the short run).

When the Constitutional debates were taking place in 2002-2003, EMU was deemed to be operating as expected. Many felt it was not the time to embark on serious discussions on revisions. However, what became more apparent at this time was that the governments of some Member States, such as Portugal, Germany and France, were not really aiming at meeting the excessive deficit criteria as set out in the SGP and the Maastricht Treaty. They had not made the necessary cuts in spending during the period of economic growth in the late 1990s. Hence, when growth rates declined their deficits mounted, which left them vulnerable to possible penalties through the provisions of the Stability and Growth Pact. At this point, many economists voiced their criticism of the SGP as implementing its rules would require that the culprits pursue countercyclical policies at a time of economic downturn. Advocates of the SGP pointed out that governments should have thought about that in the good times. Yet, at this point it was still unclear how the SGP would be implemented. The arrangements had both firm language as well as room for manoeuvre. By November 2003, it became clear that political leeway could and would be used to buy some Member States more time. At the meeting of the Council of Ministers of Economic and Financial Affairs of 25 November 2003 a qualified majority decided not to move to the next step of the provisions of the SGP, which would have led to sanctions against Germany and France. The media responded with outrage and disbelief, and those who sympathised with the course of action of these two countries' governments argued that the SGP now clearly was dead. Regardless of one's position on the value of the SGP many doubted the Stability Pact was still to be taken seriously. The Commission eventually decided to challenge the Council decision by taking the case to the European Court of Justice on 3 May 2004 and ask the judges to decide whether the Council decision was in line with the Treaty. On 13 July 2004 the Court annulled the Council decision, and indicated that the Council had the right to reject the Commission proposals, but needed to wait for a Commission initiative to propose an alternative recommendation. At the time of writing (summer 2004) it seems that the principles of the SGP are still upheld, but that the exact contents of the rules may be subject to change in the course of 2005.

The SGP debacle, the continuing debates over how to govern EMU and the questions over its institutional design, indicate how intricately linked economic, political, legal and historical matters are. In addition to the specific questions regarding policy-making in the area of economic and monetary matters, scholars discussing EMU have also contributed to the debates on legitimacy, democracy and accountability in the EU. Scholars have pointed to the fact that EMU generates important symbols of supranational unity: a single currency, a new supranational institution (ECB) and the transfer of sovereignty from the national to the supranational level (monetary policy) as well as acceptance of rules on other important areas of national sovereignty (budgetary policies and public finance). Given that we see semi-federalism emerge in this area of policy-making, one can pose the question whether democratic principles are sufficiently safeguarded. It is for this reason that proposals for an economic government (government économique) keep emerging as soon as EMU or its institutional design are discussed. The question is at what point a counterweight to the ECB (a political or economic body) might be needed as a democratic counterbalance. Some argue there will never be a need for such a body. Others say that economic policy is too political to be left to rules. They argue that the EU needs a political authority to make decisions in this area. Clearly, these questions of governance, democratic accountability and legitimacy are part and parcel of the broader soul searching that is taking place in the EU. Thus, EMU offers a microcosm in which issues that are debated in the EU at large can be studied on a smaller scale.

The above short historical overview indicates how the governance of EMU is firmly embedded in economic, political, legal, and historical perspectives. Governing EMU encompasses an appreciation of all these facets of governance. Furthermore, governing EMU in an enlarged Europe, possibly with a new constitution, will be even more challenging. The current situation raises all kinds of questions that can only be fully understood within a multidisciplinary focus. More often than not, a book on EMU will examine the issues at stake through only one of the disciplinary lenses[1]. This project has the ambition to take all four disciplines on board. We seek to examine matters that relate to the accountability and issues of democracy related to EMU governance and how it raises overall issues of democratic governance in the EU at large. What is the role of the state-society relations in EMU, what is the role of the European Parliament (EP), how does EMU fit with constitutional settings of Member States? The Stability and Growth Pact itself will be scrutinised: what are the underlying ideas behind the SGP, where did it come from, what will be the futures of the SGP, how is one to pursue macroeconomic policies in an

EMU subject to the SGP? We also seek to place the issues in its historical and geographical context. How does the euro fare in a world dominated by the dollar? Will it ever be a major reserve or trading currency? How can institutions contribute to the success of the euro? What are the best transition strategies (and timings) from different currency regimes to the euro? What is the role of standards in financial markets? Finally, the book reflects on the road ahead.

These are important issues. This book is the first collaborative product by the alumni of the European University Institute in Florence, representing the four disciplines. We have sought to address the issue from the various disciplinary perspectives and hope the reader will have a more balanced account of EMU governance as a result of reading this book.

The first section, “Democracy and Governance in the Euro area”, starts off by reflecting on the broader democratic governance issues related to EMU. Oliver Schmidtke’s **Chapter 2** raises the question of how EMU connects to issues of anti-Europeanism, blaming EMU for structural problems in the labour market and the economy. He concludes, however, that EMU might contribute to the creation of a more developed sense of citizenship and belonging of the EU. In **Chapter 3** Francisco Torres digs a little deeper into the democratic characteristics of EMU and its shortcomings. He reviews the literature and the issues at stake with EMU and its design. He focuses on the role of the EP but also whether further developments in economic governance might be necessary to offset any imbalances in democratic governance of EMU. He discusses the efficiency-legitimacy trade-off but concludes that there is no such trade-off. In fact he finds that EMU might contribute to enhancing the quality of democracy in the EU. The **fourth chapter**, by Anneli Albi, turns to constitutional matters. She examines how the creation of EMU led to constitutional changes in various Member States (four in particular). This chapter does not only examine current members of the eurozone but also reflects on likely changes that might be needed in Central and Eastern European countries that are to adopt the euro in the future.

The chapters in section two, “Between Growth and Stability”, examine various aspects of governing the SGP. Simona Talani (**Chapter 5**) offers a provocative analysis of the SGP whereby she examines ‘who wins and who loses from the ECB’s monetary policy. By looking at trade and speculating about decisions in the ECB she argues that it is mainly the interest of the largest Member States which is served by ECB policies. In **Chapter 6**, Martin Heipertz and Amy Verdun look at the origins of the SGP and offer an ideational analysis. They examine the domestic context in which the SGP was put on the international agenda, the overall dominant paradigm that existed during its creation, and what lessons can be drawn from the drafting of the SGP for its future. They suggest that the future of the SGP depends on the overall support for the basic principles on which the SGP is based. **Chapter 7**, by Roberto Tamborini, provides an analysis of the so-called 'Brussels consensus' on macroeconomic stabilisation policies in EMU. He offers an assessment of core EMU questions such as whether the policy-mix between monetary policy and national automatic stabilisers is optimal, and whether discretionary fiscal policies should be banned or limited. He concludes that rules are important to ensure stabilisation as one cannot assume good behaviour on the part of governments. The contribution by Bernhard Winkler **(Chapter 8)** reviews some of the key principles of macroeconomic governance in EMU. It discusses the argument that the notion of stability is a prerequisite for growth. Winkler also concludes that the basic consensus underpinning the Maastricht Treaty and the Stability and Growth Pact is still prevalent, although it has received increasing criticism. He argues that improvements in growth performance should be obtained through structural reforms rather than through a change in macroeconomic policies. In the last chapter of this section, **Chapter 9**, Dario Togati offers a Keynesian critique of the current EMU design, the macroeconomic theory underpinning it (in his words: the lack thereof) and the demand problems that EMU might trigger. Through a critique on the 'Brussels consensus' and a review of what a Keynesian model might bring, Togati offers a few alternative policy solutions.

Section three of the book, "The Euro as a World Currency and as a European Anchor", offers a look at the euro's international dimension. **Chapter 10** by Hubert Zimmermann argues that the motive of creating an alternative to the dollar was, especially in France, but also in other European countries, a powerful driving force in the push towards EMU. However, when the actual blueprint of the Euro-zone was drafted (in the early 1990s), this motive played a minor role due to specific historical circumstances. The eurozone is, as a consequence, ill-suited to engage in purposeful monetary diplomacy. Pompeo Della Posta argues in **Chapter 11** that the rise and fall of the euro vis-à-vis the dollar cannot be explained in terms of 'economic fundamentals'. When the euro was to be launched the analysis leaned on the euro's role as an international currency, whereas when the euro started to drop, analysts tended to argue using the argument of economic fundamentals. Through a review of the economic literature, Della Posta concludes that today one is better off reflecting on the euro as an international currency with an emphasis on expectations rather than merely focusing on fundamentals. The **12th Chapter**, by Maurice Fitzgerald takes us to the British-Irish relationship. The establishment of European monetary cooperation with the goal of a common currency prompted Ireland to abandon one of its most crucial and long-lived economic policy stances: the link of the Irish currency to the British pound. The consequences of this step can hardly be overestimated since it was essential in a radical reorientation of Irish foreign economic policies towards continental Europe. Renzo Daviddi and Milica Uvalic's contribution, **Chapter 13**, reflects on exchange rate regimes on the Western Balkans. This area is characterised by a large variety of regimes. The prospects of these countries joining EMU are still rather remote, since the variety of macro-economic solutions which is necessary to deal with the problems of transition precludes a premature attachment to the restrictive policy mix of the euro-zone. The fourth section of the book on the "Role of Standards and Legal Tender in EMU" comprises two chapters that examine selected legal aspects of the euro and EMU. **Chapter 14** by Maria Chiara Malaguti looks at the role of standards in financial markets. Examining the role of soft law and a few recommendations in this area, her chapter shows how standards are at the core of what could be referred to as a 'new legal order' and as such are of paramount importance. In **Chapter 15** Péter Munkácsi studies the copyright protection of the euro and Hungarian national legal tender. His chapter examines the lack of copyright protection and examines in particular the Hungarian case for once it joins. He advocates a better copyright protection of the euro banknotes and coins. Finally, the last piece by Paul De Grauwe **(Chapter 16)** offers an insight into the governance of EMU, including an assessment of the SGP. His analysis is critical of the SGP in its current form since it leads to too restrictive policies and possibly undesirable outcomes in the long-run if taken literally. His analysis offers food for thought to all those that are keen to learn more about the interaction between economic policy, outcomes and institutional design.

With this book we hope to have provided the reader with a better insight into the economics, the politics, the law and history of EMU. It is hoped that in so doing this volume transcends disciplinary boundaries and opens up debate on the interconnected issues at stake in the further development of EMU in the years to come.

NOTES

[1] Examples of books on the economics of EMU are De Grauwe (2003), Baimbridge and Whyman (2003) and Brunila, Buti, and Franco (2001); a political science perspective can be found in Dosenrode (2002) and in Dyson and Featherstone (1999); a legal text, that focuses mainly on the institutional aspects, is provided by Smits (1997) whereas a historical account is offered by Unger (1997).

DEMOCRACY AND GOVERNANCE IN THE EURO AREA

Chapter 2

Politicising EMU: the 'Legitimacy Gap' and the Populist Challenge to the EU

By
Oliver Schmidtke

Abstract: With the introduction of the Euro and a less benevolent economic climate over the last years Economic and Monetary Union (EMU) has become increasingly politicised and, as the key project of European integration, subject to contentious popular claims. This paper investigates the logic and driving forces behind this process of politicisation on the basis of a theoretical argument: With the transferral of considerable power to supra-national institutions fundamental questions are raised about the range and meaning of democratic rule. EMU sheds light on the growing incongruity between sites of economic and political power on the one hand and the institutional reach of principles of democratic accountability and citizens' involvement in the political decision-making process on the other hand. Against this background, the paper looks at the political implications of EMU as they are related to this critical stage of the European integration process. Firstly, EMU and the European Central Bank (ECB) are recurrently being blamed for the impending crisis of the economy and the labour market. The range of populist, anti-European forms of political mobilisation indicate that with EMU, political conflicts at the European level have become far more severe and, potentially, damaging for the EU itself. Secondly, the political repercussions of EMU can be interpreted as a driving force behind the current concerns for the EU's democratic deficit and legitimacy crisis. In this respect EMU, as the most critical arena for supra-national policy co-ordination, could indirectly contribute to the development of a, albeit thin, notion of a European citizenship status.

Keywords: EMU, legitimacy, democracy, citizenship, populism, governance, political community

1. Introduction

If one studies the public debates accompanying the introduction of EMU in the 1990s it is surprising to see to which degree this monumental step in the

European integration process was widely and primarily perceived as a procedural endeavour in the realm of economics. Initially the interest of the wider public was marginal at best and political deliberation in Europe’s parliaments and mass media remained strangely remote. Even with the introduction of the Euro and its immediate impact on the daily lives of citizens, EMU was still widely perceived as a management issue controlled by the de-politicised world of bankers, bureaucrats and businessmen. This public perception was echoed by how Europe’s political elite portrayed the integration of economic and monetary policies of the member states: They were manifestly eager to justify EMU in terms of a macro-economic rationale whose necessity was said to be too evident and too advantageous to be seriously challenged. As with other key projects of European integration in the past, EMU was highly elitist in how it was launched and, while depicted as a functional imperative, it was deliberately removed from controversial public debate.

Yet, at the same time one could detect a remarkable ambivalence in the discourse of the political elite: On the one hand the issue of EMU was largely portrayed as a kind of expert agreement, a sheer inevitability, that simply needed no public deliberation. On the other hand, however, EMU and the new stage of European integration it launched have often played a key role in the depiction of the future political identity of member states. Thomas Risse et. al. speak in this context of Europe as an ‘identity project’, which encapsulates the blueprint for the path of development that societies are supposed to embark on (Risse et. al. 1999). In this respect, the Euro can be interpreted and has been rhetorically employed as the principal symbol of an emerging European (political) identity. The German case is a striking example in with regards to this point. Although Germans only reluctantly accepted EMU and in particular the end of their much appreciated German Mark they were convinced by the argument made repeatedly by the then Chancellor Helmut Kohl that accepting the Euro means a rejection of the German militaristic and nationalistic past (Banchoff 1999). As in many other member states, EMU was justified as a critical step towards the abandonment of narrow and outdated national interests and thus towards a better ‘European future’ of the old continent. Beyond the alleged positive economic impact the last step towards an integrated market in the EU was portrayed as normatively highly desirable in moving towards the broader goal of European unity.

The key hypothesis of this paper assumes that EMU is, far from being simply a matter of economic policy co-ordination at the international level, intimately linked to the political project of European integration with substantial repercussions on structures of governance in Europe. Beyond the repeatedly discussed issues of the ECB's far-reaching independence from political authorities and its technocratic style of decision-making processes removed from any public or parliamentary scrutiny, this paper seeks to shed light on the far-reaching political repercussions of EMU. More it looks into how specifically the consequences of EMU affect the most basic provisions on which modern, nationally defined citizenship regimes are based. In the way EMU transfers critical decision making power in the field of economic and monetary policies to supranational institutions, it fundamentally challenges the rationale of national communities and the political principles on which they rest. The process of economic and monetary integration hence raises basic questions regarding legitimacy, accountability and democracy in terms of its effects on structures of governance in Europe and the political identity of the European integration process. It is not by accident that gradually, albeit increasingly notable, EMU's challenge to national sovereignty has become a critical reference point of political conflicts in contemporary Europe. In terms of public perception, EMU has become associated — accurately or not — with a deep-seated feeling of uncertainty and the loss of control in managing the economy. The less benevolent economic climate of the last years has further contributed a series of popular reactions to EMU and the power that EU institutions hold in monetary and economic policies (the recent Swedish referendum being a good illustration).

In light of these broad dominant themes in the debate surrounding EMU, this paper will address the following question: Focusing on more recent events following the introduction of the Euro, what popular reaction has the ongoing process of European integration generated? In this regard, the main task is to spell out the political dimension of EMU in terms of its popular perception and the debate it has triggered on the status and range of national communities vis-à-vis the European supranational level of decision making. I will proceed with two major steps. In the first section, the paper will analyse the political challenges that EMU poses to nationally organised citizenship regimes. Following T.H, Marshall's classical distinction of key rights associated with modern citizenship, the imminent political quality of EMU and ramification for principal political questions will be depicted. At the core of this section is an argument about the changing nature and boundaries of political communities and their mode of self-organisation in an environment of supranational co-ordination of economic and monetary policies. Here, dominant issues from public discourse will be addressed that are related to the endangered European social model and the democratic deficit of the EU. The second section identifies two politically opposing popular reactions to these challenges. While populist anti-European sentiments and the plea for a more substantiated European citizenship status have little in common in terms of the political future they envision for the EU, they both indicate a growing and increasingly controversial political debate on the ramifications of EMU. Both phenomena —the rising populist opposition to European integration and the demand for a more full-fledged European citizenship regime — are critically related to the EMU as the core initiative of the EU in the last decade. The deficient responses to the ever more apparent legitimacy gap opens the route to an institutional learning process directed at far-reaching reforms of governance structures in Europe as well as a fundamental populist opposition to the EU as a whole.

2. The political challenge of EMU to established citizenship regimes

To better understand the 'political dimension' of EMU and the popular reaction it has sparked recently additional theoretical reflections promise to be helpful. By referring to T.H. Marshall's categorisation of civic, social and political rights this chapter is meant to investigate EMU's impact on established citizenship regimes and how it challenges the regulative idea and the institutional fabric of sovereign nation-states.

EMU and the political right of democratic self-determination

With its transferral of supreme authority in the realm of economic and monetary policies to the European level the very idea of politics as the collective self-determination of citizens in a national community is in doubt. The nation-state as it emerged in Europe in the late eighteenth and nineteenth centuries became the exclusive spatial and social container of modern democratic politics (Walker 1993). It has stipulated rules of how membership in the modern form of political community is to be conceived. A fundamental function of this nationally defined community was to draw the line between those who were said to legitimately belong and those who were seen and treated as "foreigners." To become the exclusive wielder of the legitimate power of coercion (Max Weber), and thus to infringe on the freedom of individuals, the state needed a clear sense of whom its monopoly of power referred to, what the boundaries of its jurisdiction were, and whose consensus it needed for its legitimisation. The very institutional framework of modern democracy has historically been based on the regulative idea of a nation-state demarcating the community of those who could legitimately participate in and be affected by the collective decision-making process.

EMU challenges this basic rationale of a world organised in accordance with the Westphalian principles of independent and sovereign states. What can be observed in today's process of European integration is a growing incongruity between sites of economic and political power on the one hand and the institutional range of democratic transparency, legitimisation and accountability on the other (Greven & Pauly 2000, Rosenau 2000). While forms of authority outside the realm of national politics shape critical aspects of the lives of citizens, their democratic rights of participation extend to this level of decision making only in a very remote way. At the core of the 'democratic challenge' is the fact that states are gradually losing the policy autonomy and capacity necessary for determining critical aspects of their citizens' social and political existence. If democracy has at its core the right of citizens to participate in the decision-making process over those issues that determine their lives, transferring authority over economic and monetary issues to supranational institutions requires new forms of democratic governance. In this respect EMU has rapidly transformed the structural context and institutional setting in which basic democratic rights are supposed to be exercised.[2]

In opposing this reasoning, one could formulate the following two key arguments that would – albeit with other intentions – echo Schmitter's (2000a) provocative question, why we would need to bother about the democratic deficit at all. The first argument assumes that the decisions of the European bank and the EU in general are sufficiently legitimated indirectly via national contexts and, also given the mode in which central banks operate, that there is no need for extending patterns of democratic accountability to this realm of state activity. Second, following Weber´s notion of functional legitimacy, the argument could be made that EMU and its institutional framework of implementation rest on a form of output legitimacy[3]. The performance of institutions such as the ECB should be measured in terms of their effectiveness and success (and the resulting degree of satisfaction in the population) rather than by standards of democratic accountability. However, both lines of arguments do not question the poor account of participatory democratic accountability; they doubt whether its standards can indeed be applied to these policy fields and institutions at all.

While these hypotheses might have their merits they should not ignore that the degree of confidence and trust in EU institutions is comparatively low. The regular surveys conducted by the Eurobarometer give clear evidence of the irritating gap between the general willingness to support the cause of

European integration and the growing mistrust in and alienation from key EU institutions[4]. It reflects that the process of European integration and in particular the move towards a political union has undermined the effectiveness of democratic governance. While democratic practices in national contexts are far from ideal, processes of representation, accountability and legitimisation are still almost exclusively rooted in the institutionalised apparatus of the nation state (the strengthened role of the European Parliament is not likely to change this substantially). It is the gap between the lack of such an institutional arrangement at the European level and the relegation of power in key policy areas – EMU being the most pertinent one – that is at the core of the democratic challenge and legitimacy crisis that the EU after Maastricht must face[5]. As we will see in the second section, it is this distinct notion of being exposed to a level of governance and power over which one has little if any control, which has sparked the process of politicising EMU in controversial terms.

EMU, social rights and the European social model

One of the crucial challenges that the latest stage of European integration poses to citizenship regimes, is that it weakens the functional and ideological bases for the distribution of social resources (Barbalet 1989). Here, another theoretical consideration is helpful. The logic of systems such as the welfare state has traditionally been based on the principle of an "exclusive universalism," with the distinction between members and non-members in terms of entitlements and rights. Even though the benefits of the welfare state are granted to those who legally work as non-citizens in a country for an extended period of time, its provisions are clearly defined by social rights through membership in the nation-state.

In this respect, social rights are distinct from political rights. Whereas political rights (voting as the most pertinent example) could be extended to non-citizens without necessarily jeopardising the integrity of the entire system, social rights cannot. Welfare states are critically dependent on a clear definition of entitlements and thus on discriminatory measures that allow them to generate a stable pattern of social inclusion and exclusion. In this respect national exclusiveness does not necessarily reflect a morally illegitimate act; rather, it can be seen as functional with respect to securing a meaningful universalistic set of entitlements for all citizens. The foundation of the modern welfare state is also challenged by concerns regarding the political legitimacy of its processes and results. The production and distribution of scarce goods in a society require political authority that may legitimately impose taxes and re-distribute wealth in a society. Traditionally this legitimisation emerges from the collective will of the citizens as defined by membership in a nation-state.

Given the nature of the policies involved, EMU fundamentally challenges the rationale of nationally contained welfare state regimes. The harmonisation of monetary and, as currently considered by the Commission, taxation policies, drastically reduces the option that national governments have in terms of managing the economy and social relations. With the stability pact and its effects on national sovereignty in the field of economic and monetary policies there is a declining capacity of the state to provide collective goods and public services. Its regulatory power and effectiveness in this field ultimately depends on decisions taken at the EU level. The Keynesian approach to managing the economy became unfashionable already some time before the introduction of EMU (also for good economic reasons). Yet the degree to which national governments now operate within a narrowly defined range of macro-economic options is a qualitatively new phenomenon.

There is a long and highly controversial discussion as to whether EMU is to blame for the dismantling of some of Europe's more advanced welfare states, the retrenchment in public services and to which degree – if at all – it has sparked a race to the bottom in terms of restricting the state's intervention into the economy (Leibfried & Pierson 1996). This paper does not seek to engage in this debate. Rather, considering popular reactions to EMU, it seeks to point out that the image of the EU and the ECB as limiting the options of national authorities in the realm of managing the economy has found strong public resonance. Regardless of whether there is indeed a trend of convergence towards the lowest common denominator EMU has largely been perceived as a genuine threat to the so-called European 'social model' (Kittel 2001). Partly this is due to the fact that politicians from all major parties have repeatedly used the EU as the scapegoat for implementing austerity policies at the national level. At the rhetorical level, EMU has been employed in public discourse as an agent of globalised markets that can be blamed for the competitive environment to which national approaches to managing the economy seem to be condemned to adhere[6]. The convergence criteria have been employed as an important rhetorical device in public discourse to overcome domestic opposition to cutting public expenditures and expensive state welfare programs (Verdun 2000a).

Against this background it will be of decisive weight whether and to which degree the EU is able to justify fiscal retrenchment and re-distributive policies at the European level. As stated above, European welfare states are critically built on a strong sense of inclusiveness and solidarity in national communities. The more the EU will determine the margins within which fiscal spending is conducted, the more it will become vulnerable to accusations of imposing unjustifiable harsh conditions on state agencies. The critical weakness and source of vulnerability of the EU, in this respect, is that it has not yet created a strong sense of commonality and support for the European cause. In more emphatic terms, this has been described as a lack of a viable European *demos* and identity — a sense that Europeans share a community of fate in which the lives of citizens are inextricably linked. The critical question that the EU faces in terms of a common economic and monetary policy is whether there is a strong enough a European identity and commitment to the European cause to temper conflicts of interests and to extend forms of solidarity beyond national borders. The more ambitious the goals become in terms of integrating the established nation-states into a wider political union, the more it becomes obvious how fragile the legitimating base of this trans-national community is. It seems unlikely that the image of a 'market community' will prove sufficiently strong to legitimate the re-distribution of social resources at a European level. Also, the current economic crisis has repeatedly highlighted the thin social and political consensus on the basis of which the EU has to operate. Here the legitimacy gap between the efficiency of policy formation and the demand for democratic accountability again becomes apparent: The agencies that determine the policy framework for monetary and social policies are only very indirectly accountable to those whom they affect (thus violating the sacrosanct slogan of modern democracy "no taxation without representation", Schmidtke 2001). If the task to govern the economy can still be considered a key responsibility assigned to the elected representative in a democratic community EMU fundamentally challenges the traditional mode of generating accountability and legitimacy.

EMU and the transformation of the boundaries of political community

At the core of the political challenges imminent in EMU is the way in which its mode of operation questions the boundaries of established political communities. While one could argue that it is not likely to prove so difficult to extend political and social rights to the European level, citizenship and nationhood are often interpreted to be identical in modern western political life. As Brubaker states categorically, the nation-state and its delineation of a political community set the institutional and subjective framework for the very notion of citizenship and its attendant rights:

> Debates about citizenship, in the age of the nation-state, are debates about

> nationhood—about what it means, and what it ought to mean, to belong to a nation-state. As an institutional and socio-psychological reality, the nation-state is a distinctive way of organizing and experiencing political and social membership. (Brubaker 1990: 380)

Still today citizenship has thus been understood almost exclusively in terms of the nation-state, and as the inclusion into a nation-state. Halfmann, for instance, argues strongly in favour of associating citizenship with "state authority over the regulation of membership in nation-states. Membership in a nation is called citizenship" (Halfmann 1997, 266). He continues his argument by stating that from the perspective of the citizens themselves "the association of citizens forms the people who then constitute a nation by constructing a common denominator" (267). In this perspective, therefore, the nation-state is the functional prerequisite for politics in modern liberal democracies. Internally, national citizenship regimes have historically been based on a fragile equilibrium of duties and rights regulating the relationship between individuals and the political community. The nation-state guarantees a certain degree of personal liberty and social well-being for a clearly assigned constituency. The citizens in return accept nationally defined and democratically controlled politics as the agency that has the power to generate collectively binding decisions. Individual rights and entitlements on the one hand, and loyalty to the political community on the other, are the key elements in generating mutual trust and continuity.

Beyond this "rational" base for the nation-state there is an additional, pivotal element that is crucial to the stability and legitimacy of national citizenship regimes, particularly in the European version of the nation-state. This is a "pre-political" sense of belonging that is ethnically or culturally defined and provides a supposedly unquestionable reference point for deciding who can legitimately claim to be part of the community. The two dimensions, however, are closely associated. The sense of the "common denominator" can be seen as the pre-political base on which notions of equality and solidarity are built and the commitment to the political community as a whole is based. The underlying rationale of the European nation state has been rooted in both notions, a functional arrangement for rational administrative practices of the state and a cultural sense of belonging. The functional and identitarian aspects are closely intertwined in the historical role of the nation-state. Stipulating the duties and ensuring the rights of citizens depended on a particular mode of social and political integration into the community, by a binding collective identity strong enough to generate political loyalty and conformity with the rules that the community stipulated (Donati 1995).

At the centre of discussions on the status of the nation-state in contemporary politics and its relationship to the EU are concerns about the viability of this form of delineating the political community (see Bauböck 1994). Modernising the basis for citizenship would mean generating criteria for membership other than ethnic or cultural ones. It is possible that such a radical redefinition of citizenship would jeopardise its very existence. As Hannah Arendt most articulately said, questioning the idea of the sovereign nation-state as the basis for citizenship might be a politically risky undertaking:

> A citizen is by definition a citizen among citizens of a country among countries. His rights and duties must be defined and limited, not only by those fellow citizens, but also by the boundaries of a territory. . . . Politics deals with men, nationals of many countries and heirs to many pasts; its law are the positively established fences which hedge in, protect, and limit the space in which freedom is not a concept, but a living political reality. The establishment of one sovereign world state . . . would be the end of all citizenship. (Arendt 1970, 81-82)

Europe can be seen as an exemplary case about the dissolution, or at the very least, the radical redefinition of national borders. Reflecting the reality of increasingly de-nationalised processes and challenges in all major policy areas, politics and policy making in the EU transcends national borders by an ever-expanding degree. With its transformation into a political union the EU has gradually taken over legislative competence in areas formerly reserved to sovereign nation states. The sense of who can be considered a member, and an alien, within one's own community gradually shifts from the national domain to the external borders of the European Union. EMU can be seen as the driving force in promoting this redefinition of the scope and mode of operation of political community. With its supranational policy co-ordination in one of the key areas of citizens' rights and claims, EMU almost inevitably raises questions about the viability of current (national) governance structures, patterns of socio-political integration and modes of dealing with political authority. In this respect, the current stage of European integration and the drive towards economic and monetary union is politically at a critical stage. While much authority has already been relegated to EU agencies, institution building in terms of generating a more substantiated political community at the European level is still in an initial phase. One could speak of an institutional gap in terms of re-configurating fundamental rights of European citizens and their sense of political community in accordance with the emerging supranational policy regime.

3. Popular perceptions of and reactions to EMU

The somewhat paradoxical result of the successful drive towards EMU and the transferral of political authority in governing the economy to the European level is that the democratically sanctioned legitimacy of the EU has become an increasingly important issue of public concern and a subject of political controversy. While shedding light of the process of politicising EMU this section will focus on the politically more pertinent reactions to the integrated economic and monetary policies at the European level.

Anti-European populism

Given the general appreciation of the idea of European integration throughout the continent (with the notable exception of Great Britain and some Scandinavian countries) it is has come as a surprise and a shock to some supporters of the EU that Ant-European feeling have become a notable force in politics. My basic hypothesis in tackling this phenomenon is that, beyond national particularities, there is a common denominator or driving force spurring the political mobilisation of right-wing populist actors that is related to the process of European integration. The internationalisation of European societies both with respect to the integration of national economies into bigger supranational regional blocks, and the transferral of political authority from the national to the European level, has caused a level of anxiety and uncertainty that can easily be exploited by simplistic and populist forms of protest (Sassen 1998). It is against this background that the success of a variety of right-wing, populist organisations in Europe could occur. The Austrian Freedom Party, the North Italian Leagues, the Belgium Vlaamse Block, the Norwegian Progress Party, the Dutch List Pim Fortuyn, the German Republikaner, the Danish People's Party or – most established – the French Front National (just to name the better known cases) have attracted astonishing political support mainly by employing a nationalistic, anti-immigrant platform.

Increasingly these actors have also discovered Europe and the EU as a genuine field of directing their populist claims about the alleged vulnerability of the nation state and national community. In a period in which national differences and identities seem to evaporate due to the breathtaking pace of European integration, these organisations have successfully launched campaigns advocating social closure and nationalist options. The way in which EMU came into being and in which many EU institutions operate invite for such political exploitation by populist and simplistic arguments: The highly limited knowledge among citizens about the EU, the absence of a thorough public debate on some of the key projects of European integration, and the lack of transparency in the decision-making process of EU institutions make the EU and in particular the ECB — as one of its main representatives — an easy target for those who claim to speak with the 'voice of the people'. The popular perception of the EU as a remote bureaucracy seems to be a perfect fit for populist actors and their claim to articulate the alleged alienation between the people and its leaders.

The perplexing complexity of issues at stake in questioning the exclusiveness of national community can, for political purposes, be addressed by recourse to the allegedly superior and self-evident national community. National community still provides the most forceful narrative of defining identities, interests and individual entitlements. Although often oversimplified and distorted images are employed that contrast the corrupt and immoral world of EU bureaucrats and the benign realm of the national community, there is a rational notion to these arguments. They can relate to popular images of EU institutions as remote and unresponsive entities. The degree of change introduced by EMU and the unpreparedness to effectively deal with some of its political implications has generated a climate of uncertainty that is highly conducive to such populist slogans about the natural superiority of the nation-state. The complexity of political issues such as unemployment, economic management or cultural identity in a world of globalisation can be portrayed as the product of abandoning the nation state in favour of untrustworthy European institutions. In this respect the growing success of anti-European feelings in politics reflects the shortcomings of how projects such as the EMU have been launched and operated.

At the same time it needs to be emphasised that focusing on right-wing, Anti-European campaigns does not mean that more established parties are immune from using this populist tool for their own political mobilisation. In mainstream parties and the media, the issue of the EU as an alleged threat to the integrity of national community has been employed in a populist fashion designed to evoke emotional attachment to those defending national interests and identity. In times of an ever closer resemblance of major catch-all parties, the issue of Europe has repeatedly been used as an effective political device to polarise the electorate and to re-instate strong party allegiances. The British Conservative Party might be an exception in Europe but, in spite of the general pro-European attitudes of the political elite, there are tendencies pointing in a similar direction throughout the continent (interestingly on the left and right of the political spectrum). Entering into the stage of political integration the EU can no longer rely on the general, albeit rather unspecific consensus and support for the European cause. The more concrete and far-reaching the range of policies under EU jurisdiction become the more its policies are likely to become the target of political campaigns and controversies. As a result, the process of Europeanisation (Cowles et al. 2001), far from being unchallenged in political terms, has at least the potential to spark a more aggressive re-nationalisation of European politics.

The plea for a Europe of the citizens and a European citizenship regime

To oppose popular reaction to EMU is to agree with its ambitious goals regarding European integration while demanding a greater say for Europe citizens in implementing this process. This claim relates to the deficiency described in the first section of the paper: Until recently, the initiatives of the EU regarding a European citizenship have been widely restricted to ensuring economic rights of free movement, establishment and service provision. Political and social rights are still highly limited and relegated to the national domain; the whole idea of a substantiated European citizenship status has been alien to the entire integration process so far. Currently, European citizenship, as envisioned by the member-states at Maastricht and Amsterdam, is still very much a project in the making. It is yet unclear whether this European citizenship is intended to replace the whole array of rights and duties specified in national contexts, or whether it is to complement national laws (Beyme 2000, Soysal 1994).

The demand for a European citizenship status reacts to and reflects the widespread unease with the process of European integration as being exceedingly remote from the life experiences of Europe's citizens. The critical question is how the general, albeit rather abstract appreciation for the European cause can be translated into solid political acceptance of the key policies driving this process. In order to become politically meaningful in terms of broad popular support and a cohesive trans-national collective identity, symbolic integration needs to be embedded in a particular social practice. As long as the value community is something existing alongside and largely detached from the functional process of economic and administrative integration, it will remain relatively alien to the overwhelming part of the population. Extending civic, social and political rights beyond national borders could be interpreted as the necessary complement to a market driven co-ordination of economic and monetary policies at the supra-national level. The ideational common base needs to be translated into the concrete political and social practice of individuals if it is to create the strong bonds on which the popular legitimisation of the European integration process is dependent. A European identity, which would be able to create a firm base for political legitimisation and later loyalty, is dependent on a clear notion of institutionally embedded practices of political participation and social rights (Habermas 1998, Schmidtke 1998).

Reflecting these concerns there is a growing concern in public debate that the process of European integration and in particular EMU would be incomplete and in the long term politically unsustainable unless substantiated civic, social and political rights are developed at the European level for the citizens of member states. Although it could be argued that intellectuals and parts of the political elite have primarily initiated the drive towards a meaningful form of European citizenship status, this idea has been taken up by a plethora of social movements, political organisations and parties. Regardless of its actual outcome and its controversial achievements so far, the public debate on the Constitution for Europe and the work of the European Convention have been at least promising what has been fundamentally missing from previous key decisions in the process of European integration, namely a public deliberation that is key to democratic self-governance (Eriksen & Fossum 2000, Schmidt 1998).

4. Conclusions

Whilst initially portrayed as a functional imperative of the integrated European market, EMU has become gradually politicised as a key element in changing the political landscape in Europe. As the challenges that EMU poses to traditional and nationally confined modes of decision making concern fundamental provisions of established citizenship regimes, they raise critical questions about forms of governance. In this respect, issues such as concerns over democratically responsive forms of governance and re-distributive justice are not marginal to the process of economic and monetary integration in Europe. With the transferral of considerable power to supra-national institutions, EMU calls into doubt the range and meaning of democratic rule as it is institutionalised in national contexts. It sheds light on the growing incongruity between sites of economic and political power on the one hand and the institutional reach of principles of democratic accountability and citizens’ involvement in the political decision-making process on the other (Zürn 1999). EMU has transformed structures of governance and thus undermined basic patterns of accountability and legitimacy linking political authority and individual citizens. Transcending the very logic the Westphalian state model and its core idea of nationally bounded democratic regimes, EMU moves beyond the principles of state sovereignty and thus evokes ideas about the inclusion of citizens beyond the criteria of national belonging. The gradual process of politicising EMU indicates that the EU and the member states have to react to the structural imbalance between power relegated to the European level and the lack of democratic accountability and citizens' involvement extending to this policy level. The *status quo* rooted in the de-coupling of economic and political integration — characteristic for much of the post-war European integration process — seems to be no longer sustainable. At the same time, the growing popular awareness of the legitimacy gap is not yet matched by a drive towards forms of democratic governance that would suit the peculiar institutional set up of the EU.

Popular reactions to EMU in contemporary Europe mirror these concerns and fears. What the two modes of politicising EMU identified in this paper have in common is the doubt that the status-quo can be extended much further in light of the fragile popular support it can rely on: On the one hand, EMU and the EU in general are recurrently being blamed for the impending crisis of the economy and the labour market (the EU and in particular EMU as the scapegoat for economic reforms and hardship). The range of populist, anti-European forms of political mobilisation indicate that with EMU political conflicts relating to key EU policies have become far more severe and, potentially, damaging for the EU itself. The institutionally weak base for democratic accountability and the mainly market driven notion of political community and citizenship threatens to be rhetorically exploited in populist images of "foreign rule" through Brussels. On the other hand, the political repercussions of EMU can be seen as a driving force behind the current constitutional debate of the EU and the demand to generate a more meaningful citizenship regime at the European level. In this respect EMU, as the most critical arena for supra-national policy co-ordination, could indirectly (and probably unintentionally) contribute to the development of an, albeit thin, notion of a European citizenship status.

NOTES

[1] As this paper is primarily interested in how EMU is related to issues of legitimacy, accountability and democracy and what effects this relationship has had on the process of European integration in terms of popular reaction the features of what has to become conceptualised as the 'democratic deficit' of the EU will not be discussed in detail. Instead this paper seeks to point out how EMU structurally changes modes of governance in Europe and thus poses qualitatively new challenges to nationally organised democracies. For

an insightful discussion of the institutional aspect of the EU's democratic deficit see the special issue CPEE (Stavridis & Verdun 2001), Chryssochoou (1998) and Verdun (2004).

[2] The discussion on "cosmopolitan democracy" is instructive in this context: Held (1995), Held et. al. (1999) and Rosenau (2000).

[3] See the discussion by Scharpf (1998, 1999) on these terms in the context of European integration.

[4] The latest data form a survey conducted by the Eurobarometer shows similar results: Most people in this survey are clearly in favor of the idea of a constitution for the European Union. Yet at the same time a majority of these people stated that they know little about the work of the Convention and other key European projects (Eurobarometer 59 - The Spring Standard Eurobarometer).

[5] It is to be seen whether the strengthened role of the European Parliament and its mandate to govern the ECB will be successful in addressing the democratic deficit that is a structural feature of the emerging form of multilevel governance at the European level (Marks & Hooghe 2001).

[6] The fact that EMU is embedded in the Single European Market is reflected in the public perception to see EMU and the ECB as the principal agents of the global market. While the latter is as pervasive as abstract the ECB provides a clearly identifiable object of political discontent and dispute.

[7] Debate over the European Convention on Human Rights for instance indicates that citizenship as stipulated in national contexts may not yet be feasible at the European level altogether See the discussion in: Camberale 1997, Eder and Giesen 2000, Schmitter 2000b, and Wiener 1998.

Chapter 3

EMU and EU Governance [*]

by

Francisco Torres

Abstract: This chapter argues that a shift from an intergovernmental form of governance to a supranational regulation form of governance, as is the case of Economic and Monetary Union (EMU), may not only do away with the efficiency-legitimacy trade-off but also enhance the democratic quality and effectiveness of European governance in the monetary sphere. The European Parliament (EP) plays an important role in this process. It enhances the democratic accountability of decision-making in supranational regulation (monetary policy). It also plays an important role as a principal of the European Central Bank (ECB). That new role of the EP materialised because of the change in the nature of delegation, i.e. the initial principal (national governments represented by the European Council and the Council of Ministers) delegated to an agent (the ECB) in order for the agent to control the former principal's behaviour in regard to monetary policy. The EP, a principal in the making, one may argue, has also allowed for increased participation in and deliberation on the discussions about the conduct of monetary policy by the ECB, contributing in this way to greater transparency.

Keywords: Governance, supranational regulation, monetary policy effectiveness, accountability, delegation, principal-agent relations

1. Introduction

Most authors dealing with the legitimacy problem, the democratic deficit and the efficiency[1] of the decision-making process in the European Union (EU) defend that the EU would have to opt to be either a federal political union, with

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one government and one parliament, or a confederation of sovereign states, without majority-voting. In most of these analyses, the present role of the European Parliament (EP) has been somehow neglected. Most of the time, the EP's role is only analysed as a potential conventional parliament in a future federal political union. For a considerable part of this literature and also for many EU observers and national politicians, the European Parliament has "an inferior representative quality" and therefore it is argued that a parliamentarisation of the European Community (EC) system would not improve its democratic quality.

By the same token (see for instance Scharpf, 2001 and Héritier, 2002), the so-called Community method of integration is said to face an efficiency-legitimacy trade-off. It is not possible to increase the legitimacy of the EC system without decreasing its efficiency and vice versa. In other words, there is a trade-off between democracy and the European Union's problem-solving capacity. Höreth (1999) suggests that the quest for more legitimacy of EU governance is a zero-sum game. Reinforcing the input legitimacy could well reduce its efficiency.

On the other hand, from a normative perspective it can be argued that legitimacy cannot be reduced only to performance. Notwithstanding such normative objections, some output legitimisation, for example through a functioning Economic and Monetary Union (EMU), can contribute to and benefit from input legitimisation.[2]

Increased input legitimisation – transparency and accountability – smoothes the processes of agreeing on and implementing common policies, thus facilitating delivering.[3] The two processes are then cumulative in enhancing the democratic quality and effectiveness of governance in the EU. It is with that approach to input and output legitimisation that this chapter discusses the view that there is a trade-off between democracy/legitimacy[4] and efficiency in the European integration process.

1.1. Aim and scope of the chapter and its structure

This chapter analyses how European policy constraints and goals contribute to increasing the democratic quality and effectiveness of governance in the European Union. It discusses how processes (i.e. their democratic quality) and the system's effectiveness in terms of outcomes (formulation and implementation of policies) evolve in a political system such as the European Union. Thus, it looks at how the democratic quality of governance in the EU may enhance the effectiveness of the European integration process and/or of the policy-making process in the EU. Its main questions are how do domestic and European factors generate durable reforms. In particular, how do the new challenges posed by EU policy objectives bring about a change in attitude at the European and the national level? Conversely, how do such challenges, policy constraints and European and/or national objectives as well as the new modes of governance contribute to the democratic quality and legitimacy of the European integration process?

With these objectives in mind the chapter centres on the example of EMU, the making of its rules and the overseeing of the European Central Bank's (ECB) conduct of monetary policy to examine whether there is indeed a trade-off between efficiency on the one hand and transparency and accountability (and participation and deliberation) on the other hand in the process of European monetary integration.

While this example of supranational regulation may be subject to the above referred trade-off one has to acknowledge that the building-up of EMU could well have enhanced different forms of participation, namely by national parliaments and European citizens. It also represented an accountable and relatively transparent power delegation of executive authority (from the European Council and the EU Council of Ministers to the ECB). If that is the case, and if there is no evidence of decreased efficiency in that process, one has to look elsewhere for that trade-off.

The chapter also investigates whether some of the characteristics of the process of European integration can be seen as solutions both for the problems of increased complexity and individualisation of modern societies and for the on-going process of globalisation. Monetary policy may well have been beyond the reach of the democratic political system before centralisation (EMU). If that was the case, we depart from a non-zero-sum game: abandoning the intergovernmental mode of governance in that case would not even have been subjected to the legitimacy-efficiency trade-off.

In that case, "elsewhere" is in the steady-state of supranational regulation of monetary policy, that is, the system since 1999. In fact, it was in 1999 that EMU's third phase began. Consequently, EMU has to be analysed in terms of its contribution to increased transparency and accountability (and also participation and deliberation) of the implementation of monetary policy by the ECB.

An additional but rather central question (subject to efficiency considerations) that the chapter tries to answer is whether and if so to what extent the European Parliament is fit to function in a EU polity. Therefore the chapter investigates the nature of the increasingly important (though usually disputed) role of the European Parliament as a principal of the ECB. Thus, it analyses the European Parliament's increased involvement in overseeing the Central Bank's activities, aiming at understanding whether and how that new role has significantly affected the above referred trade-off (in the steady-state of supranational regulation of monetary policy). For that purpose it is necessary to understand whether the European Parliament can develop its role of principal (overseeing the activity) of the ECB without putting at risk the credibility (and consequently, effectiveness) of the European monetary authorities in the financial markets. Furthermore, the chapter seeks to clarify how the EP diverts political pressure by various interest groups away from the monetary authorities towards itself.

The chapter is structured as follows. The next section examines the issue of increased centralisation of policies and of political structures in modern societies in general and in the EU in particular. Section 3 discusses the importance of enhanced accountability as a way of improving the quality and effectiveness of European monetary integration. Section 4 deals with the question of the qualitative change in the process of continuously evolving governance in the EU against the background of the growing individualisation of society and the complexity of issues at stake. Section 5 centres on the example of EMU from the perspective of being able of bringing into account uncontrolled forces through a process of multi-level political negotiation capable of creating credible, long-lasting institutions. Finally, section 6 concludes on how the interaction between representative institutions at different levels allows for more participative and transparent modes of governance and how a shift from the intergovernmental to these modes of governance may enhance the democratic quality and effectiveness of governance in the EU. It also concludes that in the case of EMU the democratic accountability of governance in the EU has been substantially enhanced thanks to the emerging and evolving role of the European Parliament as a Principal of the ECB.

2. Increased centralisation versus the growing need for democracy in the EU

Modern societies have become more complex in nature. In addition, in an increasingly individualised society and due to the process of globalisation, the traditional mechanisms of a parliamentary democracy seem not to be satisfactory. At the level of the state, but as well at the EU level, the parliamentary system has to live up to a two-fold challenge. First, it has to be effective in the light of the growing intervention needs of the state in complex, permanently modernising industrial societies. Second, it has to be democratically legitimate, serving as an instrument in the political decision-making processes. Bureaucratisation and oligarchisation are then at the centre-stage of the democracy discussion, due to the concentration of decision-making and power in the social and political system within ever larger organisational structures.

Neumann (1950, p. 10) suggests that in a given context, any political system can be analysed in the light of some formal criteria.[5] Let us bear in mind Neumann's three most relevant criteria: efficiency, transparency and participation. Efficiency is the relation between benefits and costs (technical-rational economic performance: higher benefits for the same costs or vice versa); transparency is the degree of disclosure, important for control and indeed accountability; and participation refers to participatory observation, counselling and co-decision.

Concentration of decision-making in some institutions in modern democracies mirrors situations in which legitimate principals have delegated power to agents for the sake of efficiency. The process of delegation itself may, as for instance one can argue for the case of Economic and Monetary Union, meet transparency and accountability requirements. However, those legitimate principals expect agents to carry out policies that are consistent with their initial preferences. Nevertheless, for different reasons[6] the agent's actions may differ from the principal's preferences. Transparency, in conjunction with accountability, is critical to ensure that agents comply as mandated.

2.1 The issues of efficiency, transparency and participation at the EU level

As far as transparency is concerned, monetary reform is already leading to greater transparency. Such enhanced transparency of European monetary policy, improves the democratic quality of the European integration process.[7] In the case of EMU, compared with the previous situation (with the exception of Germany), there was already an increased degree of transparency, accountability and indeed participation. This increase occurred through referenda on the Maastricht Treaty, through public discussions during national and European election campaigns and when making of its rules. The EMU process of delegation met some accountability and transparency requirements.

However, it is possible to improve the democratic quality of monetary policy decisions by making sure that the agent's actions do not differ from the principal's preferences. It could be improved by means of enhanced transparency and accountability as well as through deliberative processes among monetary policy experts that have different perspectives on the conduct of monetary policy.[8]

To hold agents accountable one needs not only transparency but also enforcement mechanisms.[9] These provisions are particularly relevant for the relationship between the ECB and the European Parliament. In fact, although the EP's oversight of the ECB's activities lacks enforcement mechanisms – as it cannot pass any laws which define the goals and tasks of the ECB – it has been able to develop an informal role in overseeing the ECB. The litmus test for that capacity – i.e., a serious crisis or conflict – has however not taken place yet.[10]

The process of globalisation made the tension between increasing complexity and the growing perceived need for further developed democratic mechanisms in modern societies more acute. In fact, with globalisation, concentrated decision-making and larger organisational structures are well beyond the sphere of democratic influence of national social and political systems. Moreover, many of the various problems that modern societies face cannot be dealt with successfully by national political systems – let us think of monetary and financial instability, just to stick to our example (EMU).

Governments of different countries can only partly deal with such types of transnational problems by collaborating. Collaboration comes at a higher cost because at the intergovernmental level the process of reaching decisions is more complicated. There are thus (very concrete) additional costs in terms of efficiency. Examples are the difficulties to reach agreement among governments, to get then the approval of their respective parliaments, etc. Citizens may feel even more acutely the need for enhancing democratic mechanisms given the lack of transparency and/or the insufficient participation in that type of decisions.[11] In fact, one can argue that the inter-governmental level alone, while necessary for carrying on the European integration process both in terms of processes and outcomes, is neither an efficient nor a transparent way of governance in the European Union.

Where regional, national, inter-governmental and federal structures overlap, the tensions between increasing complexity and the growing felt need for democracy in modern societies is even more evident than at the national level. In the EU there is an on-going evolution in terms of sharing sovereignty that should increase efficiency. Stable forms of political cooperation among the EU Member States are hence part of the solution as a way of improving efficiency. At the same time they are also part of the problem in terms of transparency and accountability as well as participatory and deliberative processes. Given that in the EU responsibility is much more diffuse than in national systems, it becomes even more difficult to make the various institutions that formulate policies and/or take decisions at different levels accountable.

The question then is how to address the identified democratic deficit in terms of democratic accountability and transparency in the EU. Gallagher, Laver and Mair (2001), discuss different ways of making policy-decisions in the EU more accountable and responsive to European citizens. They identify three major possibilities: EU-wide referenda; direct elections for the president of the European Commission; and to operate more in accordance with the subsidiarity principle. While the latter is already enshrined in the Treaty on European Union (TEU), the two other solutions may suffer from being a too straightforward extension to the EU level of different national practices and traditions. More importantly, the growing complexity of political structures, especially acute in the case of the EU, sits uneasily with yes/no referenda (as was the case for Denmark, France and Sweden and it will be the case for the United Kingdom(UK)) and/or simple extensions of national practices beyond the nation state.

Following Neumann (1950), the only criterion for the democratic character of an administration is the full political responsibility (accountability) of the top of the administration, not towards single interests but to the whole of the voters, by means of responsible representatives (see Steffani, 1973). The EP is the only supranational EU body that represents the whole of the voters. Thus, it would be the European Parliament, or a possible European congress[12], rather than an inter-governmental body such as the European Council and/or the Council of Ministers of the EU that would act as the sole principal for the ECB and the European Commission.[13] However, one has to bear in mind that such a change has to go hand-in-hand with both the principle of subsidiarity that also reflects proximity to the citizens and the democratic legitimacy of the EU vis-à-vis the different national governments.[14]

One of the most important forms of political action in a democracy is the free election of the representatives. ‘Free’ election presupposes that social structures (such as unions or parties) remain independent from the state, are open and accessible to pressures from below and that voters can get together to solve spontaneously problems when they arise. At the EU level, there are no political parties (yet) capable of fulfilling that role. However, the collaboration of national organisations, such as non-governmental organisations and even national parliaments, with European institutions, may partially fulfil that function. In this context let us consider whether the European Parliament could be a principal, along the lines of responsible representation.

2.2. A role of principal for the European Parliament

The European Parliament is the European institution that comes closest to fulfilling the functions of responsible representation and that of principal for different other EU-supranational bodies. It is the only representative institution at the EU level that is directly chosen by the people. The European Parliament can be seen as an alternative (though from a particular perspective, complementary to national parliaments) for democratic accountability, one can argue, not only in the case of EU-supranational bodies' decisions but also in the case of qualified majority voting (QMV). In the case of the latter national governments may be outvoted in the Council and therefore cannot be held accountable to national parliaments.[15] By its very nature, the EP is also relatively open and accessible to pressures from below allowing for instance for citizens' petitions and questioning; it also facilitates the development of other emerging social structures, such as European parties or party families, independent from the national states, the Commission and the European Council.[16]

Moreover, as a representative institution, the European Parliament has a unique role in the overlapping EU political structure: it increasingly interacts with the various national parliaments[17], bridging the gap between national and European representation; it is more open and accessible than any other European institution to pressures from below, allowing for an increased participation of European citizens in the Community's life; and it provides more transparency to the process of decision-making in the EU, which enhances the accountability of other European institutions, such as the European Commission and the European Central Bank.

In the case of monetary policies, this chapter departs from the perspective, explained below and shared by other authors (see De Grauwe et al., 1998), that too informal an accountability may not guarantee lasting institutions. Moreover, as argued by De Haan, Amtenbrink and Eijffinger (1998), the trade-off between central bank independence and accountability does not exist in the longer run. A central bank that continuously conducts policies that lack broad political support will sooner or later be overridden. As discussed in section 3, politicians will put the blame for the crisis onto the institutions that escape their control. Therefore, it was not only necessary to assure a broad and long discussion about the objectives of EMU and the aims of the ECB prior to the launching of its third phase but also to assure the proper oversight of the ECB by an institution that is representative of the European population. Public opinion cannot play such a role because it lacks democratic legitimacy and lacks institutional structures. Other institutions such as the European Council and/or the Council of Ministers of the European Union have deliberately chosen not to control the ECB to avoid any misperceptions and/or any temptation of conflicting views over the implementation of monetary policy.

In the case of monetary policy the European Parliament may well increase the efficiency of governance at the European level by smoothing out various resistances to the acceptance of some common policies. But it increases efficiency as a consequence of more transparency and participation and not at the cost of driving political decision-making further away from citizens. This role of the European Parliament has been neglected in the literature. Most authors dealing with the legitimacy problem, the democratic deficit and the effectiveness problem of the European Union, defend that it would have to opt to be either a federal political union, with one government and one parliament, or a confederation of sovereign states, without majority-voting. Kohler-Koch (1999: 17) argues that the European Parliament has “an inferior representative quality” and claims that there is a broad consensus in the scientific community that a parliamentarisation of the European Community (EC) system would not improve its democratic quality.[18]

Without entering into more normative type of arguments, one can argue, that the representative quality of the European Parliament is also evolving. As will be argued in more detail in the next section the European Parliament has been assigned new roles in the Maastricht and Amsterdam treaties and European public opinion has picked up on that change.[19]

3. Enhanced accountability as a way of improving the democratic quality and effectiveness of monetary policy

Let us consider why is it important to enhance the role of a representative institution as principal of other institutions in the EU. It is important to enhance the role of a representative institution because the full political responsibility of the top of the administration is an important criterion for its democratic character. The European Parliament rather than an inter-governmental body such as the European Council and/or the Council of Ministers of the European Union should act as principal for EU-wide institutions, such as the European Central Bank and the European Commission. The EP may be particularly suited, and still enjoy the legitimacy to oversee the activities of the ECB. The European Parliament might indeed provide a good balance between, on the one hand, the "tying of its own hands" by the European Council (national governments), extended to the EU Council of Ministers, and, on the other hand, the need to assure and enhance if not the proper at least some accountability and transparency of procedures of the ECB's administration.

Bradbury (1996: 1) sees accountability as "the requirement for representatives to answer to the represented on the disposal of their powers and duties, act upon criticisms or requirements made of them, and accept (some) responsibility for failure, incompetence or deceit". The concept thus requires sanctions or enforcement mechanisms as already mentioned above and discussed below for the case of the lacking *ex-ante* specifications (working rules) of EMU. Note that there are other notions of accountability that do not necessarily require democratic accountability. An agency can be accountable to the markets (investors), to a dictator, or to specific groups. Keohane and Nye (2003) distinguish between several categories of accountability: electoral, hierarchical, legal, reputational and market accountability. Zilioli (2003) defends that an economic rather than a "formalistic" notion of accountability should be applied to independent central banks.

3.1. Credibility and political constraints

Accountability is necessary for achieving agreement on the design and establishment of lasting institutions. If institutions are not accountable one could solve short-term problems of creating independent institutions but not the longer-term problem of their sustainability. Elected politicians will only defend independent institutions, such as the ECB, in the case of crisis, if they can oversee their functioning. Paul De Grauwe (De Grauwe et al., 1998) goes even further in saying that "politicians will be willing to defend the independence of the central bank only if they know that they have the ultimate power to control the central bank". If that is not the case a disruption might well occur because "ultimately politics rules".

Even in the very special case of Germany – where the monetary authorities enjoyed broad support – one can argue that the Bundesbank could not follow its way at very (indeed the most) important occasions of post-war German monetary history (see the examples provided by the European Monetary System, German Monetary Unification and EMU). Politicians will tend to put the blame for the crisis onto the institutions that escape their control and these will have to resist the pressures for a change of their policy stance. Only by becoming accountable, independent central bankers will ensure the political support that they will need for their long-term survival.

Based on the theory of economic policy that became popular in the late 1980s / early 1990s (Torres, 1992) one needs to make a distinction between two types of constraints faced by policy-makers: credibility constraints and political constraints. Credibility constraints concern the temptation of policy-makers to deviate from their initial plans, without any disagreements over the ultimate goals of policy. Political constraints regard conflicts of interest over those goals.[20]

Governments face explicit credibility and political constraints. As a result, policies are the outcome of the government's optimization problem: the maximization of a well-specified objective subject to those binding constraints. This approach translates, in the literature, into a number of positive models of economic policy in alternative institutional settings. These different environments vary from monetary and/or fiscal regimes and reforms to changes in government colour and organization and determine the credibility and political constraints that policy-makers face. In the case of monetary policy the European Union already deals with the credibility constraints that national and European policy-makers face by "tying their hands".[21] Therefore, the functioning of European monetary institutions should be free of political interference in the sense that they should be granted autonomy, as is the case of the ECB. That is however only a way of dealing with credibility constraints and not with political constraints.

Given that political constraints regard conflicts of interest over the ultimate goals of policy, the creation of European institutions should also take into account those possibilities of disagreement. As was argued, above in the EU discussions already took place during the creation of EMU and the ECB, through nation-wide referenda, several national and European elections and public debates. The process of making the rules of EMU was subject to democratic accountability.

Now that the difference between credibility and political constraints is clarified one can better understand the importance of enhancing the accountability of the European institutions, in particular that of the ECB. The European Council wanted to "tie its hands" and make Europe's central bank independent from any political influences. Independence was a way of dealing with credibility constraints and the problem of time-consistency (see Torres, 1989b).

However, avoiding excessive politicisation of agencies removes them from direct political control (Caporaso, 2003: 13; Gustavsson, 2002). To ensure central bank accountability De Haan, Amtenbrink and Eijffinger (1998), put forward three dimensions: decisions about the ultimate objectives of monetary policy; transparency of actual monetary policy; and who bears final responsibility with respect to monetary policy.

How is one to improve the ECB's accountability without undermining its credibility in the financial markets? The answer developed below is that the European Parliament should have an enhanced role as principal of the ECB. Similarly, an enhanced role of the European Parliament in the formulation of policy decisions and/or at the EU legislative process may well improve the efficiency of common EU policies and the democratic quality of the process of European integration. Again, democratic quality here refers to the degree of accountability and the level of transparency and participation at different levels of government in the decision-making process.

3.2. The emerging role of the European Parliament

With the creation of the ECB, the heads of state and government delegated power to a new supranational institution. Yet, as put by De Haan et al. (1998), this one-time act of legitimisation cannot replace mechanisms of democratic accountability. From a normative viewpoint, such a delegation of powers to unelected officials may only be acceptable in a democratic society if central banks are in one way or another accountable to democratically elected institutions. Moreover, the EP lies somewhat ambiguously along the chain of delegation between the European Council and the ECB. The EP may act as a principal under implicit delegation from popular sovereignty. Yet, it is possible to argue that the Member States have not only intentionally chosen to give autonomy to the monetary authorities but also have delegated authority to the European Parliament to act on their behalf as principal in relation to the European Central Bank.

In fact, the Treaty of Maastricht gave the European Parliament significant competencies. According to Article 113 (3) of the Amsterdam Treaty – ex-Article 109-B (3) of the Treaty establishing the European Community (TEC) – the ECB's president has to present the annual report to the European Parliament. Moreover, the EP is entitled to hold a general debate on that basis and the ECB Executive Board can be requested (and/or take the initiative) to be heard by the competent committees. Finally, the EP has to be consulted by the European Council upon the nomination of the entire Executive Board (TEC, Article 112(2b)).

The intention of delegating power to an independent central bank in the EU went hand-in-hand with the very idea of assigning to the European Parliament a new role. The delegation of power to unelected officials (central bankers) by an act of Parliament (by a treaty ratified by national parliaments in the case of the ECB) does not by itself lack democratic legitimacy. Therefore, the idea that the European Parliament was assigned a new role regarding the overseeing of the ECB goes without contesting the legitimacy of the European Council (and the fact that it can act on behalf of popular sovereignty). Without contesting the proximity of the European Council as the initial principal of the ECB, it is possible to indicate ways of improving democracy and efficiency in the EU that are already partly taking place.

Let us follow what might have been the reasoning of the builders of EMU. One can then say that in order to deal with the credibility constraints faced by monetary authorities that do not enjoy yet a solid reputation of sticking to their announced goals, the principal (the European Council together with the EU Council of Ministers) delegated to an agent (the new European monetary authority) control over its behaviour in regard to monetary policy. Such a change in the nature of delegation – a principal tying its own hands – implied a new role for the EP, which in fact implied a change in the assignment of agents and principals. From a normative point of view, it would have been undemocratic if the agent (the ECB) had remained in control of the behaviour of future principals (the European Council and/or the EU Council of Ministers).[22] That is why leading politicians and national governments in the EU have defended an economic government as a counterweight to the ECB.[23]

The initial principal (the European Council) did delegate to an agent but also established new (potential) mechanisms of democratic *ex post* control, namely monitoring and oversight, which can raise the quality of the democratic process in the EU without affecting the credibility of monetary policy in the financial markets and among economic agents in general. The initial principal tied its own hands and that of the Council of Ministers but assigned a new role to a new principal: the European Parliament.[24]

It is in this perspective without a clear *ex ante* specification of the rules of the game –namely without any enforcement mechanism – that the European Parliament may well oversee the activity of the ECB.[25] Furthermore, EMU can indeed work more effectively if political pressure from the various interest groups is directed away from the European Central Bank (ECB) towards an institution that represents the entire European population. As defended in Torres (1996), the easiest way to secure that goal while preserving the ECB's independence seems to be to recognise and enhance the role of the European Parliament in overseeing the ECB's activity.

In fact, an institution that is representative of the European population and attaches more weight to long-term objectives safeguarding the well-being of all Europeans could better fulfil the role of a principal on whose behalf the ECB should conduct its policies than the European Council that is also driven by short-term (electoral cycle) considerations. In fact, the European Parliament cannot be so directly influenced by the electoral concerns of one or two governments in the EU. The opposition to those governments is also represented in the EP and may well have different views on the issue under discussion.[26]

The role of principal of such an institution as the EP is consistent with a principal-centred perspective (principal drift) of principal-agent problems (Elgie and Jones, 2000) that is indeed particularly adequate to analyse situations that involve credibility constraints or time-consistency problems as in the case of monetary policy. It is also consistent with an approach that takes into account the possibility of a simultaneous drift by the agency (the ECB) and the initial principal (the European Council). The EP, as it does not necessarily share the potentially drifting views of the initial principal, the European Council, is particularly suited to oversee the activities of the ECB. The increased involvement of the EP in the oversight of the ECB's activities has already been quite substantial. Besides having managed to obtain the ECB's Board of Director's agreement on the presence of its President four times a year in the appropriate committee (the Committee on Economic and Monetary Affairs), the EP also holds meetings both with members of the relevant committees of the national parliaments and with experts to prepare those hearings.[27]

Elgie (2000) finds evidence that the EP has managed to "encourage" the ECB to not focus exclusively on its primary objective, price stability, but also pay more attention to its secondary objective: to support the objectives of the EU as stipulated in the Treaties (Article 2 of the TEU and of the TEC), namely sustainable development and employment (i.e. growth).[28]

4. The on-going qualitative change in the nature of governance in the EU

Evolving political co-operation has been increasingly subject to a multi-level political negotiation process in the EU. That process comprises, among others, co-decision and all ensuing EU directives and legislation in general, the discussion and approval of the Broad Economic Policy Guidelines (BEPGs) (an increasingly important tool of soft policy coordination in EMU, supporting a more deliberative way of governance), the new open method of coordination (OMC), the new European Council Spring meetings, all sorts of European and national recommendations and parliament resolutions, the adoption of summit agendas and conclusions and of European strategies and white papers and, quite importantly, the domestic and European debate that takes place.

Since the Amsterdam Treaty even intergovernmental conferences (IGCs), convened to revise the treaties, are increasingly characterised by multi-level political negotiations. These intergovernmental conferences include representatives of the EP regularly briefed by the negotiators who can give their views on all issues under discussion. The EP's views on the IGCs are increasingly important in shaping the European public opinion on these matters and therefore the inter-governmental negotiation process.

National parliaments, too, participate in that process. Not least, they retain the ultimate power of ratifying the treaties. Moreover, they also participate in the process through regular hearings with national (and other) IGC negotiators, through bilateral and multilateral meetings with the European Parliament's Constitutional Committee and through internal and open discussions (increasingly with representatives of the Civil Society) and resolutions. The European Convention of 2002/03 was the maximum exponent of the (multi-level) involvement/participation of many parties in such a process. It is through such a process that those EU policy constraints transform into European and national political objectives.

Such a multi-level political negotiation process in the EU allows for a continuous discussion of processes and outcomes. That permanent discussion in turn permits increased transparency of and participation in the entire process of European integration. Moreover, that multi-level political negotiation process has also repeatedly allowed for the creation of a national and European consensus for reform at the EU level.

In this context, one might argue (Torres, 1994, Jones, Frieden and Torres, 1998, Verdun, 2000a) that the objective of the realisation of EMU was instrumental for creating the necessary consensus to overcome specific interests in the pursuit of social welfare. This objective was not just economic orthodoxy (as Cox, 1997 claims); it was the result of politicians (such as Delors, Kohl, Mitterrand and Gonzalez) pushing for it. EMU was an institution-building response to the challenges of globalisation (Verdun, 2000a).

In fact, it is possible to say that the EMU process has not only increased the economic sustainability of the European integration process, by avoiding the undesirable consequences of uncoordinated macroeconomic policies, but has also raised the quality of its democracy – not only in terms of efficiency but as well transparency and even participation and, one might add, effectiveness, to the extent that new challenges were brought under more democratic control.[29]

This is because it has allowed for some new forms of political negotiation in establishing new goals and it is bringing into account a new common institution, the ECB.

Previously, when monetary policy was basically set out by the German Central Bank for the entire European Monetary System (EMS) zone, national monetary authorities could not be held accountable for the implementation of monetary policy, devised and implemented in the system's anchor country, Germany. National governments (with the exception of Germany) could only be held accountable for having taken the decision (and sticking to it) of joining the Exchange Rate Mechanism (ERM) of the EMS.

The challenge of EMU may have started as the importing of "bottom-up pressures", meaning the ideas of some elites, epistemic communities, reflected by the European Commission, central bankers and monetary economists embraced only by a leading fraction but without the participation of most of the national populations.[30] However, having involved a prolonged period of multi-level political negotiation, the design and implementation of EMU allowed for increased participation of the European population.

Furthermore, the EU is in a process of transition towards a wider political union in Europe together with an increasingly important role of representative institutions. European institution-building, with more efficient and transparent bodies and even transnational political parties, may be a way of reinforcing the democratic quality of the European integration process, namely the link between participation and "responsible representation" of the voters and the guarantee that the existing social structures remain open and accessible to pressures from below.

EMU is a good example of a process of a continuous multi-level negotiation during the discussion of its very rules inscribed in the Maastricht treaty, its convergence phase and current follow up arrangements. The process includes the implementation of the various national convergence programmes, the adoption and implementation of the Stability and Growth Pact (SGP) and other changes in domestic policy throughout several national, local and European elections. These arrangements require a permanent discussion and a negotiation at different levels of government. One can also argue that the different referenda that have been held on that subject have also triggered wide-spread political discussions. Yet, EMU was a clear case in point of extending the democratic reach to areas so far beyond the national control by bringing into account at the EU level policies so far uncontrolled (exchange rate and monetary, and indeed macroeconomic, policies) at the national level (arguably less so in the case of

Germany). In most EU countries European integration challenges such as EMU have worked not only as mechanisms for economic stabilisation but also as pre-requisites for structural reform and long-term development.

The responses to European integration challenges provide good examples of evolving governance in the EU because they go together with the more clearly perceived need for democratic control of its new institutions. In addition, they also allow for an increased participation of representative institutions and the civil society in the discussions that take place before the approval of treaty changes and their ratification about the goals of the envisaged reforms, i.e. on the type of model of society envisaged.

Despite the fact that Europe does neither have (yet) a constitution nor a government and that it suffers the impact of globalisation on national political systems one may argue that such conditions may also be leading to an improvement of the democratic quality of EU governance. The EU has been experiencing re-drafting of its treaties, necessary to accommodate important institutional changes (such as the Internal Market, EMU, Schengen and the communitarisation of other matters of justice and internal affairs) that involve an explicit transfer of national sovereignty to the Union level. When constitutional changes are discussed the question of democratic mechanisms are discussed both Europe-wide and at the level of each Member State. Moreover, with on the one hand a growing individualisation of society and the resulting loss in terms of the aggregation of interests and on the other hand the increased complexity of issues at stake, multi-level political negotiation involving many different actors is a rather important mechanism for democracy which referenda cannot deliver.[31]

In fact, apparently nation- and/or union-wide referenda provide an opportunity for citizens' increased participation and even transparency in the process of decision-making. However, the necessarily simple nature of the questions, generally yes or no questions, does not really allow for more participation when complex issues are at stake. Referenda may give citizens the last word on some issue but *per se* they do not guarantee the quality of their increased participation and obviously they may affect negatively the efficiency (outcomes) of the process. On the contrary, a continuous process of negotiation at different levels of government might allow for a permanent discussion even through various national and European elections. However, clear-cut decisions over clear-cut issues may be decided very efficiently through a referendum. The same does not hold for more complex issues that cut across national interests: the probability of a continuous deadlock would be very high. Again, a multi-level political negotiation process may render policy-making more efficient by allowing for a continuous confrontation of positions at various levels of government, making it possible and easier to converge to an acceptable common position.

It follows that national parliaments, the European Parliament and European citizens in general may have all become more aware of the need for more democratic control of new European institutions but also of the need of regaining democratic control over national governments and institutions that have become more unaccountable through the process of globalisation. Therefore, despite the inexistence of a European constitution (as yet) and a European government, EU governance may not be hindering European democracy but rather extending it bringing in some new important features, such as new forms of participation, through the interaction of different institutions and citizens in that multi-level political negotiation process. The role of national and European representative (parliamentarian) institutions and also their interaction further enhances the transparency and effectiveness of EU governance.

5. Bringing into account previously uncontrolled forces

The case of EMU illustrates how EU policy constraints, to which a Member State could normally adapt rather slowly, may gradually be transforming into political objectives. The adoption of national convergence programmes was indeed a way of transforming EU policy constraints into common European and national objectives. This process obviously increases policy effectiveness but it also allows for increased participation of national citizens in a European common project that internalises at the European level some externalities that arose from uncoordinated (and probably not perceived as such before the discussion of new common objectives) national policies.

5.1 Adopting a credible monetary constitution

Joining a monetary union based on institutions that deliver price stability[32] is, as stressed by the modern political economy literature, probably the best way to implement a solid strategy of sustained economic development. The reason is that this option, besides precluding many of the transition costs (economically speaking, the output losses of a disinflation strategy) of such a regime change, is also more transparent in terms of policy objectives. Actually, fixed exchange rates, unlike other policy targets, are easily observable by the public but also easily implemented by the authorities (see Torres, 1990). In such a regime, the authorities raise the political costs of inflation because the public can constantly monitor their anti-inflation commitment. Any different behaviour would imply a loss of competitiveness for the tradables sector.

In fact, a small open economy tends to lose less (gain more) than a larger closed economy by giving up its monetary autonomy and joining in a monetary union with its trading partners. Foreign exchange transaction costs and exchange rate uncertainty tend to affect mainly small open economies. This effect results from the fact that a relatively important fraction of their trade is done with other countries and therefore they face large (and potentially unstable) foreign exchange markets. As the degree of openness increases, the benefits of adopting a common currency increase and the costs of relinquishing control over an autonomous exchange rate policy diminish; a devaluation has a much stronger impact on the price level of a relatively open economy than on the price level of a relatively closed economy.

In the case of the EU, such a project was also a way of insulating all of the European economies that had embarked on the EMU project from foreign exchange speculation, exchange rate volatility and serious currency misalignments. Those could not only affect the macroeconomic stability of weaker currency countries and the competitiveness of stronger currency countries, thereby giving rise to protectionist claims and/or retaliations, but also put at stake the functioning of the Internal Market and indeed the entire European integration project.

That argument was not trivial even for Germany since it hinged exactly on the idea of protecting the internal market from currency misalignments. Thygesen (1996) further develops that idea claiming that protectionist demands, arising from a fragmented currency system, would include industrial subsidies in the strong-currency countries.

Furthermore, high inflation countries tend to gain more than low inflation countries from sharing their monetary autonomy in a common monetary institution. Eliminating inflation through the sharing of monetary sovereignty in a common credible institution such as the ECB and the abolition of different currencies, does away with the need to waste resources on hedging against exchange risks. A common monetary institution that delivers price stability is therefore a two-fold welfare improving mechanism.[33]

Adopting a credible monetary constitution was also a means of cancelling out the primacy of monetary policy over other more important concerns facing society, which was in particular the case in countries with less developed fiscal and monetary institutions like Greece, Portugal, Spain and even Italy (and in the future all new EU members). In those cases, EMU was a means of getting rid of national currencies and, consequently, the typical excuses that technocrats find to cling to power and implement all kinds of mercantilist policies in the name of short-term real convergence.[34]

Not surprisingly, in the case of some EU (laggard) countries, those very policies, which have been pursued until now[35], implied a sharp deterioration of social cohesion and the quality of life, undermining the long-term (sustainable) real convergence with the most developed regions of Europe. In other words, what at the first glance could have been seen as top-down (EU Commission and "statesmanship") pressures were indeed a way through which some Member States regained some political control over monetary policy at the European level. In fact, in that way, those EU countries were able to bring into account at the EU level uncontrolled transnational forces, such as the permanent threat of speculation against weaker currencies within the EU, avoiding serious currency misalignments that would endanger the entire European project. On the other hand, European citizens in those Member States got rid of many ills associated with political short-term considerations that implied a sacrifice in terms of social welfare.

5.2 From EU-level constraints to national (and common) political objectives

During the entire convergence period, however, few people presented EMU as a desirable political reform instead of an external constraint. For a long time, most politicians, bureaucrats and even economists just referred to it, initially, as an objective rather unlikely to be realised and, later on, as an unavoidable development within the European Union. EMU could have been easily blamed for all the policy errors made by national governments, monetary authorities and other national or European institutions. In many instances, the EMU project was regarded as an unavoidable external constraint that went together with an exogenous political objective to which their political leaders had converged. Good examples of that perspective can be found in the reactions of some policy-makers, politicians and economists (such as the Group of 155) in Germany expressing their reluctance concerning the Bundesbank's integration into "less solid" European monetary institutions or the cross-party political resistance in Portugal, on the basis of the defence of national sovereignty, regarding the proposal to enshrine the objective of price stability in the Portuguese Constitution.[36]

The root of one of the chief misunderstandings about the entire process of monetary unification was in fact that many people tended to see it as a technocratic obsession and/or an ideological defence of the market. At the same time, some of the forceful opponents of EMU happened to be technocrats (sometimes diplomats, central bank employees and even Eurocrats) or ideological free-marketeers (as for example some economic advisers, conservatives in some countries (e.g., the UK), Keynesian-leftist in others (for instance France and Portugal) and independent economists in Germany as well as in other European countries. Instead, one can defend the idea that adopting a credible monetary constitution is a means to do away with the primacy of monetary policy over more important concerns to society. However, in the event few people did present EMU as a desirable political reform instead of an external constraint.

The decisive argument turned out to be of economic nature (by definition less relevant for countries such as Denmark, the UK and Sweden). It was that, in a multi-speed EMU, it would have been more difficult for the catching-up countries to converge. By being left out of EMU's third phase they risked becoming more exposed to international financial markets.[37] It was also perceived that it was important to qualify for accession to EMU from the outset since it was possible that core members could become reluctant to enlarging the initial club both in the monetary sphere and in other domains of European integration.

With EMU, the new European co-decision process, the forthcoming enlargement process and the prospect of a closer political union for a limited number of countries within the EU, it became more difficult for EU countries in general, and cohesion countries in particular, to follow the old rule of asking for derogations on EU directives and/or for postponing any decisions concerning the future of common European institutions and policies.

Experience suggests that the European integration process – and in particular the need to perform sufficiently well to be part of the inner political core, especially at the time of each country's presidency - provides member countries with a good incentive to leap forward and embark on a more proactive policy stance. This holds especially true for countries in which European integration is at the core of their development strategy. It is illustrative that it was during the Portuguese presidency of the EU in 1992 that the national currency, the *escudo*, joined the ERM of the EMS and that domestic capital controls were completely liberalised. The same had happened in the case of the Spanish presidency of the EU in 1989, when the *peseta* joined the ERM just a few days before the European Council of Madrid accepted the Delors Report on EMU.

Very few people had expected that Portugal and Spain, not to mention Italy, could meet the Maastricht convergence criteria on time to join EMU from its very inception.[38] One, if not the main, reason for this disbelief had to do with the so-called systemic deficiencies of their political and administrative institutions. Those deficiencies were partly overcome thanks to the importance of the challenge that the European integration process, in particular the objective of EMU, constituted for "catching-up" member countries and to which their policies had to live up.

What the example of EMU demonstrates is that EU challenges and governance at the EU level, by transforming into national political objectives, make reform possible and more effective. At the same time the process in which such challenges are raised to national political objectives becomes more transparent, allowing for increased participation of citizens, non-governmental organisations and other actors.

European integration challenges such as EMU condition the process of EU governance because they foster a clearer perception of the need for democratic control of its new institutions. They allow for a new role of representative (parliamentary) institutions and the civil society in the discussions that take place before the approval of treaty changes and their ratification about the goals of the model of society envisaged at both the European and the national levels.

6. Concluding remarks

The challenges posed by the European integration process determine a continuously evolving governance in the EU because of the more clearly perceived need for democratic control of its new institutions and of the way in which policies are formulated. However, the effectiveness of EU policies and the quality of democracy in the process of European integration can be enhanced if the intergovernmental mode of governance gives way to the interaction of representative institutions at different levels and with the civil society.

As shown in the chapter, using the example of EMU (the making of its rules and the overseeing of the ECB's conduct of monetary policy), that interaction can allow for more participated and transparent modes of governance. Besides the intergovernmental mode of governance and in addition to supranational regulation, these new modes of governance include: joint decision-making, as is the case in the Single Market, and policy coordination, as is the case of the open method of coordination of economic affairs (BEPG) or employment policy (EES).

Since the Lisbon European Council of 2000 that gave rise to the open method of coordination there has been an increasing interest in this new mode of governance which aimed at improving the problem-solving capability of the EU through policy coordination without binding rules. For some authors, for instance Scharpf (2001), the development of these new instruments of policy coordination such as the OMC are a pragmatic but credible alternative to the Community method of integration (see also Héritier, 2002) that does not face any efficiency-legitimacy trade-off.

This chapter did not elaborate on these new policy instruments. Rather, it explored issues related to the democratic deficit and challenged the common wisdom on this matter and on the efficiency-legitimacy trade-off in EU governance. It tried to show that even a shift from an intergovernmental form of governance to supranational regulation (EMU) form of governance not only does away with such a trade-off but rather enhances the democratic quality and effectiveness of European governance. This finding is mainly due to the yet very much neglected phenomenon of the interaction between representative institutions at different levels in the European Union and participatory and deliberative processes (in this case the building-up of EMU) that have characterised supranational regulation.

The emerging role of the EP in enhancing the democratic accountability of the decision-making in supranational regulation (monetary policy) has proved quite powerful at avoiding such a trade-off and indeed at improving efficiency (allowing for the internalisation at the Union level of different externalities) and democracy (transparency and accountability) in European governance. The democratic accountability of governance in the EU increased very much as the direct result of the making of EMU (democratic delegation of executive powers by the European Council and the EU Council of Ministers to the ECB). That democratic accountability has however been also substantially enhanced thanks to the emerging (and still evolving) role of the European Parliament as a principal in regard to the European Central Bank.

The new role of the EP materialised because of the change in nature of delegation, i.e. the initial principal (the Council) delegated to an agent (the ECB) control over its behaviour in regard to monetary policy. The new principal in the making (the EP) has also allowed for increased participation in and deliberation on the discussions about the conduct of monetary policy by the

ECB, contributing in this way to its greater transparency. These discussions have involved monetary policy experts and economists with different perspectives as well as national parliaments. National MPs can in turn better understand and discuss the appropriate policy mix in their own countries, with both national central bank governors and members of the national government that is accountable to them.

The interest of looking at the European model lies in the fact that it is reinventing itself continuously as the process of European integration deepens. It is why it is possible to enhance the democratic quality of governance through the evolving process of multi-level political negotiation that has emerged in the EU. The European integration process is responding to the globalisation process and to the growing individualisation and complexity of society through the development of these new multi-level negotiation mechanisms, namely the interaction of the different national European parliaments with each other and with the European Parliament, the respective governments, the European Commission and other European institutions and civil society. In fact, representative institutions (parliaments) might be unable to control international governance but they may be in the process of regaining some control over European governance.[39]

Representative institutions, in particular the EP, are instrumental in for making institutions such as the ECB more accountable and the process of policy-making more transparent and participated, while guaranteeing a balance between processes and outcomes. The EP is best placed to fulfil the role of a principal that the European Council and/or the Council of Ministers, as intergovernmental bodies, can exercise only with much difficulty.

The EP's overseeing of EU institutions, such as the ECB, contributes to an increased transparency and accountability of the system. Moreover, the interaction and collaboration between the EP and national parliaments in the EU is a way of allowing for increased participation and of enhancing its representative quality. By enhancing the accountability of EU institutions, common policies, (monetary policy), become more effective in the long run. An increased participation of representative institutions in the formulation of other common policies, such as environmental policies, national vested interests can be more easily overcome and a common position (internalising some externalities) has a better chance to be reached in the EU.

The process of integration and decision-making in the European Union is probably the only case of sovereignty-sharing that has proceeded steadily up to a point where some multi-level governance can be already regarded as a polity. The on-going qualitative change of governance in the EU, i.e. the building-up of new European institutions and the development of new policy instruments devised at the European level, can be seen as a way of extending and enhancing democracy beyond the nation state.

NOTES

[1] Throughout the chapter the concepts of efficiency and effectiveness are used in an almost interchangeable way but the former refers more to the processes that create institutions and the latter to the institutions that deliver policies.

[2] The transformation of EU challenges into national political objectives, as in the case of EMU, are also supported on some input legitimisation that involve, through a mandate and/or national representatives, transparency and accountability and deliberation (public argument and reasoning).

[3] To that extent the way in which the term effectiveness is used is somehow more demanding than just the relation between input and output of a given existing system.

[4] The concepts of democracy and legitimacy are generally used in an interchangeable way without a proper distinction and/or as communicating vessels, as put by Gustavsson (2002). Good examples are the official Nice and Laeken Summit declarations, the first talking about "the need to improve and to monitor the democratic legitimacy and transparency of the Union" and the other saying that "The EU derives its legitimacy from the democratic values it projects" (see Gustavsson 2002). Yet we know that a process can be democratic but not legitimate and vice versa. This chapter recognises the importance of legitimacy insofar as delegations of power are concerned but it focuses on democracy – how transparent and accountable governance is in the EU.

[5] These criteria are obviously to be analysed in a multi-dimensional perspective.

[6] For a brief review of these reasons, see Elgie (2000).

[7] This aspect is specifically dealt with in sub-section 5.2.

[8] See Schürz (2002) for a discussion of the issue of democratic legitimacy with deliberative institutions for the case of the ECB.

[9] See Keohane and Nye (2003) for a discussion of these issues. As discussed in Torres (1996a) and in section 3 (3.2) the *ex-ante* specification of the rules of the game (EMU) was not part of the Treaty of Maastricht that focused on entry requirement rather than on working rules.

[10] See below and also Elgie (2000). Regarding some EU common policies, such as environmental policy, there is already a much more important level of participation than in the case of monetary policy and also an increasing level of transparency due to the European co-decision procedure, see Torres (2003).

[11] For instance, for Kohler-Koch (1999) majority voting, although increasing the effectiveness of decisions in the EU at the intergovernmental level, infringes the sovereign right of the Member States to ultimately decide what is and what is not acceptable to their national constituencies, therefore upsetting the balance among the three Neumann criteria. Note that this presupposes that the state still had *de facto* sovereignty. By pooling sovereignty in the EU some Member States might at least influence some decisions that they could not affect before.

[12] Habermas (2001: 99) sees a European congress, representative of both the European population and the EU member states, as a necessity: "...in a European Federation the second chamber of government representatives would have to hold a stronger position than the directly elected parliament of popular representatives, because the elements of negotiation and multilateral agreements (...) cannot disappear (...) even for a Union under a political constitution." Also the Economist's proposal for a constitution for the

European Union of October 28th, 2000, provides for a new chamber of representatives of national parliaments, the Council of Nations.

[13] In fact, an economic government, defended by several politicians, could interfere with the statutory independence of the ECB and it would not by itself add more legitimacy to the EU institutions in the eyes of the European citizens precisely because of its intergovernmental character. This is not to say, however, that more democratic bodies could not engage in power politics.

[14] Primacy of democratic decision-making in the conduct of global governance at the EU level may also provide the conditions for the development of other forms of democratic innovations put forward by different authors. See for instance Saward (2001) for some examples of new forms of democracy: cosmopolitan, deliberative, politics of "presence" and "difference", ecological redefinitions, associative and party-based direct models.

[15] Europeans trust the EP more than other EU institutions and agencies (see Eurobarometer, 56 and 57); exceptions are Germany, Denmark, Finland, Sweden, Austria, the Netherlands and Luxembourg where the Court of Justice and/or the ECB tend to score higher. The EP is also the best known EU institution (Eurobarometer 56, fig. 7.10) and it is perceived to play the most important role in the EU (Eurobarometer 56, fig. 3.6).

[16] Different MEPs and staff tend to listen and receive all kinds of different experts and organised and non-organised interests as a way of negotiating and advancing their own proposals and reports. They are also open to citizens, the media, and researchers, regarding their political and policy options.

[17] The EP holds regular meetings with members of the relevant national parliaments' committees on a wide range of issues such as EMU and hearings of the ECB's President, the BEPG, the IGCs, EU enlargement and the European constitutional matters.

[18] This "inferior representative quality" of the European Parliament is in general attributed on the basis of the "inferior quality" of European elections (disputed not on European but on domestic political grounds and with very low turnouts and different national voting rules and party lists) and of the lack of clear political and ideological cleavages (MEPs remain rather technocratic).

[19] Regarding knowledge about the EP, how it is perceived to play the most important role in EU life and how it is the institution which on average people tend to trust most in the EU (Eurobarometer, 56).

[20] The idea of binding political constraints stems from the political business cycle literature, where governments have opportunistic incentives to adopt certain policies (for instance, in order to be re-elected), and from the theory of public choice, where there are conflicting policy preferences among different interest groups (because politicians and bureaucrats maximise their welfare rather than pursuing public interest) and/or the so-called agency and/or principal drift in principal-agent problems (Elgie and Jones, 2000).

[21] For the classical example of tying hands as a solution to the time-consistency problem, see Homer's Odyssey: Ulysses asking to be tied to the ship's mast in order to be able to listen to the sirens while resisting to the temptation to try to join them. See Elster (1984) and Torres (1987, 1989b).

[22] This claim parallels the normative claim referred to by Elgie and Jones (2000) that the preferences of both the principal and the agent should remain in line. The positive claim, that is also underlying to agency drifting, that their preferences are bound to diverge stresses the need for some form of oversight.

[23] The sub-optimality of the ECB's accountability has been recognised by several authors; see for instance Torres (1996b: 76/77), De Haan et al. (1998), De Grauwe et al. (1998), Verdun (1998) and Harrison (2001). This latter author concludes however that, because of the relatively high degree of transparency of the ECB and the strength of its commitment technology, that sub-optimality should not impact on "its effective framework for success".

[24] Clear *ex-ante* specification of the rules of Economic and Monetary Union was not part of the Treaty of Maastricht and/or Amsterdam. See Torres (1996) for a discussion of possible ex-ante specifications of EMU rules concerning, among other things, enforcement mechanisms.

[25] As put by Elgie (2000), in the case of the ECB, any renegotiation of the set of *ex-ante* controls is unrealistic and even if the Treaty could be reformed that would undermine its very credibility.

[26] Hix (2001) concluded that for the first year of the 1999-2004 European Parliament transnational party group affiliation was more important than national affiliation for determining how MEPs vote. It follows that it is not to be expected that say the German or Portuguese opposition would come to rescue their respective countries from an early warning concerning the excessive deficit procedure.

[27] The first of those meetings – proposed by a national Member of Parliament and a Member of the European Parliament at the May 1998 London COSAC, one of the bi-annual meetings of the Conference of European Affairs Committees of the EU National Parliaments and the European Parliament – took place in Brussels on November 3, 1998.

[28] In the terminology of Farrell and Héritier (2002), this fact supports the importance of the effects of an informal institution on the interaction between the EP and the ECB. While these authors refer to empirical evidence indicating that such informal institutions have an important effect on interactions between the European Parliament, the European Commission and the Council of Ministers, I focus here on the importance of the effects of such informal institutions on interactions between the European Parliament and the European Central Bank (see Elgie, 2000, for evidence).

[29] See Erik Jones (2002) for a similar conclusion in regard to efficiency and transparency.

[30] Jones (2000), points out that such influences reflected epistemological rather than distributive considerations.

[31] As Ulrich Beck (1992, p. 36) put it: poverty is hierarchic, smog is democratic. In other words, as in a modern (risk) society social differences are more relative, there is a loss in terms of aggregation of interests.

[32] By institutions that deliver price stability it is meant here not only the European Central Bank but also the monetary constitution of the EU (the ECB's status) and other macroeconomic rules, such as the Stability and Growth Pact, etc., its *ordnungspolitische Grundsätze*, one may say. In that sense and according to Douglass North (1990: 3), “Institutions are the rules of the game in a society or, more formally, are the humanly devised constraints that shape human interaction”.

[33] The reason is that it internalises both the costs of excessive inflation and exchange rate instability (see Torres 1996). Eichengreen and Ghironi (1996) provide other arguments for the case of low inflation countries in the context of EMU.

[34] What, at a first glance, could be branded as a mere “new constitutionalism” approach in the interpretation of Hewson and Sinclair (1999) – that is ring-fencing central banks from political interference with mandates to combat inflation – goes much further than that in the case of a common European monetary institution. In fact, the new monetary constitution of Europe, EMU, may be a way of avoiding the ring-fencing of many national authorities on monetary and financial external constraints and of creating the necessity – and the conditions – for increased transparency and accountability.

[35] For instance, cohesion countries, namely Greece, Portugal and Spain, and also the UK and Ireland, tend to opt for derogations on matters such as energy costs (giving wrong economic incentives through lower energy costs to pollute more) in the name of short-term competitiveness.

[36] In 1997, all political parties refused, on the grounds of national sovereignty, to enshrine in the Portuguese Constitution the objectives of EMU in the article concerning the central bank. At the same time, however (mind the contradiction!), they accepted to comply with whatever international rules (external constraints) Portugal would accept in the future.

[37] Note, however, that this reasoning already implicitly enshrines the idea of bringing into account previously uncontrolled economic forces such as speculation against weaker currencies within the EU.

[38] Greece also managed to join EMU in 2001 two years after the beginning of its third phase but still one year before the replacement of all national currencies by euro coins and bills.

[39] Take the case of the reluctant but inevitable and quite predictable acceptance by governments and political parties alike of the model of the convention of 2002/03, already used before for drafting the Charter of Fundamental Rights. That may also reflect the fact that the European co-decision procedure is in practice reinforcing the role of national parliaments and indeed democracy in the EU.

Chapter 4

Common Currency and National Constitutions *

by

Anneli Albi

Abstract: The power to emit national currency has traditionally formed a core area of a state's sovereignty, and it is regulated to some extent in most constitutions. In the European Union, twelve Member States have substituted their national currencies with a common currency. The purpose of this paper is to examine how the Member States have legitimised this move. It focuses in particular on the constitutional amendments pertaining to Economic and Monetary Union (EMU), and on the decisions of constitutional courts where challenges to monetary integration have been addressed. The paper will also look at the debates concerning the amendment of monetary provisions in Central and Eastern European accession countries. It concludes by advocating the constitutional solutions of France, Germany, Portugal and Greece because these provide higher legitimacy to the transfer of monetary sovereignty, as well as meeting better the rationale of national constitutions.

Keywords: National constitutions; Sovereignty; Legitimacy; Constitutional courts; Referendums; Enlargement; Accession countries

1. Introduction

The power to issue national currency has traditionally been regarded as a core part of a state's sovereignty. Therefore, national constitutions, establishing the *pouvoir constituant*'s pact on how sovereign powers are exercised in a country, often lay down the basic principles governing the national currency and the role of national central banks. Since the creation of Economic and Monetary Union (EMU), the Member States of the European Union (EU) have restricted the role of their national central banks in favour of the European Central Bank (ECB) and, in an unprecedented move in January 2002, twelve of them substituted their national currencies with a common currency. The

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purpose of this paper is to examine how this far-reaching step of transferring monetary powers has been legitimised at the national level, with a particular focus on constitutional amendments. While the discussion on the governance of EMU has predominantly focused on the EU level (see eg Beaumont and Walker (1999), Zilioli and Selmayr (2001), and contributions to the current volume), it is important to complement this with a consideration of legitimacy of the delegation at national level, as national constitutions remain key building blocks in the multi-level governance in the EU.

The paper starts with the Maastricht Decision of the French Constitutional Council, where monetary integration was held to go against the 'essential conditions of the exercise of national sovereignty' and therefore led to amending the French Constitution with regard to EMU as well as other aspects of EU membership. It then studies the constitutional amendments pertaining to EMU in Germany, France, Portugal and Greece, and amendments of a more general nature in other countries, as well as briefly looking at national referendums. The third section studies two cases pertaining to the constitutionality of EMU which arose in Germany regardless of prior constitutional amendments. The fourth section takes a look at the prospects in the Central and Eastern European countries, as several of them have undergone constitutional debates pertaining to amendment of provisions where the their national banks' exclusive right to issue national currency is established. The paper concludes with an assessment of how the constitutional regulation concerning the delegation of monetary sovereignty relates to the rationale of the national constitutions - to determine the distribution and exercise of state competences - in view of gradual but consistent transfer of powers from national to European level.

2. EMU and the 'essential conditions of exercise of sovereignty'

Control over national currency, which has been closely associated with a state's authority and and national identity, the control over national currency has traditionally formed a core area of sovereignty. It is 'a qualifying element of a state's sovereignty' and has been described as a sovereign state's 'ambassador in international markets' (Chirico, 2003:139). In some countries, the name of the currency derives from the state's name, such as *franc* (France), *lita* (Lithuania), *lat* (Latvia), or from a state's central symbol such as *krona* (Scandinavian countries). The principle of monetary sovereignty has also been recognised by the Permanent International of Court Justice, according to whom it is 'a generally accepted principle that a State is entitled to regulate its currency'.[1]

Since the Delors report in 1988, the Community has been moving towards a common monetary policy. This process led to the establishing of the European Monetary Union by the Treaty of Maastricht and the creation of the European Central Bank - the exceptional case of a central bank without a State (Zilioli, Selmayr, 1999:643, cited in Chirico, 2003:141), culminating in the introduction of a common currency in twelve Member States in January 2002. The creation of Monetary Union is based on a realisation, yet in another field, that states are more successful in performing their functions together rather than individually in the contemporary globalising world. Common monetary policy serves the objective of enhancing economic growth, by factors such as mass-scale savings in cross-border exchanges and transactions, securing stable prices and low inflation, stimulation of investments, stimulating competition and transparency of prices, strengthening of the single market, as well as facilitation of the movement of people. At the same time, the creation of Monetary Union also has a clear political goal - it is aimed to strengthen European identity, to intertwine more closely the Member States' policies, and thus foster a move towards a political union. Indeed, the German Foreign Minister Joschka Fischer has portrayed the introduction of the common currency as an act of sovereignty, and thus primarily a political rather than an economic issue (Fischer, 1999, cited in Chirico, 2003:175). Furthermore, in words of Francis Snyder, 'EMU … is a metaphor for the European Union. It represents the culmination of a process set in train by the founding Treaties, consolidated in the Maastricht Treaty, and left virtually untouched by the Treaty of Amsterdam. The debate about EMU thus is a debate about the future of the EU as a polity, the European social model, and the nature of European identity' (Snyder, 1998:4).

Besides touching a core field of a state's functions, the entrance into Monetary Union is of significance to sovereignty also for the reason that it means a complete, albeit progressive, surrender of monetary competences, by contrast to many other policy areas where only some prerogatives have been delegated from the Member States to the EU (Bonnie, 1998:527). This results not just in a transfer of powers, but in a true loss of competences over money by the nation states, and their acquisition by the EU (Chirico, 2003:144). The complete denationalisation of monetary policy is, in words of Chiara Zilioli and Martin Selmayr, a well-known feature of EMU and, since 1 January 1999, it has been practically undisputed in legal doctrine (Zilioli and Selmayr, 2001:13). As a consequence, common currency has been likened to 'a textbook example' on challenging sovereignty (Bonnie, 1998:527); it has been commented that '…Euro has probably represented the most profound limitation of sovereignty which has ever been accepted by sovereign states' (Ronzitti, 1999: 373 – 394, cited in Chirico, 2003:144).

Because of such a tangible effect on sovereignty, compared to prior piecemeal delegation of competences, Monetary Union became one of the main reasons for national constitutional challenges to the Treaty of Maastricht. The French *Conseil Constitutionnel* was the first to clearly spell out, in its *Maastricht* decision of 9 April 1992,[2] that EMU harms the 'essential conditions of exercise of national sovereignty' and therefore necessitates a constitutional amendment prior to ratifying the Treaty.[3] The Treaty was referred to the Constitutional Council by the President Mitterrand, under art 54 of the Constitution which subjects treaties to a preliminary constitutional review. The *Conseil Constitutionnel* examined the Treaty in the light of various constitutional provisions, including art 3 of the 1958 Constitution which provides that 'the national sovereignty belongs to the people who exercise it through their representatives and by way of referendum', and the Preamble of the 1946 Constitution which states that France complies with the rules of public international law and that 'under the condition of reciprocity, France consents to the limitations of sovereignty necessary for the organisation and defence of peace'. Besides these provisions, the Constitutional Council invoked the concept of 'essential conditions of the exercise of national sovereignty', which according to its earlier jurisprudence include the state's institutional structure, independence of the nation, territorial integrity, and fundamental rights and liberties of nationals.[4] While establishing that the respect for the principle of sovereignty does not prevent France from undertaking international commitments or transferring competences, the Constitutional Council made it clear that the authorization for ratification of a treaty must be preceded by a constitutional revision in case the treaty involves obligations contrary to the Constitution or affects the 'essential conditions of the national sovereignty'.

These 'essential conditions' were indeed found to be encroached upon by the transfer of monetary competences. Amongst individual provisions, the Constitutional Council pointed out art B of the TEU which established the Economic and Monetary Union with the objective of leading to a common currency, and art G of the TEU and some other provisions which amend arts 2, 3a and 4a of the EC Treaty, which add the completion of the EMU to the list of the Community's missions, provide for the irrevocable fixation of the exchange rates and create the European system of Central Banks and the European Central

Bank. Further, the 'essential conditions of sovereignty' were found to be challenged by the conditions for the Second Phase of completing EMU, such as the prohibition of restrictions of movement of capital and payments, prohibition of funding the state's budget by public deficit, the loss of a privileged access to credits of financial institutions by authorities and public enterprises, and the transfer of the exchange policy to EU level. Moreover, the entrance into force of the Third Phase means, according to the *Conseil Consitutionnel*, that the countries will put into effect a single monetary policy and a single exchange policy, while the European Central Bank will be the only institution to authorise the emission of banknotes in the Community (art 105A).

Under these provisions, the Constitutional Council concluded that the completion of EMU means that 'a Member State finds itself deprived of its competences in a field which affects the essential conditions of exercise of national sovereignty'.[5] It reached the same conclusion also in respect of those provisions of the Maastricht Treaty which establish the common visa policy and voting rights of EU citizens in local elections. Therefore, this judgement led to supplementing the French Constitution with a new chapter on the EU, which will be discussed in more detail in next section.

3. Adaptation of national constitutions

National constitutions, as a rule, set forth the general principle of sovereignty, and establish the framework rules of governance, including those pertaining to the main aspects of monetary control within a state. As we saw in the previous section, the entrance into Monetary Union was found to go against these constitutional rules in France and therefore led to a constitutional amendment. Germany, Portugal and Greece too found the membership in Monetary Union to require a constitutional authorization. Other countries have accommodated the transfer of monetary powers under broader provisions on the participation in the EU or international organisations, and some have held referendums. We will subsequently take a closer look on the developments in individual countries with regard to their constitutional adaptations for monetary integration.

In France, the above-discussed decision of the *Conseil Constitutionnel*, where EMU was found to affect the 'essential conditions of national sovereignty', led to a constitutional amendment in June 1992 in order to ratify the Maastricht Treaty. The new art 88-2 expressly provides that: 'Under the condition of reciprocity and according to the modalities provided in the Treaty on European Union …, France consents to the transfers of competences necessary for the establishment of the Economic and Monetary Union'. This article formed part of a new Title XV on European Union, which was introduced into the Constitution and included a general clause on transferring powers for their common exercise in the European Union, as well as authorizing other aspects of integration, such as common visa policy and electoral rights of citizens of other Member States. The new EMU-article sets into a new light art 34 of the Constitution, which reserved to the Parliament's legislative prerogative the regime of emitting national currency. The Maastricht Treaty underwent a referendum on 20 September 1992, which was won by a narrow majority of 51% against 48.9%.

In Germany, the ratification of the Maastricht Treaty was likewise preceded by an amendment of the constitutional provisions which reserved to the Federation the exclusive power to legislate in matters of currency, money and coinage (art 73), and to establish 'a note-issuing and currency bank' (art 88). The amended art 88 provides as follows: '[The Bundesbank's] … tasks and powers can, in the context of the European Union, be transferred to the European Central Bank which is independent and primarily bound by the purpose of securing the stability of prices'. While the government's initial project of constitutional revision was limited to a provision which would open the possibility of transferring the *Bundesbank*'s competences to the ECB, the parliamentary deputies added the obligation for the European Bank to be independent and give priority to price stability (Classen, 1997:16). Besides the amendment of monetary provisions, Germany also introduced a general clause on participation in a unified Europe, and on the delegation of state competences in this respect (art 23), as well as a number of amendments concerning various specific aspects of EU membership. However, regardless of this prior constitutional authorization, the membership of Monetary Union brought about two challenges in the Constitutional Court, to which we will come in the next section.

The Portuguese Constitution similarly reserved to the Bank of Portugal the exclusive right to issue currency, and to define the main goals of the financial and monetary system. In order to join EMU, art 105 on the Bank of Portugal was amended in 1992, providing that: '[t]he Bank of Portugal, in its capacity as a central bank, collaborates in the definition and execution of the monetary and financial policy and issues the currency, under the conditions provided by law'.[6] However, this provision was not found to meet the conditions for participating in EMU and, therefore, the amendment was again brought onto the agenda in 1997.[7] Parliamentary deputy Francisco Torres raised the issue that this article should be reworded so as to establish the price stability as the objective of the Central Bank,[8] directly or indirectly through the European System of Central Banks. At first, the two major parties (PS and PSD) refused to reopen the discussion because this article had already been amended with relation to the Maastricht Treaty and, on grounds of national sovereignty, further EU-induced changes were objected. However, the risk of excluding Portugal from EMU led to a somewhat contradictory compromise in that the parties accepted the introduction of a reference to 'international rules' – thus any potential external constraints.[9] As a consequence, the Parliament decided in 1997 to amend art 102, which now provides as follows: 'The Bank of Portugal, in its capacity as a central bank, shall carry out its functions in accordance with the law and with the international rules to which the Portuguese State is bound'.[10] In addition, it is interesting to note that art 9 of the Portuguese Constitution mentions the promotion of Portugal's 'international currency' amongst the basic responsibilities of the State. Besides monetary amendments, the Portuguese Constitution also provides for the transfer of powers for their common exercise in the European Union (art 7.6), as well as containing further amendments pertaining to specific aspects of EU membership.

In Greece, the Constitution was amended with a view to EU membership in 2001. The package of amendments included an 'interpretative clause' on participation in the EU (art 28), and revision of art 80, para 2 of which provides that the law regulates the regime of emission of currency. The amendment provides that this paragraph does not obstruct the participation of Greece in European Economic and Monetary Union, in the framework of art 28 of the Constitution.

In Austria, Finland and Ireland, the membership in the Monetary Union is accommodated in the constitutions under more general provisions on the participation in intergovernmental or international organisations, which were introduced at the time of the Maastricht Treaty (Ireland introduced a special reference to this Treaty). Since Ireland held a referendum on the Maastricht Treaty and the Austrian and Finnish referendums on joining the EU took place at the time when the Maastricht Treaty was on the agenda, these referendums could partly be regarded as referendums on EMU because it formed a focal element of the Treaty.

The remaining EMU-countries have not undertaken specific steps to legitimise their membership in Monetary Union. Instead, monetary integration was accommodated, as with other steps of integration, under existing broader provisions on delegation or transfer of powers to international organisations. In fact, some of them still contain only minimal or even no references to any aspects of EU membership. These constitutions appear to share a common trait of not regulating monetary affairs, or leaving a wider room for interpretation. For instance, in Belgium, where art 112 provides that the 'King may mint money, in keeping with the law', the participation in EMU takes place under art 34 (formerly 25bis), which states that 'the exercise of delimited powers can be attributed … to institutions of public international law'. Belgium, however, has a longstanding experience in pooling monetary sovereignty, due to its monetary union with Luxembourg since 1921. In the Netherlands, art 106 provides in a general mode that the law regulates the monetary system. Although some authors have found the attribution of monetary competences to the Community institutions to contravene this constitutional article, the Government and the Parliament approved the Maastricht Treaty by an ordinary procedure. According to their interpretation, this article was meant to reserve the legislative power in monetary affairs with regard to *internal* division of competences, whereas it did not prohibit attribution of powers to an *international* institution (reported in De Witte, 1997:368). The Italian Constitution contains a provision providing that the Republic "shall encourage and safeguard savings in all forms; it shall regulate, coordinate and control the provision of credit" (art 47.1), which according to Italian scholars implicitly makes a reference to the Bank of Italy.[11] The transfer of monetary competences to the EU in Italy is accommodated under broader article 11, which declares that 'Italy may consent, on equal terms with other states, to limitations of sovereignty'.

The three non-participating countries - Denmark, Sweden and UK - have stayed out of EMU partly due to the very question of constitutional legitimisation, which accentuates the controversial character of referendums in this process.[12] In Denmark, the referendum on the Maastricht Treaty in 1992 ended with a rejection of the Treaty. This led to a special arrangement at the Edinburgh Summit, where Protocol No 12 was annexed to the Maastricht Treaty, providing that 'the Constitution of Denmark contains provisions which may make it necessary to hold a referendum before the country engages to the Third phase of the European Monetary Union' (De Berranger, 1997:108). The entrance into the Third Phase was put to referendum on 28 September 2000, and was rejected by the Danes by 53.1 per cent of 'no'-votes. All Danish political parties have committed themselves not to revoke the exemptions without consulting the people via a referendum (Roberts-Thomson, 2001:117). Sweden's referendum on joining the Monetary Union held on 14 September 2003 equally resulted in a rejection.[13] Should Sweden decide to join in future, a government bill on constitutional changes provides that the Constitution needs adaptation.[14] This is because art 12 of Chapter 9 of the Government Act, forming part of the Swedish Constitution together with three other acts, provides that '[t]he Riksbank is the central bank of the Realm [and]…. is responsible for monetary policy. No public authority may determine how the Riksbank shall decide in matters of monetary policy'. In addition, art 13 provides that '[t]he Riksbank alone shall have the right to issue coinage and banknotes'. Although the third non-participating country, United Kingdom, is the only one not to have a written constitution and thus no overt constitutional conflicts to deal with, it has nevertheless repeatedly announced that the question of membership in Monetary Union will be decided in a referendum.

The above account indicates that special provisions relating to Monetary Union were introduced in the countries where the monetary sovereignty was expressly regulated in the constitutions (France, Portugal, Germany and Greece). Interestingly, these countries also introduced a more general provision on transfer of powers to the EU, as well as making other amendments concerning EU membership. This appears to reflect the constitutional culture in individual countries, in that whether preference is given to adapting the constitutions by explicit amendments or by means of interpretation (implicit amendments). This, in turn, may be influenced by an interesting correlation that the countries where the constitutions still in 2004 merely make a general reference to participation in international organisations or even do not mention any aspects of EU membership at all, tend to have more difficult amendment procedures. For instance, the amendment of the constitutions involves a dissolution of the parliament in Belgium, Luxemburg and, in case of fundamental provisions, in Spain, where also a referendum is required. The approval by two successive parliament memberships is required in the Netherlands, Finland and Greece (the relatively late stage (2001) of Greek amendments is notable in this respect). The Danish Constitution requires a referendum or an extremely high parliamentary consensus. Finally, the constitutional regulation of EU membership may also depend on the existence of a constitutional court in the country. As pointed out by Alex Stone Sweet, the so-called *Kompetenz-Kompetenz* problem has arisen only in those Member States which have a constitutional court - such as Germany and France (Stone, 1998:325). This finding could perhaps be extended to the situation concerning the constitutions: it is likely that in those countries where the treaties are likely to find challenges in constitutional courts, the parliaments have a stronger motivation for ensuring the compatibility of the constitutions with the treaty obligations.

4. Challenges to the Euro in the German Constitutional Court

Notwithstanding the prior constitutional amendments pertaining to membership in the EU and EMU in Germany, the Constitutional Court was asked on two occasions to review whether the participation in Monetary Union was in compliance with the German Constitution. In 1993, accession to EMU was contested in the less known part of the famous *Maastricht*-decision; in 1998, the entrance into the Third Phase of the EMU led to another constitutional challenge. In the *Maastricht* case, the complainant argued that the entry into the Maastricht Treaty would set under threat the 'existence of the Federal Republic of Germany as an independent sovereign State, something which under Article 79(3) of the Constitution … cannot be subject to constitutional amendment'. In this respect, the complainant argued that Monetary Union would create forms of factual compulsion, which in practical terms would render the journey towards a European federal state irreversible.[15]

The German Constitutional Court, finding that the extent of delegation was not such as to threaten sovereignty, affirmed that 'Germany is maintaining its status as a sovereign State in its own right'.[16] This was mainly because the powers delegated by the Maastricht Treaty were defined in a sufficiently clear and foreseeable manner and, as the Member States continue to be the 'Masters of the Treaties', each new delegation would be subject to a national approval and ratification. As concerns specifically Monetary Union, the Court highlighted three additional reasons to demonstrate the absence of a threat to Germany's sovereignty.

Firstly, it emphasised the conditional nature of monetary integration: '[g]iven the conditional nature of the content of the Treaty and the factual convergences it presupposes, the time for the commencement of the third stage of economic and monetary union must … be understood as a target rather than as a legally enforceable date'.[17] The target date is aimed to encourage and accelerate the progress, rather than to complete it automatically within the time limit. Secondly, the German Parliament retains the right to carry out its own parliamentary control regarding the transition into the Third Phase. The Court stated that by ratifying the Treaty, Germany '…is not subjecting itself to an "automatic" progress to a monetary union, which is unsupervisable and the momentum of which puts it beyond control; the Treaty opens the way to a further integration … by stages, which at every further step is subject either to conditions which are already foreseeable so far as the legislature is concerned or to a further assent from the Federal Government which may be influenced by parliamentary means.' [18] Thirdly, the Court made it clear that Monetary Union will not automatically result in a political union. This requires a new political decision and an amendment of the treaty, which could not happen without a decision of the institutions of the nation state, including the German Parliament.[19]

However, the Court did acknowledge that the participation in the Monetary Union affects the principle of democracy:

'The possibilities for influence by the *Bundestag*, and therefore by the electorate, have no doubt been taken away almost completely in so far as the European Central Bank has been made independent as regards the European Community and the Member States ... An essential political area, in which individual freedom is supported through maintenance of the value of the currency and, through the money supply, the state of public finances and the political spheres dependent thereon are determined, has been excluded from the powers of state authorities to give instructions and … from parliamentary supervision ... Placing most of the tasks of monetary policy on an autonomous basis in the hands of an independent central bank releases the exercise of sovereign powers of the state from direct national or supra-national control in order to withdraw monetary matters from the reach of interest groups and holders of political office concerned about re-election'.[20]

At the same time, the Court found this modification of the principle of democracy justified for the reason that monetary stability can be better achieved at a supranational than state level. It stated that '[t]his restriction of the democratic legitimation which proceeds from the voters in the member-Sates affects the principle of democracy but, as a modification of that principle provided for in Article 88, second sentence of the Constitution, is compatible with Article 79(3)'.[21]

Ahead of the entry into the Third Phase, the participation in Monetary Union underwent another challenge by the so-called 'gang of four professors'.[22] The group claimed a breach of their rights under art 38(1) of the Constitution which establishes the principles of electoral law, arguing that their rights as voters to partake in an open European political process have been infringed. In addition, they also claimed a breach of the right to property under art 14(1), and of the right to a stable currency. The *Bundesverfassungsgericht* rejected the claim by referring to its earlier *Maastricht*-Decision, where it had found that Germany's participation in the Monetary Union is, in principle, permitted under art-s 23 and 88(2) of the Constitution. The Maastricht Treaty lays down the standard and the procedure for the entry into the Third Phase, which, according to the Court, opens up room for economic evaluation and prognosis, where the Government and the Parliament have room of discretion concerning the safeguarding of financial property.

Thus, regardless of constitutional amendments whereby Germany's accession to EMU was legitimised, the Constitutional Court was compelled to further justify the compatibility of various aspects of monetary integration with the fundamental principles of the German Constitution. Demonstrating the importance of constitutional amendments in a country where delegation of powers may face the prospect of constitutional court's scrutiny, these decisions implicitly elicit questions about the legitimacy of the transfer of monetary sovereignty in countries where European integration is still accommodated under a general constitutional provision on participation in international organisations.

5. EMU and the constitutions of the Central-Eastern accession countries

The question whether monetary integration should be preceded by a constitutional authorization has also arisen in the Central and Eastern European accession countries. Although the transition to the common currency will not take place immediately, their participation in EMU is obligatory as of the date of accession and no opt-outs are available.[23] Therefore, the debates on amending the constitutions for EU accession included (unsuccessful) proposals to carry out amendments pertaining to the Monetary Union, albeit to no avail. This would have avoided the repetition of the arduous procedure of constitutional amendment in near future, as well as providing higher legitimacy to harmonisation of obligations under the monetary *acquis* which the Candidate Countries had to take over into their national legislation. The constitutional conflict with monetary *acquis* primarily lie in the exclusive right of the national central banks to emit the national currency, which is expressly established in the constitutions of Estonia, Lithuania and Poland. In addition, several constitutions charge their country's national central banks with the task of safeguarding the stability of currency, as opposed to the ECB's objective of safeguarding price stability.

To take a look at the individual countries, Poland faced calls for amending art 227(1) (Wojtowicz, 2001:42). This article provides that the National Bank of Poland is the central bank of the State, it has 'the exclusive right to issue money as well as to formulate and implement monetary policy' and is 'responsible for the value of Polish currency'. In Lithuania, art 125 provides that '[t]he Bank of Lithuania shall have the exclusive right to issue bank notes'. Some foreign experts have pointed out that even though the delegation of monetary sovereignty could be accommodated under a general provision on delegation of powers, this article may need an amendment with a view to transparency. On the other hand, the Rapporteur of Lithuania's Working Group on the constitutional amendments has interpreted art 125 as not being incompatible with the *acquis*. This is because EU accession does not mean automatic participation in the third stage of EMU and, in addition, the expression 'to issue bank notes' could be interpreted as meaning the Lithuanian national currency *Lita*, thus not necessarily contradicting the powers of the European Central Bank to issue a single European currency (Vadapalas, 2001:358).

In Estonia, art 111 provides that the Bank of Estonia 'has the sole right to issue Estonian currency'; it shall 'regulate currency circulation' and 'uphold the stability of the national currency'. The Constitutional Amendment Expert Commission deemed it necessary to amend art 111 in its 1998 Report (*Võimalik liitumine Euroopa Liiduga...*, 1998). This opinion was also supported by several foreign experts,[25] the Legal Chancellor[26] and the President of the Bank of Estonia.[27] On the other hand, it has been commented that the tasks of the ECB and the Bank of Estonia are different: the former has to maintain price stability, whereas the latter is to secure the stability of the currency. Since these tasks are mutually exclusive, the tasks of the Bank of Estonia cannot be delegated to the ECB, which is why a rewording of this article has been advocated instead, so as to abolish the responsibility of the Bank of Estonia to safeguard the fixed exchange rate.[28]

Similar problem with a move from currency stability to price stability may arise in the Czech Republic, Hungary and as we saw above, with the Polish article 227. The Czech Constitution provides that the Czech National Bank 'is the central bank of the State. Its activities are primarily oriented towards currency stability; it is possible to interfere with its activities exclusively on the basis of law' (art 98.1). In Hungary, art 32D(1) of the Constitution provides that '[t]he National Bank of Hungary is responsible for issuing legal tender, protecting the stability of the national currency and regulating the circulation of money, in such manner as provided for by a separate statute'.

The margin of interpretation appears to be wider in Slovenia, Slovakia and Latvia, where the participation in EMU is likely to be accommodated under a general provision on EU membership. In Slovenia, art 152(1) provides that: 'Slovenia shall have a Central Bank which shall be independent in its operations and accountable to the National Assembly'. In Slovakia, art 56 provides that '[t]he Slovak Republic establishes a bank of issue'. In both countries, further conditions are to be determined by law. Latvia's laconic Constitution, which is an amended version of the 1922 Constitution, does not regulate monetary issues. It is interesting to note that the most detailed regulation of national currency is incorporated in the Constitution of Romania, a country expected to join the EU at a later stage, where it is specified that the national currency is the *leu*, with its subdivision, the *Ban* (art 136.2).

Notwithstanding the calls for amendment, the issue of constitutional revision in respect of Monetary Union has been postponed to the post-accession period, as part of a general trend to keep the amendments minimal. With the exception of the Czech Republic, Slovakia and Slovenia, the countries opted for substantively or/and procedurally minimal amendments, so as to avoid the sensitive question of sovereignty becoming a risk for membership in the accession referendums (see in more detail Albi, 2003a). However, it is likely that the question of amending these provisions will resurge ahead of the eventual adoption of the Euro.

6. An assessment in the light of the rationale of a constitution

New stages in European integration bring about the question to what extent need successive delegations of competences be reflected in the constitutions of the Member States? Monetary integration exemplifies well this dilemma: widely acknowledged as one of the most tangible interferences to sovereign governance, it has nevertheless found express authorization only in four constitutions - French, German, Portuguese and Greek, albeit others have broader provisions on delegation of powers to the EU or international organisations. In fact, half of the Member States' constitutions in 2004 still make minimal references to the EU or even do not mention it at all. As discussed above, this has partly been dependent on factors such as the level of precision of the current regulation of monetary affairs in individual constitutions, as well as of the difficulty of the amendment procedures and of the existence of a constitutional court. In addition, one must recognise the role of implicit amendments, interpretation and the political costs of amending the constitutions.

However, this increasingly leads us to a fundamental question about the role of the national constitutions in the process of European integration. The constitutions have been likened to social contracts by which the *pouvoir constituant* agrees on what are legitimate ways of exercising power in a state. The rationale of the constitutions - their purpose, essence and justification - is to determine the distribution and exercise of power competences. Internal changes in the distribution of powers between the domestic institutions of governance have usually led to constitutional amendments, whereas this has been considerably less so with changes caused by a move of powers to external, international institutions. . More than half of the Member States' legislation derives today in a varying degree from EU institutions, including some core areas of sovereign statehood, such as foreign and defence policy and internal security. EC law is supreme and directly applicable. There is EU citizenship, and democratic legitimacy is partly exercised by the elections of the European Parliament. And, importantly to the line of argument of this paper, twelve Member States have adopted the common currency. As these substantial shifts in exercising powers have found reflection only in few constitutions, they have been rightly caracterised as suffering from a 'European deficit' (De Witte, 2001:73), for being obsolete with regard to the actual distribution of powers.

In order to increase the legitimacy of delegating powers to European level, as well as to uphold the rationale of the constitutions, the surrender of national currency seems to justify a call for a revision of national constitutions in a wider range of countries, following the model of France, Germany, Portugal and Greece. An adequate reflection of the level of EU integration in the constitutions would also be desirable from the point of view of constitutional courts, who have often be left with an *a posteriori* task of stretching the 'gum' constitutional norms to legitimise the fundamental shift of powers, which for the sake of legitimacy should rather be decided by the parliaments. Furthermore, references to the EU's role in the national exercise of powers would certainly contribute to transparency and clarity, thus reducing the democratic gap between the EU and the citizens.

In the case of the countries of Central and Eastern European (CEE) accession countries, there are additional arguments in favour of introducing express references to EMU, once their transition to common currency will take place. As we saw above, several CEE constitutions expressly limit emission of national currency to the national central bank or declare the stability of currency as opposed to stability of prices to form the goal of their central banks. Furthermore, these constitutions are distinctly more protective of sovereignty compared to the constitutions of the 'old' Member States (Albi, 2003b). In addition, adequate EU-amendments would contribute towards keeping their new constitutions as clear, up-to-date and directly applicable legal documents, considering their fifty-year experience with the declaratory Soviet constitutions, in which the mechanisms for exercising power and guarantees against state intervention remained but illusory. In fact, some CEE constitutional courts have expressly stated that based on the principles of sovereignty, legitimacy and rule of law, the constitutions may only be amended by the prescribed procedure and not in a disguised way by ratifying foreign treaties.[29]

Besides constitutional amendments, the Monetary Union further strengthens the case for a revision of the traditional concept of sovereignty. The calls for a new understanding of the concept of sovereignty gained particularly momentum in the wake of the *Maastricht*-Decision of the German Constitutional Court, which was criticised for using antiquated constitutional concepts to assess the EU, a novel multi-faceted entity (eg MacCormick, 1999; Walker, 2003; Habermas, 1999; De Witte, 1998; Hobe, 1994, 127ff). Instead, pointing out that the concept of sovereignty has transformed many times during its history, this line of literature argues that the processes of globalisation and European integration have brought about the case for another such adaptation. However, the consensus still has to emerge on how the new concept of sovereignty might be understood.

7. Conclusions

This paper examined the legitimisation of the transfer of monetary sovereignty to the EU in the national constitutions of the Member States and in the accession countries. While the French Constitutional Council found that this move goes against 'the essential conditions of exercise of national sovereignty' and therefore requires a constitutional amendment, only three other countries - Germany, Portugal and Greece - deemed it necessary to amend their constitutions with regard to Monetary Union. The remaining countries accommodated this move under broader constitutional provisions on participation in the EU or international organisations. The reasons for this include the level of precision in their constitutional regulation of monetary powers, difficulty of the amendment procedures and constitutional traditions. Although diverse solutions can be found in the experience of the 'old' Member States, the paper recommends the model of France, Germany, Portugal and

Greece to the accession countries once they are ready to join the common currency. The reasons for this include higher legitimacy for delegation of powers, upholding of the rationale of the constitutions, as well as some characteristics specific to the constitutions of Central and Eastern European countries.

NOTES

[1] Permanent International Court of Justice, 12.07.1929 in *Publications*, Serie A, n. 20, p. 45 e n. 21, at 122, cited in Chirico (2003:139).

[2] Decision n° 92-308 DC, 09.04.1992, available at http://www.conseil-constitutionnel.fr/decision/1992/92308dc.htm.

[3] See for comments on the ratification process and the Maastricht decision, including brief annotations of the part concerning the EMU eg. Oliver (1994:5), Bonnie (1998:527), Jacque (1992:256) and Dubois (1997:217-218).

[4] These criteria are, according to Jacques (1992) contained in the *Conseil Constitutionnel* Décision of 22.05.1985.

[5] Decision n° 92-308, supra note 2.

[6] Constitutional Law No 1/92, 25 November 1992.

[7] See in more detail on the two amendments Miranda (1997: 393), Moura Ramos (2001: 134) and Botelho Moniz (1998: 468ff).

[8] MP Francisco Torres, Proposal of Constitutional Revision, submitted to the Special Committee revising the Constitution, and to the Plenary Session on 19.02.1997. See in more detail about the proposals that the constitution should be revised and that the Central Bank of Portugal should be independent and its objectives should include price stability in Torres (2000: 120) and Torres (1989a), respectively.

[9] Torres F. EU Governance and EMU, this volume.

[10] Constitutional law no. 1/97 of 20 September 1997.

[11] The author is grateful to Alessandra Chirico for pointing this out in her comment during the conference.

[12] See for a brief discussion on referendums in the context of EMU, Torres (2004).

[13] The referendum was consultative, but the parties in the *Riksdag* announced in advance that they intended to follow the outcome. In Sweden, a referendum is called if there are divided opinions among the *Riksdag* parties concerning the issue, or the opinion of the *Riksdag*'s majority differs from the majority of its voters. Both conditions were present with regard of the question of joining EMU. See *The Referendum. Swedish Parliament*. Available at http://www.riksdagen.se/eu/teman/emu/en/folkomrostning/index.asp.

14 The Riksbank and the EMU. Available at: http://www.riksdagen.se/eu/teman/emu/en/om_emu/riksbanken.asp.

[15] BverfGE 89, 155 (1993) [hereinafter 'German Maastricht-Decision']. English translation in *C.M.L. Rep*. (1994), at 75.

[16] German *Maastricht* Decision, supra note 15, at 91.

[17] German *Maastricht* Decision, supra note 15, at 99.

[18] German *Maastricht* Decision, supra note 15, at 100-101.

[19] German *Maastricht* Decision, supra note 15, at 103.

[20] German *Maastricht* Decision, supra note 15, at 103-104.

[21] German *Maastricht* Decision, supra note 15, at 104.

[22] Decision of 31 March 1998 - 2 BvR 1877/97 and 2 BvR 50/98, English abstract available at www.jura.uni-sb.de/Entscheidungen/abstracts/euro.html; also Reuters, German Constitutional Court throws out euro challenges www.turkishdailynews.com/old_editions/04_03_98/for2.htm#f13.

[23] See in more detail on the conditions for accession countries to join common currency Christina Loli's contribution to this volume.

[24] Comments by C. Mueller-Graff and I. Pernice, available in English in the collection *Stojimas I Europos Sajunga Ir Konstitucija. Seminaro Medziaga* 29-30.06.1999 (Vilnius: Eugrimas, 2000).

[25] Experts M. Niemivuo, L. Lopez Guerra, H. Beemelmans and J. Gardner; the opinions are available in the collection "*Põhiseaduse Juriidilise Ekspertiisi Komisjoni Tegevuse Aruande Lisa 'Välisekspertiisid'*" [Appendix 'Foreign Expert Opinions' to the Report on the Activity of the Constitutional Expert Commission]. (Tallinn: Justiitsministeerium, 1998).

[26] Legal Chancellor's opinion on amending the Constitution, submitted to the European Affairs Committee of the Parliament, is available in an annotated form in the Parliament's Press announcement of 12.10.2001, www.riigikogu.ee.

[27] See: Kraft V., (1999).

[28] Andres Tupits, Legal Expert in the Bank of Estonia, in electronic communications with the author in January 2002.

[29] Hungarian Constitutional Court's Decisions 30/1998. (VI 25) AB, *Magyar Közlöny*, para V.3 and Resolution No 2/1993 (I.22). (1996) 3 *East European Case Reporter of Constitutional Law*, pp 26-33, at para 26; the Slovenian Constitutional Court's Decision of 05.06.1997 on Europe Agreement, www.us-rs.si/en/index.html, para-s 35-38.

Comment
by
Stefano Bartolini

The chapters by Oliver Schmidtke and Francisco Torres share the greatest merit discussion papers can have: without much hesitation, they articulate clear-cut theses that are, in many ways, unconventional and therefore serve as a perfect staring point for the debate. Schmidtke paper discusses the extent to which the Economic and Monetary Union (EMU) has come 1) to be or to be perceived as a challenge to the nationally bounded social citizenships, and 2) has become the focus for growing ‘politicisation’ and ‘populist’ protest. The paper by Francisco Torres investigates the hypothesis that EMU and the European System of Central Banks (ESCB) could 1) be submitted to the overseeing of the European Parliament (EP) considering the latter as a potential ‘principal’, and 2) eventually contribute to enhance EU accountability and transparency in macro-economic policy.

These theses are ‘unconventional’, as I said, in many respects. Oliver Schmidtke’s thesis is most of the time expressed blaming different institutions and policies. The ‘erosion’ of national citizenship rights resulting form the European integration process does not immediately point to the responsibility of the EMU. The liberalising, de-monopolising, free circulation elements of the European Economic Community (EEC), the various principles of direct effect, supremacy, etc. of European law over the national one, and the case law activities of the European Court of Justice (ECJ) are often regarded as an historically antecedent and a more fundamental challenge to the national social citizenship than EMU itself. Even the popular resentment against the EU, to which Schmidtke refers in the paper, is infrequently attributed directly to the Euro and to the mechanisms of its central administration, but to more mundane and directly perceptible ‘intrusion’ of the distant Brussels bureaucracy. One of the reasons for this is that ordinary citizens have hardly the necessary competence and information to perceive the potential and indirect constraining effect of the common monetary policy over national social policy decisions.

Also the central thesis by Francisco Torres is unconventional in the same sense as above. Looking for the ‘principal’ of the European Central Bank (ECB) and for a body able to oversee its activities, most observer would point to the Council or to some sort of special European Executive Committee or High

Commissioner for the monetary policies, rather than to the EP. After all, even at the domestic level when a direct political subordination of the Central Bank is or was foreseen, this was always subordination to the national executives, not to the national parliaments. And the main reason for this executive role was exactly one of the central points discussed in Torres' paper: how can one oversee and politically direct the role of the (national or for that matter European) Central Bank without jeopardizing its financial market credibility.

In many ways, therefore, the interest of the papers is exactly that they look into questions that one would not normally regard as the normal ones. Yet, this does not means that the arguments are wholly convincing. Leaving aside for space and time considerations the thorny and complicated question of 'democracy' in the EU, the less convincing parts of the papers have to do with two key concepts largely used by both of them: the concept of 'accountability' and that of 'governance'.

Torres' paper acknowledged that 'accountability' has many meanings but fails to clearly indicate in which way the ECB - which has a single Treaty defined goal (price stability) and has operationalised it in full autonomy (price stability = no more than 2% inflation) – could be 'accountable' to the EP. To be more precise, it is unclear which 'sanctions' in the hands of the EP could or should qualify such accountability, admitting that –as the author does – accountability requires sanctions to be real. If sanctions for deviant or disliked behaviour cannot be identified, then we should use a different term than 'accountability'. In many ways I have ha the impression that the term meant by Torres is more 'responsiveness' than 'accountability'. In fact, many mechanisms of a formal and informal nature can achieve a certain degree of 'responsiveness' - that is of responding sympathetically - even without direct accountability, that is without direct sanctions.

Finally, even the resort to the concept of 'governance' in relation to the EMU and its predefined goals would require some clarification. Governance is an ambiguous term. A minimalist but generally accepted definition considers it as a form of decision making inherently different, if not opposed, to 'government', that is to binding decisions monopolised by a relatively centralised and monopolistic body. If this so, then the concept of 'accountability' and 'governance' are indeed at odds. No governance can, *strictu sensu*, be accountable for the very reason that it does not allow a clear cut identification of whom is to be regarded as accountable and whom should be sanctioned in case this was deemed necessary.

Finally, to include EMU and the ECB within the system of European ‘governance’ is indeed improper in my view. One may regard the system of decision-making concerning the European currency as the more ‘governmental’ process of the EU. For monetary policy, the transfer of power to the ‘federal’ level is full. The cohesion of the common currency system and of the bank system is so high and strong to coincide with an absolute ‘unity’. The central Bank position is characterised specific and exclusive powers to reach operational tools at its disposal. The other bodies of the EU have policies equally defined by the constitutional or treaty norms (cohesion, occupation, etc.), but do not have operational tools under the complete control of those who decide because complex procedures that involve other subjects are necessary. In the many policy areas of the EU, there are less clear definitions of the objectives and a less direct and immediately available use of operational means and operational as it is the case in monetary policy. In fact, in the monetary policy, the instruments of action find immediate and full coincidence in the juridical structure and in the operational structure for which the currency has an immediate impact in the individual spheres of action.

In the community system the lack of a centralised power capable to materially exercise coercion towards the member states (or toward citizens) makes the difference with a real ‘federal’ structure. But in the case of currency there is no need of a coercion power. The power given to the ECB and to the ESCB is directly operational and without intermediation for what concerns the currency (emission and printing, the rates). The direct implication and operability of the decisions concretises the perfect identity between the juridical and the economic orders. In the currency domain the direct relationship between citizens and federal state (fundamental characteristic of the federal system) is guaranteed by the function of the currency itself.

EMU, in my opinion, is the most unitary, centralised, monopolistic, and direct effect - and therefore the more ‘governmental’ - system of the EU decision-making. It should therefore be regarded as a federal sub-system in a non-federal system. Paradoxically this makes it also the most accountable in principle, because one knows clearly which decisions are taken and by whom and in what capacity.

I conclude these remarks by arguing, somehow paradoxically, that EMU could become ‘accountable’ exactly because it is the less ‘governance’ and the more ‘government’ sub-system of the EU. It remains an interesting but open question whether this unified ‘agent’ can find its ‘principal’ in the fragmented structure of the EU bodies and decision making, and whether this principal could the EP – which indeed rests on unitary principle of representation – rather than the intergovernmental Council.

Comment
by
Svetlozar Andreev

The chapters by Francisco Torres and Oliver Schmidtke are two well-written papers with clear research questions and interesting investigation puzzles to debate. Although they deal with seemingly distant topics: Francisco Torres – with the role of the European Parliament (EP) as a possible 'principal' overseeing Economic and Monetary Union (EMU), and Oliver Schmidtke – with the alleged democratic deficit and legitimacy problems, created by the introduction of the Euro, and the latter's impact on the evolving concept of citizenship in Europe, they have a common set of concerns: how to improve the democratic accountability of EMU and how to prevent the further deligitimation of EU on the basis of the highly technocratic and distant-from-the-public supranational monetary arrangement in Europe.

In a broader sense, these two papers discuss the political and social effects of the introduction of EMU in the late 1990s, and the possibility of controlling and steering a series of fiscal mechanisms by local and regional actors. What is laudable in both publications is that they talk about processes rather than products related to EMU. Moreover, and implicitly, they do not perceive the evolution of EMU as a unilinear process, leading to a certain set of (mostly positive) economic, social and political results, but they try to offer a constructive critique, which sees European monetary integration as a reversible process. As has the practice in this field taught us during the 1970s and 1980s, EMU could often and quite rapidly experience setbacks. Thus, it is highly instructive to explore the potential political and social causes and results of this, as well as to try to strengthen the legitimacy of this fiscal arrangement among domestic and supranational constituencies. Finally, both papers are complementary as they analyse both top-down (EP as a 'principal') and bottom-up (strengthening European citizenship) approaches to the accountability and legitimacy problems spurred by EMU.

Any academic debate about the political and social effects of one or another kind of fiscal arrangement usually engenders two things: the necessity for (a) a *functional autonomy* of the decision-making bodies, and (b) a *degree of control* by the representatives of the population. As has been proven during the transition to and consolidation of democracy in many countries of Southern

Europe, Latin America and post-communist Eastern Europe and Asia, the almost complete independence of national central banks from the executive and the legislature has been key to the successful economic transformation and ability to attract foreign investment. This policy of central bank autonomy has also been actively promoted and fully supported by the International Monetary Fund (IMF), the World Bank and the Organisation of Economic Cooperation and Development (OECD). At the same time, however, there have been at least three arguments put forward against such an arrangement: (1) the lack of transparency and rigidity of rules associated with virtually fully-independent central banks, (2) the possibility that autocratic rules may install loyal people at key positions in the central bank before and during the transition to democracy (the example of Chile during the 1980s and 90s is telling in this respect), and (3) the limited scope of control by popularly elected bodies, although their performance might seriously be affected by what the central bank does or fails to do. It is also necessary to clarify that the introduction of a supranational monetary policy and its related institutions, and a regional/international central bank in particular, leads to further complications of the above-mentioned problems. The complexity of managing EMU, *via* the setting-up and controlling the European Central Bank (ECB), is expressed by the dynamic interplay between national and supranational levels of authorities in the EU, on the one hand, and between them and an independent ECB, on the other. The specific political, economic, fiscal and social interests of these centres of authority are often overlapping and superimposing (from where the notion of "multi-level and polycentric governance in the EU"), while the institutions and accompanying rules of EMU are still in a process of partial transition and maturation – that is why it is easy to witness and predict conflicts of interests and a potential for instability in this kind of setting.

Another important point that both papers make is about the impossibility (or, better, the limited possibility) of legitimating EMU – and, hence, the EU – only on the basis of performance, as opposed to rules and the direct political contribution of the citizens and their popularly elected institutions. As numerous publications on the democratic/legitimacy deficit in Europe have indicated, there are four principal modes of legitimating the EU governance system:

1) *Output legitimacy*: Efficiency and effectiveness of European problem-solving ability and capability; **government *for the people***;
2) *Input legitimacy:* Direct democratic legitimation of European politics through the elected European Parliament; transparency; citizen participation and consultation; **government *by the people***;

3) *"Borrowed" legitimacy through Member States*: Indirect democratic legitimation of European politics and their already legitimated authorities (member state governments, national parliaments, civil servants and nominated experts); **government *of the people***
4) *"Formal"/Constitutional legitimacy:* Legitimation through constitution, the law and direct effect; ***government by the rule of law***

It is easy to empirically testify from the more than half-a-century life of the supranational institutions that they have traditionally relied on the first and third types of legitimisation. Both the citizenship and constitutional dimensions of legitimising the European integration have largely been ignored until the mid-1990s. Nowadays, however, they are seen as main, if still not fully exploited, ways of legitimating the EU governance directly.

Oliver Schmidtke's paper elegantly links the problems, associated with the introduction of the Euro, with the evolution of supranational citizenship. He even concludes that "EMU could indirectly (and probably unintentionally) contribute to the development of an, albeit thin, notion of European citizenship status." This, according to the author, is/ would be achieved through the gradual redrawing of "community boundaries" and the reinterpretation of the "European social model." However, as already stated, this cannot be achieved using 'traditional' forms of legitimation – based on output and redistribution. The stress put particularly by the EMU policy is on coordination and oversight by the popularly elected institutions, such as the national and European parliaments, as well as the exponents of civil society. A similar hunch is expressed in Francisco Torres' paper, in which the author (rather counterintuitively) proposes the EP to serve as the ultimate body to keep the EMU under scrutiny. What might be said in terms of critique in relation to Schmidke's paper is that it uses the notion of European citizenship in a very limited sense, i.e. of only "social citizenship," without specifying (and operationalising) what is meant by the latter concept. The reader is left with the impression that a common European model of a 'social citizenship' already exist, while EMU is seen as somehow intervening with this model, without making clear the concrete mechanisms and loci of 'subversive' activity. Finally, related to the 'populist reaction' to EMU at the national and supranational levels, one is tempted point out that political and social reactions spurred by the introduction of the Euro are not fully and logically linked to the evolution of EMU as a policy area. Thus, it is necessary to make a clear conceptual distinction between money and a monetary mechanism, and to clarify their possible effects on society.

In his paper, Francisco Torres makes the interesting case for the role of the EP as a ‘principal’ controlling EMU. However, one should recall that, although being the only supranational institution directly elected by the European people, it nevertheless (a) is with limited, albeit slowly growing, decision-making powers, and (b) represents only a small part of the EU population (e.g. also excluding the immigrants and legal residents), and tends to reproduce mostly national and hardly any European cleavages. The question in Torres’ paper is rightly put to highlight the potential improved legitimacy-efficiency trade-off (in favour of the first) and the quality of democracy, ensuing from an increased EP participation in fiscal matters. However, the results of this research have to be better spelled out and put in a context. Both the EP and EMU have rapidly evolving roles in the European governance. Thus, it is difficult to explain how the first might exactly influence the latter in the short and medium-term future. This problem does not, however, diminish the relative scientific merits and highly innovative nature of this paper. Finally, I tend to agree with the other commentator, Prof. Stefano Bartolini, that, because being less ‘governance’ and more ‘government’ (or governmental), EMU has a chance to become more ‘accountable’ compared to other supranational policy fields, **provided** that the major ‘stakeholders’ (i.e. the governments), stick to their initial promises of fiscal discipline and manage to ‘auto-supervise’ themselves, thus maintaining the international and domestic credibility in and legitimacy of EMU.

Comment

by

Alessandra Chirico

Anneli Albi's contribution touches a very interesting topic related to the establishment of Economic and Monetary Union (EMU) - namely the modalities through which Member States have legitimised the adoption of the common currency -, and developes a thorough analysis of the major national constitutional amendments and constitutional court cases where monetary integration has been challenged.

The main aim of the present comment will be, instead, an attempt to investigate the process of legitimisation, not from the national level, but adopting the different perspective of the European Union (EU) level, trying to make sense of the theoretical and institutional transformation occurred within and around the EU with the establishment of EMU, assuming that such an institutional transformation has had far-reaching implications for the nature of the newly emerging European polity as such. Particular attention has to be paid to those implications affecting the traditional categories characterising the consolidated way of structuring the institutional background against which the relationship between money and state sovereignty has been built and developed, in consideration of the fact that the transfer of national monetary sovereignty to the European Central Bank has fundamentally changed the economic and monetary constitution under which both European and national economic policies are conducted.

The basic focus on the institutional changes occurred with the building-up of EMU is due to the fact that they represent a new, highly meaningful stage in the development of public international law, most notably if one takes into account the complex issues related to the set up of the European System of Central Banks (ESCB) within the body of EMU seen as a "metaphor" for the EU. Undoubtedly, since the beginning of its first steps, EMU has challenged consolidated assumptions about national sovereignty and the "essential conditions of its exercise", legitimacy and national identity, since it has always been perceived as bolder, riskier, and more controversial than the single European market, as a meaningful stage toward economic integration. In fact, although the Maastricht Treaty falls short of the original and ambitious expectations in the field of politics, it certainly fulfils the intentions laid down in the preamble with respect to monetary union. The introduction of the single currency lies, in a sense, in the interstices between the economy and the state in that it combines functional economic elements with institutional political ones. The single currency does away once and for all with internal exchange rate fluctuations, completes the Single Market and, with a single money for almost three hundred million people, increases the efficiency of currency use in an unprecedented manner. The transfer of national monetary sovereignty to the ECB represents thus a partial surrender of political sovereignty, which is rightly perceived by citizens as marking a deep change in the way in which nations consider themselves. As a result, the monetary order established by the Maastricht Treaty - together with the detailed Statute of the ESCB and of the ECB -, "by itself represents a crucial building block for the development of a European statehood".[1] The success of the ECB's monetary policy and the stability of the euro constitute a test case for European integration above and beyond monetary and currency issues.

As a very first remark, it has to be said that the very existence of the ECB and of the Eurosystem was indeed the result of a democratic and highly political process (as well highlighted in Albi's paper).[2] The Treaty provisions, and with them, the same mandate of the Governing Council of the ECB to maintain price stability and its high degree of independence, were formulated by the political system itself. In fact, it has to be recalled that the national parliaments of each of the EU Member States approved these provisions and the principles, tasks, objectives and institutional set-up of the Eurosystem, and, in some countries, also the constitutional courts expressed themselves in order to specify the precise contents of the constitutional authorisation by their Member States.

More generally, it is worth underlining the fact that the introduction of the euro as such and the establishment of the ECB constitute a new, significant step in the process of European integration which has now been under way for more than half a century. This process was and is still based on the political view that an integrated Europe is in the interest of stability, security and prosperity. The European integration process can thus be seen primarily as a political process with, of course, important economic aspects and benefits, which cannot be disregarded.

Having pointed out all that, one can even move further arguing that the whole process related to the institutional configuration of the Eurosystem has been a matter of finding the best balance between the reasons of political primacy (mainly characterised by an intergovernmental component) and those of the emerging economic/monetary power (a truly supranational one), in terms of democratic and political control,[3] on the one hand, and monetary policy effectiveness, on the other.[4] In a society based on democratic and market principles, both these requirements are crucial. However, as they are partially conflicting, clear definitions and an appropriate balance in their implementation need to be found.[5]

In particular, it should be borne in mind that the policy decisions of the Governing Council of the ECB affect the lives and welfare of the almost 300 million people living in the euro area. This is why the transfer of such substantial power into the hands of independent, non-elected central bankers can only be legitimate if effective democratic control (*ex ante*) and accountability (*ex post*) are in place.

As a matter of fact, democracy based on representation assumes a symmetrical relationship between legitimated power and accountability. In fact, when public power is implemented someone must be firstly legitimised to exercise it and then be able to be held accountable for it. In principle, such a reasoning should be applied also to the ECB as bearer of monetary sovereignty (a new, still controversial form of public power) within the EU. Still, such a “sovereign” power is used by the ECB without or outside the traditional forms of political control which otherwise should follow automatically. This can be partially justified by taking into account that the Eurosystem – following the logic of central banking - has to be in a position to effectively carry out its tasks, i.e. to actually safeguard the currency and deliver price stability, a prerequisite which may set conditions, and even a limit, to the way in which democratic control is exercised. In particular, the forward-looking character of monetary policy, the long time lags with which monetary policy works, the sensitivity of relevant information and the powerful market reaction to policy announcements, all have to be seriously evaluated in designing the methods of democratic control and accountability that are appropriate for the central bank.

Some remarks on the notions of legitimacy and accountability in EMU

Thus in order to well develop the analysis of the notion of accountability within the context of the ECB, it is good to start from the basic constitutional ideas to be applied to the European Union as such, namely that in a democracy citizens delegate power to politicians. The politicians exert this power until they face the electorate again. As a result, the delegation of power to the politicians has two stages. The first one starts when the politicians are vested with power. During this stage they exert this power independently from the electorate. The second stage is the accountability stage, when the electorate evaluates and sanctions the record and the performance of the politicians.

Much of what politicians do is to further delegate power to specialised institutions. This secondary delegation must have the same two stages. In the first stage, the politicians delegate power to the institution in the form of a contract in which the objectives and the means to achieve the objectives are specified.[6] In the second stage the politicians evaluate the performance of the institution. The first stage can be called the stage in which some form of independence is granted, the second one is the stage in which control is exerted (accountability). These two phases are inextricably linked. The politicians, who are accountable to the electorate, cannot afford to delegate power to an institution (making it independent) except if they can also exert a sort of control over that institution.[7] Applying in such a case the theory of principal vs. agent, it seems evident that "the core sense of accountability is clearly grounded in the general purpose of making agents or subordinates act in accordance with the wishes of their superiors".[8]

The more the politicians delegate power, the better the control must be organised about how this power is used. If there is little delegation, there is little need for control. Thus, applying these principles to the case of central banks, if the government decides about the interest rate then there is no need for having explicit accountability of the central bank. If, on the contrary, the government delegates a lot of power to the central bank, there is a corresponding need to have a high degree of accountability. The reason is that the government maintains its full accountability towards the electorate, and therefore cannot afford to delegate power without maintaining control over the use of this power. As a consequence, independence and accountability are part of the same process of delegation.

Moreover, it has to be said that delegation of power implies the consensus of both parties involved in the process on an agreement in which the objectives to be pursued are specified, together with the method to achieve these objectives.

A crucial issue is thus the precision with which the objectives are described. If objectives are left vague, it will be difficult to monitor the behaviour of the central bank. Accountability will be weak. In fact, the more precise the objectives are defined, the easier will be the monitoring.

Having established the basic *ex post* character of the ECB's accountability,[9] two further questions need to be addressed in order to make this concept meaningful for the present investigation: should the ECB be "accountable for what? accountable to whom?"[10]

With the aim to find an answer to the first question, it has to be recalled that the Eurosystem should be held accountable simply for the fulfilment of its mandate. In this context, the maintenance of price stability, and hence the formulation and implementation of the single monetary policy, is at the centre of attention. The Treaty itself provides a yardstick, the maintenance of price stability, against which the Eurosystem's actions should be measured.[11] In any case, beyond being accountable with reference to its success in fulfilling its primary objective, the Eurosystem is supposed to be held accountable also in relation to its other tasks. Not least in the dialogue with the European Parliament (EP), it happened that the ECB was called upon to explain its actions and decisions, *inter alia*, relating to payment systems, euro banknote design and production, etc.[12]

Second point to be discussed is: accountable to whom? As the currency is one of the most pervasive components of the social system, and given that price stability is a public good, it should be clear that the Eurosystem is, in the broadest sense, accountable to the European citizens at large.[13] The fact that the European citizens place their trust in the Eurosystem to safeguard the currency and to defend their savings makes them the ultimate addressee of the Eurosystem's accountability.[14]

In the political order of the EU, the only institution that directly derives its role and legitimacy from the citizens is the EP. Irrespective of the county and constituency where he or she was voted, each member of the EP has been elected to pursue the European public interest, just as parliamentarians of Member States are entrusted with the national interest. The EP is the institution of Europe's democratically elected representatives, which represents the interests of the peoples of Europe. This is why accountability quite appropriately relates, first and foremost, to the EP and the dialogue between the ECB and the EP represents the principal means to exercise accountability.[15] Beyond that, complying with its reporting requirements, the ECB is engaged in a dialogue with all the bodies that play a role in the European political process: the Council of Ministers and the European Commission in the first place, but also the Economic and Social Committee.[16] The ECB participates in meetings of the Eurogroup, the Ecofin Council. In return, the President of the Ecofin Council and a member of the European Commission have the right to attend the meetings of the ECB Governing Council. The Eurosystem also reaches out to other relevant groups in society, such as the social partners, by joining, for example, the discussions of the Macroeconomic Dialogue. These contacts allow the ECB to explain its decisions, to share its analysis and to receive political feedback and thus be connected to the European political process. At the national level, the national central banks also relate to their national parliaments and entertain links of communication with their governments.[17]

Having said that, it can be concluded that it is quite encouraging to observe a growing recognition and appreciation for the Eurosystem's distinct method of accountability, which derives not only from the specificity of its institutional profile, but also from the environment in which it is embedded. It should be clear, in fact, that the Eurosystem neither operates in an institutional vacuum, nor is it supposed to do so. Being held accountable should not a burden for the Eurosystem, on the very contrary it should be seen as a safeguard. "It is through discharging its accountability tasks, through exchanges of views and opinions within the European public sphere, including open criticism and controversy, that the Eurosystem can earn its in«dependence every day, and grow in stature".[18]

NOTES

[1] See O. Issing, (2000).

[2] For a further elaboration on this point see O. Schmidtke in this volume.

[3] It is interesting to note that during the debate in the European Parliament on *Democratic accountability in stage three of EMU*, the French, Italian and Portuguese versions of the draft report initially used the term *contròle démocratique, controllo democratico* and *controllo democratico*, respectively, while the Spanish version referred instead to *responsabilidad democratica*. Such an element testifies the significance of the issue at stake here in the institutional construction and configuration of the ECB as bearer of monetary sovereignty.
On this point see the illuminating paper written by L. Bini-Smaghi and D. Gros, (2001), where the authors, reflecting on the idea of democratic control, identify three constraints on the exercise of government: (a) *ex ante* control, which defines the rules, standards and principles laid down in advance by a democratically elected body, to be followed by the accountable body in the exercise of its functions; (b) accountability as such, viewed as the act of listening to criticism and responding to questions about the past and future behaviour that may be put forward by a democratically elected body; (c) popular mandate, which refers to the attribution of power through democratic procedures. However, it should be said that the above criteria cannot fully be applied to central banks. The third criterion, in particular, is not relevant in that independent central banks do not receive mandates nor they choose their own policy objectives. "This would imply that the central bank had become *a new separate branch of democratic power*", which is not the case (Ibidem, p. 2. Emphasis added).

[4] As pointed out by F. Torres in this volume, there is an efficiency-legitimacy trade-off, by virtue of which "it is not possibile to increase the legitimacy of the EC system without decreasing its efficiency and vice versa". According to the author the emerging role of the European Parliament in enhancing the democratic accountability of decision-making in monetary policy's matters may prove quite powerful with respect to avoiding such a trade-off and indeed improving efficiency, transparency and accountability in European governance.

[5] As rightly observed by B. Dutzler (2003), "the task is to reconcile democratic organisational principles and central bank independence, or its compatibility with the axiom that every exercise of public authority must be democratically legitimised". All this appear to be a real challenge and represents a truly controversial issue in the academic debate. In principle, if the democratic principle can operate at the European level, the Europeanisation of monetary policy cannot constitute *per se* a challenge to it. Nonetheless, the specific

institutional framework adopted for this purpose in the Maastricht Treaty still does. The Treaty assigns to the ECB full responsibility for the conduct of the single monetary policy and an extremely high degree of independence from the other Community institutions, as well from the governments of the Member States. In other words, it grants to a group of appointed officials full decision-making powers for a key aspect of macroeconomic policy. It can be concluded – together with C. Hadjiemmanuil, (2001), – that "the establishment by means of constitutional rules of depoliticised, non-majoritarian central banking arrangements, would appear to constitute, at the supranational as much as at the national level, a direct and gross violation of the democratic principle".

[6] It has to be borne in mind that the more clearly and precisely this mandate is defined, the easier it will be to monitor the performance of the central bank. Moreover, "the more clearly and narrowly the mandate is defined, the easier it will be in a democracy to justify the delegation of powers to an unelected body, since value judgements and trade-offs concerning several unranked objectives should naturally remain the preserve of democratically elective representatives" (O. Issing, 1999).

[7] A partially different reconstruction of this process is provided by A. Cukierman (1992), notably at p. 350. The author argues that "the conveyance of authority to the CB by political authorities can be viewed as an act of partial commitment. By delegating some of their authority to a relatively apolitical institution, politicians accept certain restrictions on their future freedom of action. The main motive for such delegation is usually the preservation of price stability" (…) "By delegating some of their authority to the CB, political authorities try to reduce the set of circumstances under which price stability is sacrificed in order to achieve other objectives. The higher the independence of the CB, the stronger will be the commitment".

[8] A. Mulgan (2000), at p. 563. The author further argues that "the ever-present threat of being called to account, the potential implicit in accountability, will serve as a sufficient device to secure a satisfactory degree of compliance with political preferences (Ibidem, p. 567). On the same line of reasoning see F. Torres, *op. cit.*, who observes that "the process of delegation itself may" (…) "meet transparency and accountability requirements. However, those legitimate principals expect agents to carry out policies that are consistent with their initial preferences. Nevertheless the agent's actions may differ from the principal's preferences. For that reason, transparency, in conjunction with accountability, is critical to ensure that agents comply as mandated".

[9] In the theorical reconstruction of B. Dutzler (2003) p. 110, the *ex post* accountability comprises different components, namely (i) reporting requirements, (ii) regular statutory hearings of central bank representatives before political bodies, (iii) the power of political bodies to demand appearances, (iv) and inquiries into policy matters. All this applies to the ECB.

[10] These are the fundamental questions examined by C. Wyplosz (2000), pp. 275 and ff.

[11] As a general rule, central bank performance can be assessed by observing the concrete results of its policies, with a specific look at the inflation statistics. Given the time lag between the setting of monetary policy and its actual effect on price levels, however, observation of the latter enables the observer to assess actions taken about two years earlier. This, of course, is of little interest to market participants and the public at large. Moreover, as pointed out by L. Bini-Smaghi and D. Gros, (2001) other further elements complicate the exercise of accountability. It should be recalled, in fact, that inflation is a "monetary phenomenon in the long run, but not at each and every point in time. In the short run inflation is dominated by a number of other variables, such as labour costs, import prices and taxes, which are beyond the control of the central bank and are difficult to forecast". As a result, "the central bank can thus not be held accountable for temporary deviations from price stability, which are not due to its own behaviour". The underlined element has to be taken into account, but it has to be – at the same time – counterbalanced by the consideration that not always market participants know if such deviations are temporary or not, and whether they are due to monetary factors or to some other causes.

[12] In any case, it should be stressed that, despite the general principle highlighted in the text, given the vagueness of the Treaty about the other objectives besides price stability, the ECB has the tendency to interpret this to mean that it has to pursue only price stability. All reference to other objectives has been basically dropped, if and where possible. As a result, the ECB has drastically restricted the domain of responsibilities about which it can be called accountable. If the ECB's interpretation of the Treaty is left unchallenged, the ECB will be able to claim that its only responsibility is inflation, and that it cannot be made responsible for business cycle developments and movements in employment. This strategy, if successful,

will make the ECB accountable only for its perfomance in the area of inflation. The contrast with other central banks is huge. The Fed, for instance, has been made responsible by law for movements in employment. There is no way it could decide on its own that the employment objective is out of its responsibility, the way the ECB has done. As a consequence, the area of responsibilities about which the Fed is accountable is much broader than the ECB's.

[13] According to W. Duisenberg, (2000): "in a democratic society, the public and its elected representatives should have the opportunity to scrutinise the design and implementation of important public policies by independent bodies. In the context of monetary policy, central bank accountability is therefore an essential element in a democratic society".

[14] On this point the German Constitutional Court held: "it is part of the unassailable content of the democratic principle that the carrying-out of state functions and the exercise of state powers is derived from the people of the state and the persons doing so are fundamentally answerable to the people" (BverGE 89, 155, translation in CML Rev, 1994, 255) Similarly it can be rightly argued that "by virtue of the democratic principle, the holding and exercise of political authority – power of people over people – is not justifiable in itself, but authority must be derived from the people, who are the ultimate bearer of this authority. The performance of public tasks, therefore, needs to be legitimised by the people itself" (B. Dutzler, (2003)).

[15] It should be added that all European institutions are supposed to be accountable for their action. There is an interesting article by V. Mehde, (2003), where the two above-mentioned concepts of responsibility and accountability are accurately analysed. With specific regard to the position of the European Commission, the author quotes an illuminating excerpt taken from the *First Report on Allegations of Fraud, Mismanagement and Nepotism in the European Commission*, written by the Committee of Independent Experts on 15 March 1999, where it is argued that "the responsibility of individual Commissioners, or of the Commission as a body, cannot be a vague idea, a concept which in practice proves unrealistic. It must go hand in hand with an ongoing process designed to increase awareness of that responsibility. Each individual must feel accountable for the measures he or she manages" (…) "The tempatation to deprive the concept of responsibility of all substance is a dangerous one. That concept is the ultimate manifestation of democracy" (Ibidem, p. 429).

[16] Despite such a plurality of parties involved in the "accountability's game of the ECB", it has to be borne in mind that there is a significant difference between the situation characterising the Community level and the national level. In fact, monetary policy viewed in the traditional, national sense includes balancing the parliament and the government on the one hand and the central bank on the other. On the contrary, in the European Union the ECB has no equivalent counterpart. The independence of the ECB is further strengthened by the fact that it does not interact with just one, but with several national governments which also means that political pressure remains weaker than in a national environment.
On this point see P. Leino, (2001), according to whom the ECB, having to deal with several partners - such as the European Parliament and the Ecofin Council which both represent national interests, and the European Commission, which represents "a vaguely defined Community interest" -, is in a much stronger position, given that all these counterparts cannot properly mobilise an influent political pressure. It is as if the dialogue between the ECB and its interlocutors were fragmented and, as a consequence, becomes less authoritative in terms of accountability.

[17] In addition to the direct communication with the political decision-making bodies, all the statements and publications of the ECB form a natural additional information channel to the politicians. For instance, the Monthly Bulletin, and its editorial, can be considered very important for the whole euro area. Beyond that, the NCBs produce their own statements and publications for their national audiences which complement the euro area-level information.

[18] Id., *op. cit.*, p. 7. Such a target can be achieved by greater transparency. Given its high degree of independence, the ECB should in fact be more transparent than other central banks. On this point, namely the importance of empowering transparency and communication, see A. Blinder, C. Goodhart, P. Hildebrand, D. Lipton and C. Wyplosz, (2001).

General discussion

A Comment

by

Philippe Schmitter

Will EMU make it easier or more difficult to democratize the EU?

If nothing else, the complex of institutions that we now call the European Union (EU) is the product of voluntary choices by actors representing national states. These states expect to retain their independent existence and the distinctive institutions at the same time as they agree to pursue common policies by peaceful means. Whatever its effects upon both the established 'domestic' democracies of its member states and the eventual democratization of the EU itself, EMU will be the outcome of a similar process, i.e. protracted negotiation and compromise among "consenting adult-states" that will retain both their entry and exit options. Provided a country is willing to pay the economic, social and/or political costs of "non-membership," no one is going to force it to join and no country is going to be prevented from leaving EMU.

The Democratization of a Supra-national Europe?

There is no *a priori* reason why the institutions of the EU have to be made more democratic – least of all, in the near future. In **retrospect**, virtually all Europeans would agree that transforming their initially autocratic national polities into liberal representative democracies was a good thing, even if there was little consensus (and, in many cases, a great deal of violent resistance) at the time this was accomplished. In **prospect**, however, the case for democratization is much less compelling at the supra-national level. Not only are there serious impediments of size and scope involved in creating such an accountable Euro-polity, but there is also very little evidence that individual citizens of Europe presently want such a thing. They still identify overwhelming more with their national (or, in some case, sub-national) units and place much greater confidence in the capacity of their "co-nationals" to respect their freedoms and govern them in a legitimate fashion. Even those who are most insistent in decrying the "democracy deficit" of the EU do not necessarily draw the conclusion that the answer lies primarily in changing its institutions. It is at least as plausible to conclude that what is needed are major reforms in the way that national institutions process the decisions made in Brussels and make them transparent and responsive to individual citizens and their representative institutions.

In short, even if it could be demonstrated EMU will make the democratization of the EU less, rather than more likely, this might not be a valid argument against merging one's national currency with the euro and accepting the authority of the European Central Bank (ECB) Those who argue that their "domestic" political institutions and practices will remain for the foreseeable future much better at protecting their rights (and, especially, their entitlements) as citizens than any conceivable set of supra-national ones, might very well welcome EMU – if they were convinced that it would postpone or even make impossible the creation of an eventual Euro-democracy.

In a book entitled *How to Democratize the European Union … and Why Bother?* I have argued that there are two good reasons why it may be timely to begin this experiment with supra-national democracy sooner rather than later:

(1) There is considerable evidence that rules and practices of democracy at the national level have become increasingly contested by citizens. This has not (yet) taken the form of rebellious or even "unconventional" behaviour, but of what Gramsci once called "symptoms of morbidity" such as greater electoral abstention, decline in party identification, more frequent turnover in office and rejection of the party in power, lower prestige of politicians and higher unpopularity of chief executives, increased tax evasion and higher rates of litigation against authorities, skyrocketing accusations of official corruption and, most generally, a widespread impression that contemporary European democracies are simply not working well to protect their citizens. It would be overly dramatic to label this "a general crisis of legitimacy," but something isn't going well — and most national politicians know it.

(2) There is even more compelling evidence that individuals and groups within the European Union have become aware of how much its regulations and directives are affecting their daily lives, and that they consider these decisions to have been taken in a remote, secretive, unintelligible and unaccountable fashion. Whatever comfort it may have given them in the past that "unwarranted interference" by the Eurocrats in Brussels could have been vetoed by their respective sovereign national governments, this has been dissipated by the advent of qualified majority voting. Europeans feel themselves, rightly or wrongly, at the mercy of a process of integration that they do not understand and certainly do not control – however much they

may enjoy its material benefits. Again, it would be over-dramatizing the issue to call this "a crisis of legitimacy" but the "permissive consensus" of that accompanied European integration in the past is much less reliable – and supranational officials know it.

These two trends are probably related causally – and together they create a potentially serious "**double bind**" for the future of democracy in Europe. If the shift of functions to and the increase in supra-national authority of the EU have been contributing to decline in the legitimacy of "domestic democracy" by calling into question whether national officials are still capable of responding to the demands of their citizenry, and if the institutions of the EU have yet to acquire a reputation for accountability to these very same citizens when aggregated at the supra-national level, then, democracy as such in this part of the world could be in jeopardy.

From a Functional to a Political Logic

Although EMU has been called "the Mother of all Spill-Overs," I am not convinced that it will re-kindle the neo-functionalist logic and provide the integration process with a renewal of the momentum it so obviously lost since the difficult ratification of the Maastricht treaty and the disappointing results of the subsequent Treaties of Amsterdam and Nice. The reason for this is that citizens are now far more aware of how widely and deeply their lives are being affected by the EU. The politicization of these issues has become both the cause and the consequence of partisan mobilization for and against further extensions of the scope and level of EU authority. While, in my opinion, this is a healthy (and long overdue) development, it does pose some serious difficulties for the immediate future. Switching from the deliberately "apolitical" strategy that predominated during the early years of the integration process to an overtly "political" one based on democratization might help to regain momentum, but it is a much riskier entreprise. Euro-democratization, especially under such unprecedented circumstances and for such a large-scale polity, is bound to activate unexpected linkages, to involve less predicable publics and to generate less limited expectations.

What is needed is an entirely new strategy that adopts a much longer timeframe and seeks deliberately to involve special interests and mass publics at various stages of the process. Only by deliberately politicizing the issues involved at the level of Europe as a whole and by gradually building up expectations concerning a more definitive set of rules with regard to citizenship, representation and decision-making can one imagine a successful democratization of the EU.

As we shall now see, this is where monetary unification may enter the picture since it is likely to provide one of the issues around which different expectations will focus. Controversies revolving around the distribution of its costs and benefits across and within countries could provide the raw material that will determine, not only whether the eventual Euro-polity will become a state, but also whether its regime will be democratic.

Introducing EMU as a Possible Motive for Urgency

Monetary integration is one possible motive for having to deal with Euro-democracy sooner rather than later. Unfortunately, for our analytical purposes, it is not the only factor that is likely to affect the choice of decision-making rules in the immediate future. The enlargement of EU membership to include ten new countries is much more salient. For example, the agenda of the Convention that drafted a "Constitutional Treaty" for the EU was much more driven by worries about the impact of these small, over-represented and under-developed countries on existing balances between member states in both procedures (voting weights and seats) and policies (agricultural subsidies and regional funds) than by anticipations of how these countries are going to react to EMU – if and when they ever get into it. So far, the potential conflicts generated by a common exchange policy and interest rate have been successfully confined to the virtually invisible machinations of a highly specialized and secretive group of decision-makers within the ECB or to the even less transparent deliberations of the Council of Economics and Finance Ministers (ECOFIN).

Whatever visibility the common monetary policy attains now that the citizens of the twelve member states that joined EMU, have its bills in their wallets and its transparency of wages and prices in their minds, I am convinced that policy area will not provide the integration process with a renewed dynamic of spill-over into functionally related matters. EMU institutions are much more "segmented" in their operation than was the case for trade negotiations, the Common Agricultural Policy, Structural and Regional Funds, Competition Policy or any of the other policies pursued by the EU. By design, the ECB's decision-making process is kept behind closed doors and thus seem to lack transparency. Instead of producing decisions that are readily observable, discretely distributed and temporally specific – such as a price level for mutton, a permit to merge with another firm, or a definition of what a cucumber is – those of the ECB are more difficult to measure in terms of their economic effect, diffuse in their social impact, and take a much longer time to register on political institutions. And, even when they registered by the affected groups, their differential effects will be much more difficult to translate into demands for compensation or expansion in related domains. This is often the case with decisions by central banks, but the ECB is less keen to share how it came to take its decisions, than, for example, the Bank of England.

So, my suspicion is that monetary unification alone will not produce much further integration *via* functional spill-over. It is much more likely to generate diffuse reactions within large clusters of public opinion than focused responses by circumscribed groups of beneficiaries and victims. The latter furnishes raw material to interest associations, especially those representing class, sectoral and professional categories; the former typically has provided the fodder for “catch-all” political parties and “broad-band” social movements. The latter has proven useful for furthering integration, despite the sharp controversies they sometimes provoked; the former triggers a politicization of issues that is much less predictable and could just as well increase as decrease resistance to further devolution of authority to EU institutions.

Which brings us to the likely political consequences of monetary unification, since that is increasingly the terrain upon which its longer-term contribution to European integration is going to be experienced.

Let us begin by distinguishing two broad categories of political effects: (1) those **directly** involving the differential responses to the policies set by the ECB; (2) those **indirectly** affecting the probability of the eventual political integration of Europe. Both could contribute to making the eventual democratization of the EU more or less difficult.

Tracking the Direct Effects

The direct effects are a bit easier to predict – even if they remain difficult to sort out from other challenges and controversies that are bound to assail the EU in the coming months and years.

First and foremost is the expectation that a common exchange and interest rate policy will have a differential impact across the participating member states and across the sub-national units within these member states.

How this will be distributed will depend on initial factor endowments and the extent to which national institutions are capable of adjusting to the loss of autonomy in these policy areas. The usual assumption (often illustrated historically by reference to post-Risorgimento Italy) is that the gap between rich and poor countries/regions will widen and, therefore, demands for redistributive policy measures will increase. To the extent that the losers are becoming increasingly capable of forging alliances across national borders, this raises the spectre of a polarization into pro- and anti-integration clusters of public opinion that may not correspond to long-standing lines of domestic cleavage. It goes without saying that those who are negatively affected will be more vociferous in their opposition than will be those who are benefited in their support. In the worst scenario, this could be sufficient to fragment national party systems without providing enough fodder for their transposition into a viable European party system. To paraphrase Marx & Engels, the old (national) order will have been destroyed before the new (European) one is ready to emerge! More optimistically, one could imagine that EMU will produce such a strong net balance of winners over losers that the inevitable complaints of the latter can be encapsulated within insignificant fringe parties of the extreme right or left whose Europe-wide expression will be marginal (and, in all likelihood, undermined by fierce nationalistic disputes).

As plausible as this "polarization" hypothesis seems, it is confounded by a simple empirical observation: support for EMU (as far as we can judge it from surveys of mass public opinion) seems to be significantly stronger in the less-developed "Southern" member states than in the more-developed "Northern" ones. Those who are supposed to be initially disadvantaged and who have had to make the greatest changes in national policies and institutions to meet the convergence criteria for EMU are the most favourable! Those who have been practising "sound monetary economics" in their respective national compartments for some time are more sceptical about doing the same thing at the level of Europe as a whole. Of course, this distribution of opinion could reverse itself as the effects of EMU begin to accumulate, but it should give us some pause.

A **second** direct impact is likely to come from the sheer visibility of differentials in income and prices across the member states. It is one thing to "know" that Germans are better paid than Portuguese, or that French wine can be cheaper in Spain; it is another thing to have this expressed in the same units of currency on an everyday basis. My hunch is that this transparency is going to generate new forms of interaction among occupational and, especially, consumer groups. In addition to the obvious competitive pressure this will put on firms, it will also mean a quantum leap in political collective action across national borders – much of which is probably going to focus on demands for national-level responses to disparities in taxation, monopolistic or oligopolistic pricing, wage setting mechanisms, levels of collective bargaining and systems of welfare provision – but some of which is going to find its way into the corridors of Brussels. Tax harmonization is one obvious issue that will become more salient. Trade unions may find it increasingly difficult to explain to their members why salaries and benefits are so much less than in a neighbouring country, and it will become easier to envisage Europe-wide collective bargaining, at least for certain relatively privileged and more mobile professions. One is tempted to predict a diminution in the more corporatist forms of national interest concertation, especially at the macro-level, and a greater tendency for more flexible and specialized, i.e. pluralistic, modes of pressure politics, if it were not for the factor of individual country's having to meet the strict fiscal and budgetary constraints contained in the Stability and Growth Pact. As I have argued elsewhere, this has proven to be a powerful incentive for the revival of macro-corporatist practices in several member countries.

And this new transparency in prices, wages and benefits is closely connected to the **third** direct effect that is likely to emerge – namely, the growing disparity in political influence between capital and labour. Any form of liberalization within a market economy will tend to enhance the relative value of that factor of production that is most mobile and, hence, capable of reacting to the enlarged opportunities with the lowest adjustment costs. Globalization, in the sense of a lowering of barriers to the flow of capital, technology and managerial skills across national borders, has already had a quite considerable effect on this "balance of class forces" and will continue to do with or without EMU. Most workers and many employees simply do not have the "cosmopolitan skills" in language and life style that allow them to move easily across these borders. Moreover, their mobility is further restricted by a variety of non-transferable entitlements to national systems of unemployment insurance, welfare payments, public housing, retirement, education, etc.

Monetary unification exaggerates this intrinsic disparity and adds to it an even greater burden – namely, the loss of two national policy instruments that helped this very large segment of the population adjust to exogenous shocks or shifts in relative productivity: currency devaluation and deficit spending. Once EMU and its "Stability and Growth Pact" are in place, all that is left at the national level are policies that are aimed at improving competitiveness by lowering the cost of labour. The accepted slogan for this effort is "flexibility," although that can include an absolute as well as relative decline in various social entitlements.

In defence of EMU, one should observe that this shift in the burden of adjustment will take place in any case (and, liberal economists argue, should have taken place long ago). The existence of the euro and the EU policy mechanisms surrounding it do open up the possibility for negotiating collective agreements that could “Europeanize” certain measures of social policy and protect some particularly exposed groups from the even more brutal and disruptive impact that unrestricted globalization could produce. They also provide a compelling argument that national politicians can use to introduce changes in welfare systems and collective bargaining that their economies can no longer afford – at, at the same time, allows them to pass on the political responsibility for these measures to those remote and faceless bureaucrats in Brussels and, now, Frankfurt.

A **final** direct effect is the probability that the authorities of the ECB will be overzealous in their efforts to promote price stability in order to enhance their originally weak credibility and, thereby, generate more austerity and less growth than would otherwise have been the case. Again, according to this scenario of “over-austerity,” those members that had been more inflation-prone in the past will find themselves much worse off in relative, if not absolute, terms. We have seen periodic conflict over interest rates and the ECB has quite publicly resisted following the momentary demands of even its most powerful member, Germany, for their reduction. What we have not seen (yet) is the translation of these demands for different policies into a clear set of national (or sub-national) winners and losers. One can always claim that, thanks to certain accidents of timing, Europe has been able to avoid such a zero-sum conflict, but this may be waning thanks to the appreciation of the euro vis-à-vis the dollar. To the surprise of most observers, the previous decline in its relative value did not produced a marked rise in the intensity of conflict between EMU member states – least of all, a polarized confrontation between those that previously had “hard” and “soft” currencies – but its rise may prove more controversial.

Groping for the Indirect Effects

The **indirect political effects** of EMU are even more difficult to pin down. They are going to be “contaminated” by a host of other simultaneous developments at both the supra- and the national levels and who knows how long their “incubation period” will be. Nevertheless, there is one notion that permeates almost all thinking about the secondary consequences of EMU: namely, the proposition that it will transform European integration from an economic into a political process. One frequently encounters the assumption (usually by economists) that, since the EU does not presently constitute an “optimum currency area,” it will have to acquire the characteristics of one – or it will fail. From this follows the notion that the participants will have to adopt a series of “flanking policies” in order to promote the mobility of factors of production and symmetry of reaction to external shocks that such an optimal area is said to require. Since these policies, especially harmonization of fiscal policies and elimination of barriers to the flexible deployment of labour, are bound to be controversial, the EU will have to come up with a continuously revised set of rules for making binding political decisions that will permit it to overcome the resistance of individual member states and affected social groups. Driven by these “functional imperatives,” all that would remain to make the EU into a full-fledged federal state would be the drafting and ratifying of an eventual constitution.

Above, I have suggested several reasons why EMU may not have such a strong “spill-over effect” – least of all, one that would be powerful enough to produce both a state and a regime at the level of Europe as a whole. I can imagine a number of “policy equilibria” that would fall far short of both for the indefinite future. Mostly, these solutions involve allegedly “technical” corrections in related areas that would be presented to the general public (*ex post)* as inevitable and in their own interest. If and when “asymmetric” pressures do assert themselves upon the member states, there will most certainly be a great deal of controversy surrounding their political resolution. However, I suspect that the EU institutional response will be both “flexible” and “forgiving” leaving a range of options for individual countries to “opt-in” and “opt-out.” Economists (and political scientists who think like economists) seem to have forgotten that common currency areas such as the Scandinavian Monetary Union and the Belgium-Luxembourg Economic Union have lasted for some time without generating any appreciable momentum for political unification. One could even consider the pre-World War One Gold Standard as an analogous trans-national arrangement and it was insufficient to prevent war between its members, much less to entice them into closer political cooperation! The “trick” has been to so segment and de-politicize the setting of exchange and interest rates as to convince the population that politically targeted intervention was either technically unfeasible or potentially counter-productive.

The De-democratization of National States

Elsewhere, I have argued that European integration has already shown signs of producing significant changes in “domestic democracy” through its mechanisms of differential empowerment:

1. It has increased the relative power of executive over legislative institutions.
2. It has increased the relative power of national (i.e. central) territorial authority over that of sub-national units.
3. It has increased the relative power of national judiciaries to the extent that they have been able to use the supremacy and direct effect of EU law to enhance their power of constitutional review.
4. It has promoted the influence of economic and monetary authorities at the expense of ministries and para-state organizations dealing with social, cultural and other matters.
5. It has increased the relative influence of interest associations over that of political parties.
6. It has increased the relative influence of business and professional associations at the expense of trade unions and social organizations.
7. It has increased the influence of more specialized “sectoral” forms of associability at the expense of broader, “inter-sectoral” or class-based ones.

None of these changes have been conclusively proven – least of all, across all member countries. They remain, however, “plausible working hypotheses” for research.

If I were to venture a guess about the probable impact of EMU, I would say that it will strengthen all of the above trends – with some subtle variations. For example, not only will those public institutions dealing with economic and monetary affairs gain even more influence at the expense of other ministries, but central bankers aggregated at the level of Europe as a whole will find it easier to assert their monetarist priorities at the expense of those national officials more concerned with economic expansion and employment levels. Political parties and social movements will find themselves more excluded from critical aspects of decision-making (and forced to adjust their programs accordingly), but even those specialized units of organized interest that had previously gained such privileged access to EU *comitologie* will find themselves more and more on the outside looking in on the hermetically sealed operations of the ECB. National executives, of course, will have lost one of their major instruments of power, i.e. the ability to print more money and loan it to themselves and their friends, but they may be able to use this “transposition” to the level of Europe as a convenient excuse not to make decisions (and to pass on the responsibility to those in Frankfurt and Brussels).

Trying to Reach a Conclusion

All of these trends pose a serious challenge to "domestic democracy" and do nothing (yet) to promote "supra-national democracy." I am still convinced that the democratization of the European Union is a desirable objective and that EMU makes it all the more urgent. I am also convinced that its member states are better off within the embrace of the ECB, rather than outside it. Some countries may be temporarily comforted by the illusion that they can continue practicing "domestic democracy" as before with all its national peculiarities, but they will soon discover that their elected representatives will be less and less capable to monitoring and intervening effectively in the process of making decisions for Europe as a whole. If they decide to leave EMU or not to join it in the first place, they will discover even more quickly that these politicians cannot deliver what their citizens want and need purely on a national scale. And, whatever they choose to do, they will continue to suffer the consequences of decisions made by those who do participate in its complex and obscure processes.

So, I am convinced that EMU makes Euro-democracy more necessary, but does it make it easier? There, I confess, my response is much more ambiguous. Many features of this policy area make it unusually difficult for citizens and their political parties, interest associations, and social movements to grasp its impact and to mobilize citizens to demand that rulers pay more attention to their interests and passions. One can virtually forget about the prospects for ensuring *ex ante* consent given the necessary secrecy and the technical nature of the issues involved. The best one can expect is some modicum of *ex post* accountability – and even that has not proven easy to accomplish at the national level. For central banks and central bankers (along with general staffs and generals) belong to a species of institution that democratic theory and practice has tended to ignore. These agencies act as "guardians" or "custodians" providing certain public goods that are necessary for a democracy to function well, but they cannot themselves be organized democratically or even controlled democratically – or, they would fail to perform adequately. Theorists of democracy do not like to admit that such non-democratic agents are necessary. They are even less likely to concede that the role of some of these guardians/custodians has increased considerably in recent decades, precisely because of the expanded agenda of regulation that is demanded by a more mobilized citizenry trying to cope with more liberalized markets and interdependent polities.

Fortunately, however, monetary unification is not the only new policy area on the horizon of the European Union. It is only when one combines the uneven effects its decisions are bound to have upon member states with different endowments and social groups with different capacities to respond to the opportunities and threats of globalization/Europeanization with other issues such as enlargement to include the countries of Central and Eastern Europe, enhanced cooperation in internal security affairs and the formation of a common external security policy that the prospect for Euro-democratization begins to look more promising – and imperative.

NOTES

[1] Schmitter (2000a).

[2] Presumably, something like this double bind is what Fritz Scharpf had in mind when he wrote: “Since …Europe is part of the problem (of democratic legitimacy), European policies can also help alleviate it.” Scharpf (no date).

[3] For a particularly clear and convincing exposition of the reasons why the making of monetary policy in the EU will be different from the usual “network” mode of governance, see Dyson (1999).

[4] Schmitter and Grote (1999).

[5] Schmitter (1999).

A Comment
BY
Michael Artis

The Governance of EMU

It is a relatively new fashion, but not overdue, to stress the relevance of *the policy framework* when appraising a monetary union and, especially when considering the case for new adherents to join. This is a complement to the usual traditional optimum currency area criteria and has been around a long time in the attenuated form of a privilege for central bank autonomy. The new fashion is to insist on a panoply of factors – central bank independence, certainly, but complemented by a coherent fiscal policy framework and by clarity and transparency in the objectives set for both arms of policy. At the same time, there is a background of democratic accountability which gives validity to these features. Experience in EMU is also teaching us that there are other types of policy – “supply-side” policies and wages policies – that have a bearing on the governance issue. In fact one of the problems is to know where it is reasonable to draw the line.

Fiscal policy is the first thing that most people think of in this context and rightly so. The Stability and Growth Pact (SGP) is (or was?) a major achievement in international economic policy diplomacy, on a level with the creation of the Bretton Woods system which served the world well for nearly three decades. A central feature of both the Bretton Woods system and the SGP is the combination of rules and individual country discretion mediated through a system of peer review. In Bretton Woods, countries agreed to stick by agreed exchange rates, which could be changed only in defined conditions; the clash between sticking to the pre-agreed exchange rates and the evolution of economic conditions was, importantly, mediated through the operations of OECD Working Party 3. Meetings of WP 3 could illuminate likely tensions and by this means help to avoid their realization in a violation of the rules. Yet there was no co-ordination as such. In much the same way the SGP obliges countries to stick to some rules of fiscal behaviour and the European Commission, in reviewing member country programmes and through its advice to ECOFIN, helps to illuminate when those rules are likely to be broken. In both systems, the outcome is a form of Rules-based Coordination. This is in itself an optimal result, avoiding the prohibitive cost of real time co-ordination and the more practical dangers of episodes of cooperation. The coordination shields the European Central Bank from undue pressures. All of this needs to be preserved in a revival of the SGP, the chief problem of which is in the precise form and numerical magnitude of the deficit rule that was chosen. If, instead, a deficit rule could be chosen which incorporates a feed back on debt and on the cycle, then the formal issue of sanctions (the immediate reason for the problem with the SGP) could probably be forgotten.

Supply-side and wages policies in EMU are, though there is not much that is explicit about the assignment, left to the national governments and it is difficult to imagine at the moment that it could be otherwise. Yet, if there are externalities and important spillovers, it might seem that this would not be the best assignment. As matters stand mutual awareness of national policies in these areas becomes available through meetings of ECOFIN and routine Commission reporting. But when eurozone (or EU-) wide objectives are proclaimed, as those embraced in the Lisbon process, it is immediately clear that there are no corresponding Union-level instruments available for achieving them. As for wages policies, in the fullness of time there might appear a Eurozone-wide labour market, which will force a corresponding policy development, but at present there is not really such a market, rather a series of national markets.

Accountability. The Eurozone's governance arrangements controversially include a degree of independence of the European Central Bank which is neither complete nor perhaps sufficiently modest. It can be argued that this reflects the immaturity of the Eurozone as a monetary union and as an entity. That the independence is not complete is reflected in numerous ways – most recently perhaps in the failure to consider a response to the potential enlargement of the Eurozone that could have taken the form of the replacement of the Governing Council by a Monetary Policy Committee (committee of experts): instead, a convoluted method of rotating representation based on size (itself a convoluted measure designed to enhance the power of the status quo countries) was invented to keep the number of voting members within bounds. At the same time the independence of the Bank is jealously asserted in its dealings with others and especially in its pronunciations on the Stability and Growth Pact. It is implicit in these compromises that the Eurozone is too immature to accept that the ECB's conduct of monetary policy should be assigned to experts. And, at the same time, that the Bank can usefully assert its independence by criticizing the conduct of nations in undermining the SGP, when its own policies arguably have contributed to the very pressure on the SGP that has brought about its difficulties. In the long run some more acceptable balance must emerge.

EMU governance is an awkward, but evolving, thing. The compromises that it displays are a reflection of the fact that the EU and the Eurozone are evolving entities, displaying all the tensions between the desire to keep the nations in charge and the contrary one to delegate national authority to Union-level institutions that can be seen in day-to-day political developments.

THE ECB BETWEEN GROWTH AND STABILITY

Chapter 5

Governing EMU: The European Central Bank Between Growth And Stability

By
Simona Talani *

Abstract: This contribution tries to show how, in the first years of implementing Economic and Monetary Union (EMU), politicians, scholars, public opinion, and indeed also central bankers shifted their attention from the performance of the inflation rates to growth and employment. The lack of transparency in the implementation of monetary policy by the European Central Bank (ECB) de facto helped the monetary authority to include in its policy making also considerations about the performance of the real economy. The chapter attempts to identify who benefited the most from this policy and thus addresses the question: *Who wins and who loses from the implementation of monetary policy by the ECB?* The answer to this question will be sought by identifying which economic sectors in which member states gained the most from the monetary performance of the ECB in its first years of activity. The result suggests an intergovernmentalist explanation of ECB monetary policy making

Keywords: European Central Bank, European Monetary Union, European monetary policy, the political economy of EMU

1. Introduction

The European Central Bank (ECB) is the most independent of all Central Banks.[1] Indeed, its independence was guaranteed by its statute in order to ensure, as its exclusive goal, the achievement of monetary stability, defined as a level of inflation below two percent. Whilst independence from political constraints, both national and supra-national, created preoccupations over the democratic deficit of the European institutional setting, it allowed central bankers to concentrate, at least in theory, solely on monetary variables, and to ignore the performance of the real economic indicators, namely growth and employment rates.

* I am very grateful to Prof. Bernard Casey for his essential help in revising the paper.

However, as the analysis of the decisions of the ECB demonstrates, monetary policy has not been conducted entirely without regard to the performance of the real economy. This led experts to identify a number of puzzling questions in the performance of the ECB. These questions are:

What is the importance attributed by the ECB to output performance in the euro area relative to inflation?

Do considerations about single member states matter, or is it the outlook of the euro-zone as a whole that definMMes the Bank's choices?

What is the attitude of the highest European monetary authority towards exchange rates?

This contribution shows how in the first years of implementation of the Economic and Monetary Union, politicians, academics, public opinion, but also central bankers, shifted their attention from the performance of inflation rates, to growth and employment. It also attempts to identify who benefited the most from this.

In particular, the chapter will address the question:

Who wins and who loses from the implementation of monetary policy by the ECB?

The answer to this question will be sought by identifying which economic sectors in which member states gained the most from the monetary performance of the ECB in its first years of activity. This analysis is carried out with reference to Frieden's model on the exchange rate preferences of economic sectors.[2] The model identifies economic sectors' preferences vis-à-vis the two interrelated dimensions of exchange rate regimes (fixed or flexible) and levels (appreciated or depreciated). With respect to the second dimension of the model, namely groups' preferences vis-à-vis the level of the exchange rates, Frieden notes that export oriented traditional manufacturers and primary producers of non-agricultural products have a vested interest in supporting the devaluation of the currency. On this basis, it is also plausible to presume that countries more heavily relying on the exports of manufacturing goods outside the EU would gain most from the devaluation of the Euro. In other words, these countries are the ones benefiting most from the adoption of a policy of "benign neglect" of the depreciation of the single currency by the ECB.

This suggests an intergovernmentalist explanation for some of the puzzles about the ECB monetary policymaking. The intergovernmentalist approach to European economic integration has its intellectual origins in realist theories of international relations. It postulates that nation states dominate EC politics and that outcomes directly reflect the interests and relative power of the member states. It seeks to analyse the process of European economic integration as the result of strategies pursued by rational governments acting on the basis of their preferences and power, assuming that national preferences in foreign economic policies are dictated by specific economic interests. The latest versions of the approach introduce explicit theories of domestic politics, like the Frieden's model, to account for the set of economic interests states choose to pursue in international arena. As applied to the working of the ECB, intergovernmentalists would predict that the interests of the most powerful member states prevail over the ones of smaller states in the monetary decision making process. More explicitly, in the Euro-area, the interests of Germany France and Italy should define the conduct of monetary policy by the ECB. In turn, these three countries should also be the ones getting the most out of a shift of emphasis in the ECB monetary policy making from the performance of monetary aggregates, to growth and employment, through the adoption of a policy of laissez faire vis-à-vis the devaluation of the Euro.

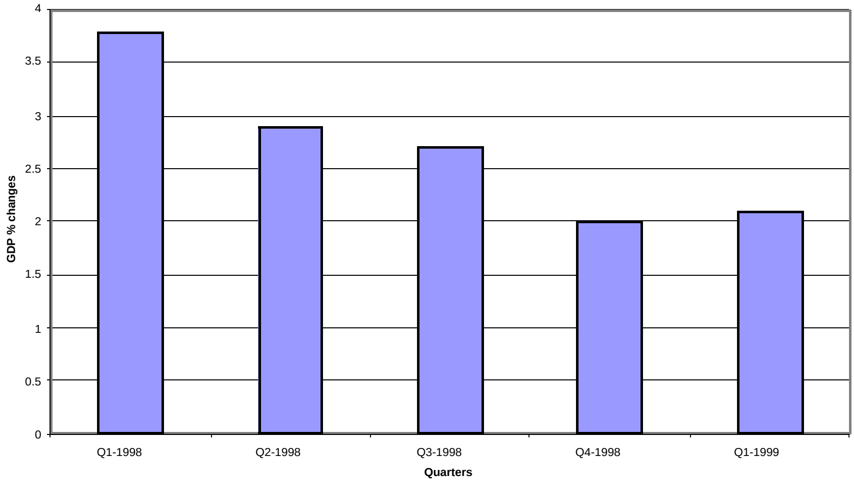
The chapter is divided into three sections. The first section reviews the outlook of the European economy at the beginning of EMU. It highlights the shift of emphasis from price stability to employment and growth. The second section addresses the analysis of European monetary policy in the light of the developments of the real economy. It points out the contradictions characterising the implementation of monetary policy by the ECB. The final section elaborates on the national and economic sectors' preferences in terms of monetary policy. It identifies the actual winners and losers from the ECB monetary policy and concludes that an intergovernmentalist explanation helps accounting for the puzzles arising from its implementation.

2. Economic background at the beginning of EMU

On the 1st of January 1999, the day the euro was born, the international economic environment was characterised by the persistence of unusually high levels of growth in the US and by the growing concerns for the Asian financial crisis. The euro-area was experiencing the highest aggregate unemployment rate since the 1930s together with a marked slowing of the Gross Domestic Product (GDP).

The situation was particularly worrying in Italy, where unemployment was around 12% and GDP growth had fallen to only 0.8% in 1999; in Germany, where unemployment was over 9% and a GDP growth fell from 2% in 1998 to

Figure 1: Euro-area GDP % changes 1998-1999



Source: ECB

Figure 2: GDP growth and unemployment in the euro-area 1998-1999

	Unemployment rate (%)		GDP growth rate (%)		
	98	***99***	***98***	***99-Q1***	***99-Q2***
Austria	4.7	4.3	3.3	1.7	1.7
Belgium	9.5	9	2.9	1.7	1.7
Finland	11.4	10	5.6	3.4	3.3
France	11.7	11	3.4	2.4	2.1
Germany	9.4	9.1	2	0.6	0.6
Ireland	7.8	6.7	8.9		
Italy	11.9	11.4	1.3	0.8	0.8
Netherlands	4	3.2	3.2	3.1	3.1
Spain	18.8	15.6	4	3.2	3.6
Portugal	5.1	4.8	3.5		

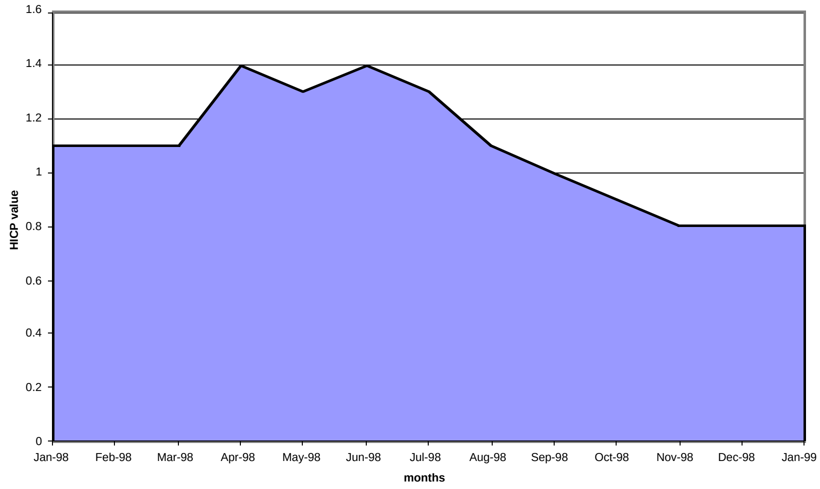
Source: Eurostat

Note: Greece is not included in the table because in the year 1999 it was not yet part of the Euro-area.

0.6% in 1999; and in France, where unemployment was around 11% and the GDP growth slowed from 3.4 in 1998 to 2.1 in the second quarter of 1999.

Accordingly, it is not surprising that academics and political commentators were focusing on the pro-cyclical effects of the monetary constraints imposed by both the Maastricht Treaty and the Stability and Growth Pact while the European institutions sought to devise an appropriate employment strategy (or, at least in rhetoric) (Talani, 2004). This was reinforced by the fact that the level of inflation, i.e., the main statutory concern of the ECB, was very low. It recorded an unprecedented 0.8% in 1999 and made some worry about the possibility of negative inflation.

Figure 3: HICP in euro-area (% changes) 1998-1999



Source: ECB

How did the ECB react to the growing concern over the performance of real economy variables?

3. The performance of the ECB from its establishment: flexibility vs transparency

Given the unprecedented nature of its tasks as the body responsible for the implementation of a European common monetary policy and for the management of a European common currency, there were many worries concerning the performance of the ECB at the eve of its establishment. These ranged from the lack of credibility of the ECB's monetary stance, to the lack of flexibility of its statute, and from the need to increase its democratic accountability, to the need of ensuring its independence from the governments of the Member States.

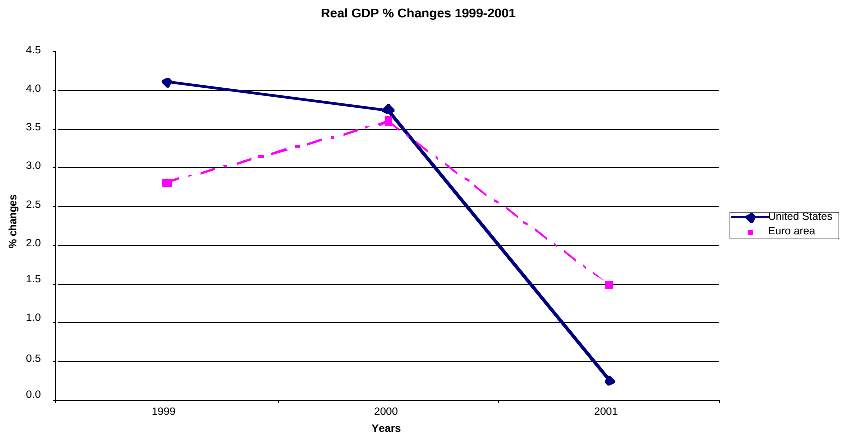
According to the Favero et al. (2000a), the ECB displayed, from its inception, more flexibility than expected in tackling asymmetries within the euro-zone. This result was possible thanks to the adoption of a so-called "two pillar" monetary strategy, but it was achieved at the expense of transparency. Given the goal of price stability, defined as HIPC inflation between zero and two percent, the first pillar of monetary policy was represented by the setting of a money growth reference target, defined as an increase of the monetary aggregate M3 below 4.5%. The first pillar was, in the declarations of the members of the ECB, the basis of monetary policy decisions and it implied the belief that, by following the performance of monetary aggregates and reacting accordingly with appropriate changes in the level of the interest rates, it was possible to keep inflation under control. In short, the basic assumption was that the interest rate tool would be used only to affect monetary variables and would not affect the real economy – the standard monetarist assumption. The second pillar of the strategy was the monitoring of a number of unspecified indicators including the exchange rate and asset prices. That meant that the ECB would have to take into consideration the inflationary consequences of an undervalued currency. In a period when central banks were abandoning monetary targeting, replacing it with more transparent and accountable (expected) inflation targeting, this strategy has been judged rather obscure[3].

One might argue that in the trade-off between transparency and flexibility, the balance will not necessarily be in favour of the former. In case the ECB would publish regularly its (expected) inflation targets, this might weaken its credibility vis-à-vis financial markets, if the target could not be reached. It would then leave less scope of manoeuvre to harmonise monetary policy with the performance of the Euro-area in real terms. However, the issue is far from being uncontroversial. Critics underline that the reduction of transparency resulting from the multiplication of targets and indicators leads to surprises that unsettle financial markets, and this uncertainty might result in higher borrowing costs (CEPR, 2000).

Leaving the debate over the trade-off between transparency and flexibility to the experts[4], and turning to the concrete monetary policy performance of the ECB during its first years of activity, the picture is not much clearer.

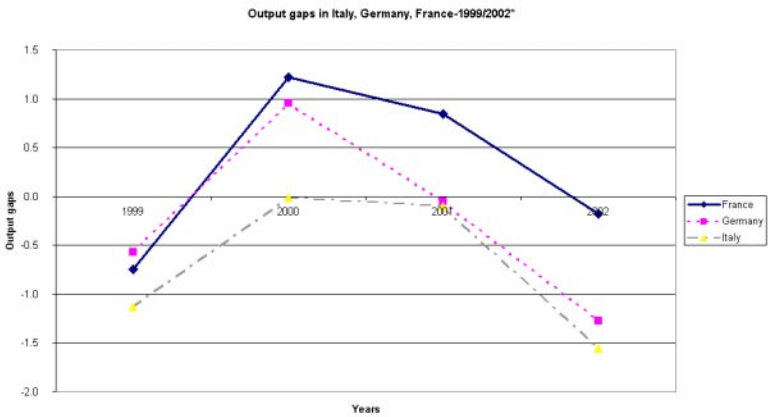
The first issue to address is the importance attributed by the ECB to output growth in the Euro-area (and in some member countries in particular) relative to inflation. After the establishment of EMU, in 1999, there has been a marked slow-down in all Organisation of Economic Cooperation and Development (OECD) countries for the first time since the 1970s. Whereas the Japanese economy was already in a recession, in 2001 the US economy experienced the first substantial slowdown in a decade. Also the euro-zone, with a lag of some months with respect to the US, slowed significantly in the year 2001.

Figure 4: Real GDP % changes 1999-2001



Source: OECD

Figure 5: Output gaps in Italy, Germany, France-1999-2002*



* Output gaps are defined as the variations of actual GDP from potential GDP as a percentage of potential GDP; Source: OECD

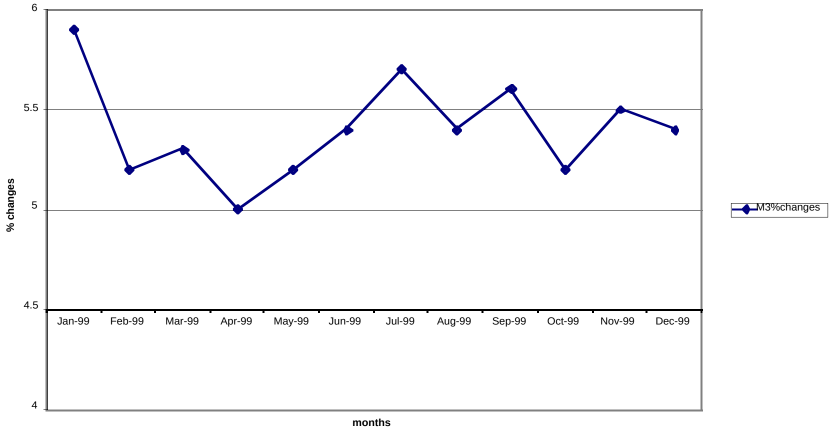
Here is not the place to analyse the causes of such a global decline[5], although it is important to notice that this had a major impact especially on the most important European economies, namely Italy, France and Germany (see Fig. 5).

Theoretically, and as underlined in many speeches and documents[6], the ECB should pay little attention to short-run output developments. This is meant to avoid the threat of losing credibility with the markets with regard to in its anti-inflationary stance. Despite this, it is easy to note that the 30 basis point cut of interest rates to 3% on 1 January 1999 was associated with deflationary risks in the wake of the Asian crisis. Furthermore, the April 1999 cut to 2.50% coincided with declining output in important euro-land members (notably Germany). Lastly, the cut of the 17 September 2001 in the minimum bid rate on the Eurosystem's main refinancing operation by 50 points to 3.75 matches a similar decision taken by the US Federal Reserve in the aftermath of the terrorist attacks of the 11 September and their potentially recessive consequences. More sophisticated analyses show that the ECB monetary policy, and, in particular, the timing and frequency of interest rate changes, reflect the aim of stabilising output and not only of controlling prices, although leading Central Bank personalities deny this (CEPR, 2000).

If the output level was never officially recognised as a point of reference in the making of monetary policy, but was, nevertheless, taken into consideration, the opposite was the case with respect to monetary targets. Indeed, the "two pillar" strategy rests on the prominence of the target for M3 growth as the main official indicator for ECB monetary policy decisions. However, on many of the occasions when the target has been overshot, the ECB has not reacted accordingly. For example, despite the fact that the target had been set at 4.5% for 1999, no measures were taken by the ECB when it became clear that the target would be missed by the end of the year. On the contrary, the ECB cut the interest rates and engaged in sophisticated explanations for why the departure from the reference M3 growth rate did not represent any rupture with its "two pillar" strategy.

When, by the end of 1999, projections for inflation suggested it would be rising, the ECB intervened promptly and increased the interest rate by 50 base points. Of course, given the parallel increase in the M3 growth, this seemed to be consistent with the monetary strategy declared by the ECB. Equally, the final divorce between the ECB changes in the interest rates and the M3 growth rate appears justified by the necessity to keep the HICP within the 2% limit.

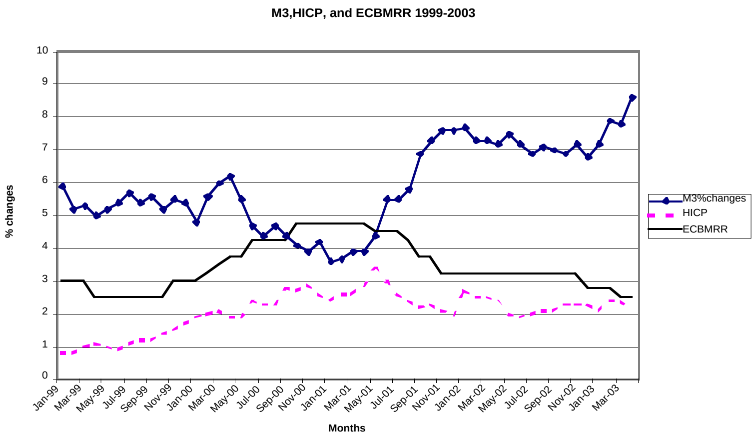
Figure 6: Adjusted M3 percentage changes per month in relation to the 4.5% target - 1999



Source: ECB

However, the suspicion that the M3 target was never really given the importance implicit in the adoption of the "two pillar strategy", and that it was often subordinated to pragmatic considerations about the level of output, was never abandoned by the experts. Indeed, reacting to the many criticisms regarding the first pillar, the ECB made some modifications of the M3 series, first by removing non-resident holdings of money market funds from the definition of euro zone M3 and then by removing non-resident holdings of liquid money, market paper and securities.

Figure 7: M3, HICP and ECB main refinancing rate % changes 1999-2002



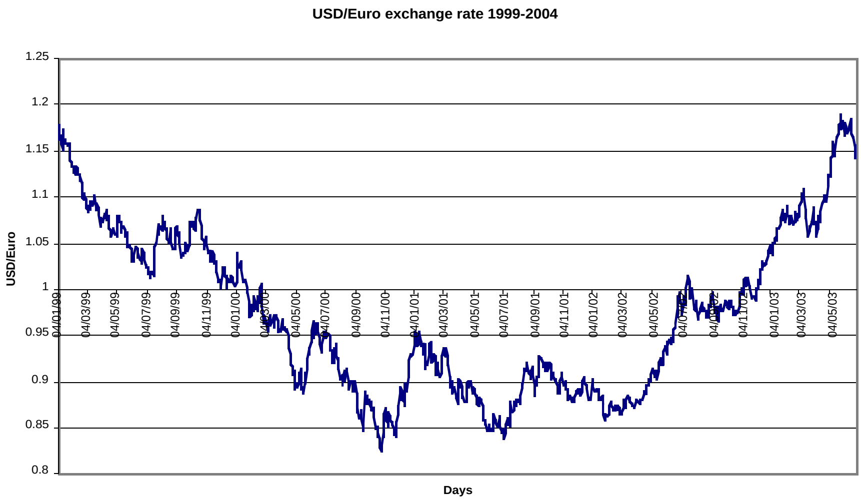
Source: ECB

This adjustment is no more than a cosmetic change and does not improve the reliability of the monetary pillar. If anything, the figure below shows that M3 percentage changes and interest rate decisions by the ECB have gone in opposite directions (See Fig. 7). All this undermines the transparency and credibility of the ECB monetary policy-making.

Even more obscure is the role attributed by the ECB to the exchange rates within the second pillar of the two-pillar monetary strategy (Favero *et al.*, 2000a). Indeed, the second pillar of the strategy makes explicit reference to a series of indicators influencing the ECB monetary decisions among which the euro exchange rates have a critical position. In particular, a steady and marked depreciation of the currency should increase inflationary pressures and prompt the reaction of the ECB, in the form either of an increase in interest rates or of direct interventions in the currency markets.

Looking at the performance of the newly born currency in the first months of its existence, it is difficult to avoid the suspicion that the Bank had adopted an attitude of "benign neglect" vis-à-vis the exchange rate of the euro.

Figure 8: USD/Euro exchange rates 1999-2003

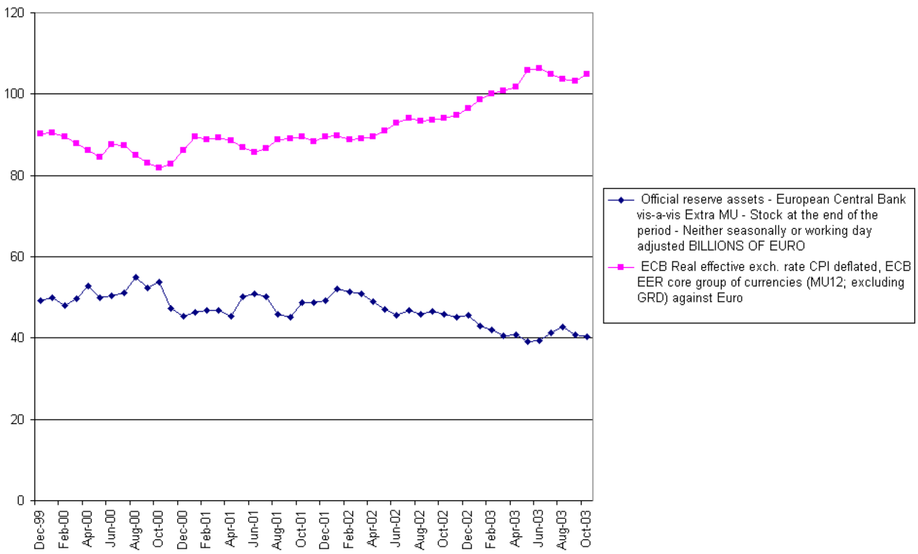


Source: ECB

The euro lost around fifteen percent of its value relative to the dollar between August 1999 and August 2000 – parity itself being lost as early as January 2000. Also the effective nominal and real exchange rate of the euro experienced a marked decrease between August 1999 and August 2000 – by 11.3% and 10.1% respectively).

Despite this parlous performance, the ECB did not intervene in the exchange rate markets. (See Fig. 9). Obviously there is no formal obligation to do so, given the fact that the international exchange rate regime is a floating one. However, this demonstrates clearly an attitude of “benign neglect”.

Figure 9: ECB official reserves compared to the performance of the real effective exchange rate of the euro



Source ECB

NB: The declining trend of the ECB official reserves is the consequence of the devaluation of the dollar, being the majority of reserves constituted by dollars.

Of course, the ECB always argued that the performance of a currency had to be assessed “in the long run”. And indeed in the long run the Euro/ Dollar exchange rate has witnessed a reversal of its pervious performance with a marked appreciation of the euro - although it would be better to talk about a strong fall of the dollar rather than a strong rise of the euro. Nevertheless, the substantial lack of concerns on the fall of the euro in the first year provoked further doubts about the real scope of the two-pillar strategy[8]. In the last section, attention is focused on the distributional effects of such a monetary policy to investigate on the political economy dimension of the ECB interventions.

4. National interests and economic sectors' exchange rate preferences: Who wins and who loses from the devaluation of the Euro?

In trying to frame the analysis of the ECB monetary and exchange rate stances within a typical intergovernmentalist framework, it is worth recalling some of the institutional characteristics of the decision-making bodies of the ECB.

Although, as already mentioned, the ECB is independent of governments of the euro-area member countries, and the "no-bail out clause" eliminates any possibility for the ECB to intervene to support the fiscal position of any individual member state, some of its institutional characteristics retain intergovernmentalist elements. In particular, the composition of the Governing Council, which includes the governors of the national central banks and the members of the Executive Board, strongly reflect national differences (Artis, 2003).

This does not mean that the ECB monetary policy is geared towards the interest of the biggest countries because decisions are made on a formal intergovernmentalist basis. It does, however, allow for the legitimate suspicion that national central bankers express national expectations and demands in the formal meetings of the Governing Council. Moreover, the fact that the minutes of the discussions taking place in the meetings of the Governing Council and of the Executive Board are not published adds to the difficulty in identifying the extent to which these national interests count.[9]

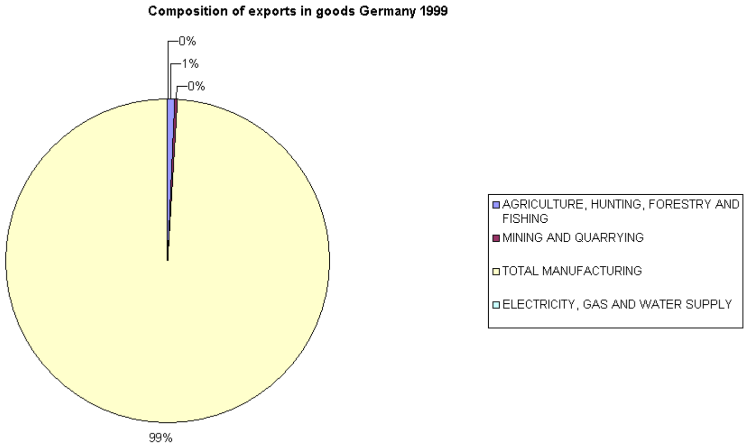
With respect to national preferences formation, and, therefore, to the identification of the set of national interests that are more likely to reverberate on the ECB policy-making, it is worth recalling Frieden's model on the preferences of economic sectors vis-à-vis the exchange rate level and regime. It is true that preferences cannot be expressed any more with respect to national currencies, but it is not implausible to hypothesise that national economic sectors have a vested interest in the performance and international status of the Euro.

In particular, following Frieden, it is possible to claim that the export oriented manufacturing sectors would gain the most from a devalued currency. Therefore, the countries heavily relying on the performance of the extra EU export oriented manufacturing sector, such as Italy, Germany and France, are likely to have a vested interest in adopting a policy of "benign neglect" with respect to the depreciation of the Euro[10].

To begin with, it is worth clarifying to what extent Germany, Italy and France are relying on a strong export oriented manufacturing sector. To show this, the following indicators are used: ratio of exports of manufactured goods over total exports of goods; extra EU trade balance of goods over GDP.

Regarding the first indicator, the figure below show that 99% of German exports of goods was composed by manufacturing in 1999. This percentage remained constant in 2000 and 2001 (See OECD, www.oecd.com).

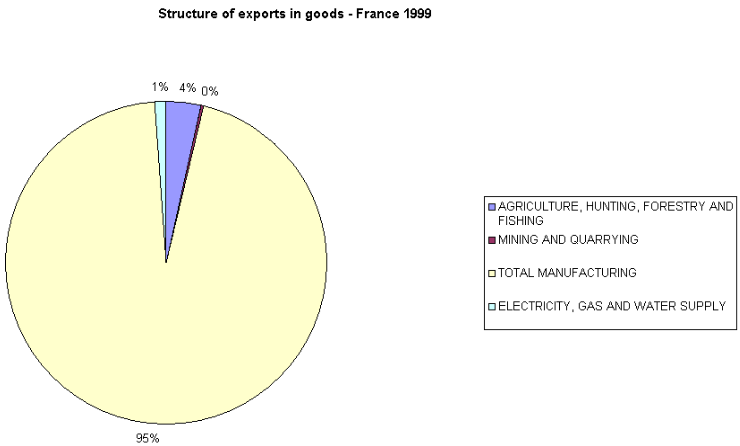
Figure 10: Composition of exports of goods in Germany-1999



Source: OECD

In the case of France, manufacturing weight on total exports of goods was 95% in 1999 (see Figure 11), and 96% in 2000 and 2001.

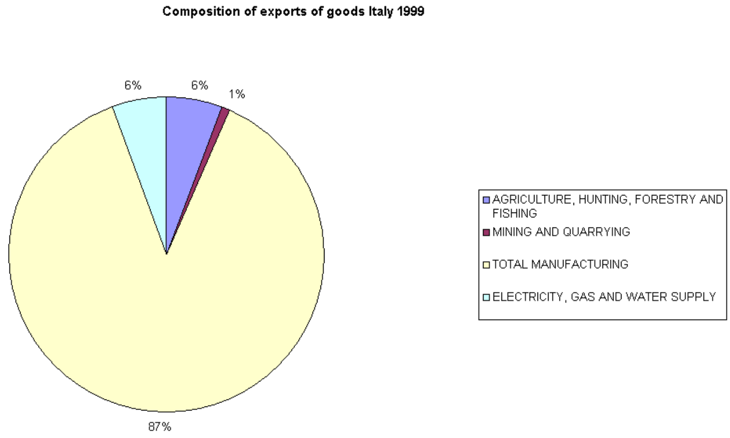
Figure 11: Composition of exports of goods in France-1999



Source:OECD

Finally, in Italy manufacturing constituted 87% of total exports of goods in 1999 (Fig.12), 88% in 2000 and 87% in 2001.

Figure 12: Composition of exports of goods in Italy-1999



Source: OECD

Moving to the analysis of the second indicator, the table below shows how the balance of trade in goods with the US contributes to the national GDP of some Euro-area countries.

It is worth noting that the balance of trade in goods with the US constituted up to 1.2% to the national GDP in Italy, and up to 1.5% of the German GDP in the period between 1998 and 2001. Relating these figures to the ones presented above about the composition of exports, it is possible to conclude that the export of manufacturing goods to the US does indeed contribute substantially to the national GDP of Italy and Germany and, to a more limited extent, France.

The table above also allows drawing conclusions about the impact of the devaluation of the euro vis-à-vis the dollar in the same period. Looking at how the balance of trade in goods with the US changed between 1995 and 2001 in some members of the euro-area, the countries recording the highest increase in absolute terms of their trade balances with the US were Italy, France and Germany. (The figures about Ireland are very high but have to be related to the overall incredible improvement of the country’s economic performance in the same period.)

Analysing the Italian case in more detail, it is possible to note that Italy’s balance of trade in manufactured goods with the US shows a positive trend until 2002 when the euro started appreciating again.

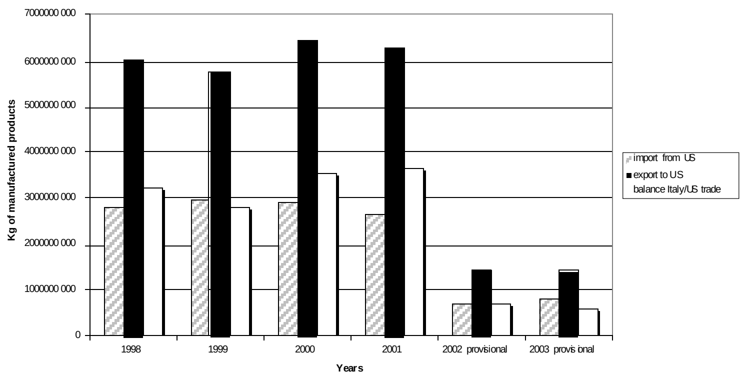
Table 1: International trade in goods balance with the US (Millions ECU/EUR and % of GDP)

	Millions of €	1995	1998	2001
AUSTRIA	GDPat current prices Millions of €	163427.6	179644.8	201138.8
	Balace of trade with US Millions of €	-700	200	800
	Balance of trade with US as a % of GDP	-0.4	0.1	0.39
FINLAND	GDPat current prices Millions of €	85499	103100	120944
	Balace of trade with US Millions of €	600	100	3400
	Balance of trade with US as a % of GDP	0.7	0.09	2.8
FRANCE	GDPat current prices Millions of €	1095157	1197107	1358915
	Balace of trade with US Millions of €	-3600	5100	7500
	Balance of trade with US as a % of GDP	-0.3	0.4	0.55
GERMANY	GDPat current prices Millions of €	1690400	1810250	1925060
	Balace of trade with US Millions of €	10100	18300	28300
	Balance of trade with US as a % of GDP	0.6	1	1.5
GREECE	GDPat current prices Millions of €	73858	96750	118940
	Balace of trade with US Millions of €	-500	-1100	-1200
	Balance of trade with US as a % of GDP	-0.7	-1.1	-1
IRELAND	GDPat current prices Millions €	47104	70049	102911
	Balace of trade with US Millions of €	700	400	6700
	Balance of trade with US as a % of GDP	1.5	0.6	6.5
ITALY	GDPat current prices Millions of €	868637.7	997660.1	1140830.5
	Balace of trade with US Millions of €	6300	2900	13800
	Balance of trade with US as a % of GDP	0.7	0.3	1.2
NETHERLANDS	GDPat current prices Millions of €	281464	325762	393440
	Balace of trade with US Millions of €	-5000	-8900	-11200
	Balance of trade with US as a % of GDP	-1.776426115	-2.732055918	-2.846685645
PORTUGAL	GDPat current prices Millions of €	73979.9	91721.4	111687.4
	Balace of trade with US Millions of €	0	100	0
	Balance of trade with US as a % of GDP	0	0.1	0
SPAIN	GDPat current prices Millions of €	422351	500018	617517
	Balace of trade with US Millions of €	-2500	-1400	-500
	Balance of trade with US as a % of GDP	-0.6	-0.3	-0.08

Source: Elaboration of the author on OECD and Eurostat data

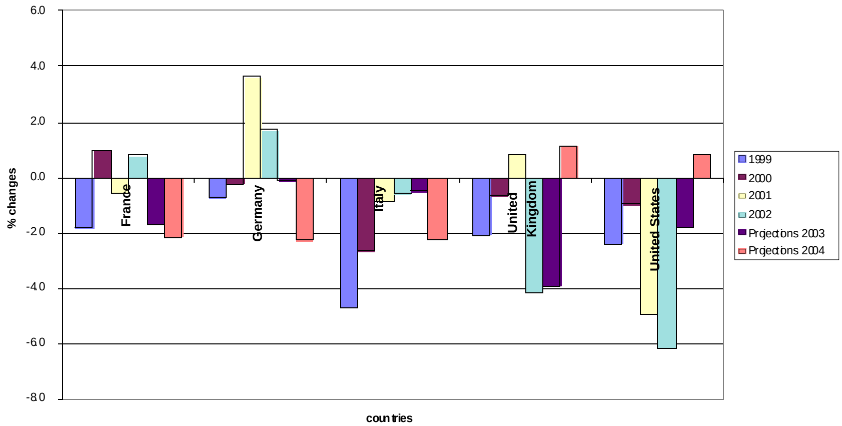
Equally, German export performance was at its apex in the year 2001, when the euro was very weak vis-à-vis the dollar, whereas its outlook for the years 2003 and 2004 was fairly bleak. The situation is very similar in the case of Italy and France, while exactly the opposite happens for the export performance of the UK and the US.

Figure 13: Italian manufactured goods trade with US-1999-2003, Kg



Source: Istat

Figure 14: Export performance in selected OECD countries



Note: Export performance is the ratio between export volumes and export markets for total goods. The export volume concept employed is the sum of the exports of non-manufactured goods and manufactures. The calculation of export markets is based on a weighted average of import volumes in each exporting country's markets, with weights based on trade flows in 1995. The export markets for total goods facing each country is calculated as the weighted sum of the individual export markets for non-manufactured goods and manufactures, where the weights correspond to the commodity export structure of the exporting country in 1995.
Source: OECD

Summing up, it is difficult to deny that the weakness of the euro favourably influenced the performance of the export oriented manufacturing sector, particularly in the large euro-area countries.

What remains to be ascertained is whether the groups representing the interests of this sector did actively intervene in the debate over the making of European monetary and exchange rate policy.

Although the subject would require a much more thorough analysis then what is possible to effect in this context, it may be claimed that, right from the onset, the Italian Association of Industry (Confindustria) was opposed to the adoption of a strict monetary stance by the ECB, while tended to favour a policy of "benign neglect" towards the depreciation of the euro[13].

For example, when in November 1999, the ECB decided to increase the interest rates from 2.5% to 3% to counter mounting inflationary pressures, the then President of Confindustria, Giorgio Fossa, did not conceal his worries for the impact of such a move on Italian industry. He claimed that the increase of the interest rate would be "a heavy weight more on our shoulders"[14]. On the other hand, the weak performance of the euro was widely recognised by Confindustria analysts as the main drive of the strong increase in Italian industrial production in the last two months of 1999[15].

Moreover, in February 2000, the Italian Statistical Office (ISTAT) published the figures relating to industrial production from the beginning of 2000. These showed a record increase in Italian industrial production, whose value grew by 21.5% with respect to February 2000. In the words of Guidalberto Guidi, head of the study division of Confindustria, there was no doubt that such an increase "was driven by the competitive euro devaluation"[16].

In Germany, Gerhard Schröder, the Chancellor, addressing an audience of eastern German businessmen in September 2000, called the weakness of the euro "a cause of satisfaction, not concern". The press was adamant that the statement was mainly meant to reassure the industrial community, especially in East Germany, which was very keen on the devaluation of the euro.

5. Conclusions

It is not an easy task to assess the effectiveness of the ECB monetary policy making or even to identify clearly its strategy. Indeed, many questions remain open.

This contribution tried to answer some of these questions suggesting an intergovernmental interpretation of the first years of the ECB monetary policy. The institutional independence of the ECB, and the lack of publicity of its meetings' minutes, makes it difficult to draw any conclusions on the intergovernmental nature of its formal decision making process. However, the consequences of the monetary policy actions, or non-actions, of the ECB on some leading member states and, within them, on their most relevant economic sectors, suggest the existence of some relation between the interests of the biggest nation states and the preferences of their leading economic sectors and the policy choices of central bankers.

In particular, the emphasis on the performance of the monetary aggregates (M3) as the first pillar of the ECB monetary strategy, seems to conceal the desire by the Central Bank to trade-off some of the transparency that the adoption of an alternative monetary strategy would imply (such as targeting the inflation rate), in exchange for more flexibility. In turn, this flexibility was used to pursue output objectives that would not, prima facie, have been acceptable within the strict anti-inflationary mandate of the ECB.[18]

Similarly, the attitude of the ECB towards the performance of the exchange rate, particularly in the first two years of its activity, an attitude that the economists fail to fully understand (Artis, 2003), acquires a completely different meaning when the performance of manufacturing exports is analysed. Why the smaller states should subscribe to the adoption of monetary policy decisions favouring the bigger member states remains an open question. The answer might be obtained by deepening the intergovernmentalist analysis to look at the kind of side-payments the less powerful states are able to obtain in return for consent to the policy approach that is adopted. Although it is not possible to access the relevant documents to verify the existence of the bargaining that, no doubt, does take place in the governing council of the ECB, it might be possible to underline how the interests of the smaller members of the euro-area do often coincide with those of the bigger ones.

Lastly, as the analysis of the latest developments of the euro/US dollar exchange rate demonstrates, when the international situation changes, in the absence of an international monetary agreement, euro-area member states, and the ECB for that matter, have no influence over international monetary and exchange rate dynamics. Perhaps it is the economic interests of an even bigger state, the US, that are what, eventually, really matter.

NOTES

[1] For a similar interpretation see Berger, H., de Haan, J., and S. Eijffinger, (2000); See also Cukierman, A., Webb, S.B. and Neyapti, B., (1992).

[2] See Frieden, J., and Jones, E., (1998).

[3] For a structured criticism of this monetary pillar, see Begg et al. (2002).

[4] See, for example, Artis (2003).

[5] For more information see ECB (2002).

[6] For some quotations see Begg et al. (2002).

[7] See Begg et al. (2002).

[8] Doubts on the behaviour of the Euro exchange rates have been expressed by many economists. See, for example, Artis, M., (2003). Koen, V., (2000), EMU: one year on, OECD Observer, March-Paris, OECD.

[9] However, and as many have remarked, the publication of similar minutes would not necessarily eliminate the possibility of shifting the real discussion to more informal settings (Artis, M., 2003).

[10] For a more detailed discussion of Frieden's model and an application to the case of EMU see Talani, L.S. (2004), European Political Economy: political science perspectives.

[11] For data on the openness of the economies mentioned and their export structure see OECD web site (www.oecd.org).

[12] These indicators have been selected on the basis of indications provided by personnel of the OECD.

[13] For more information about this subject see Talani, L.S., (2000), Betting for and against EMU, London: Ashgate.

[14] "Un mattone in piu' sulle nostre spalle", see La Repubblica, "Borse europee in rialzo La Bce non spa--venta", 4/11/1999 web-site: http://www.repubblica.it/online/economia/ tassi/tassi/tassi.html accessed 27/01/04

[15] See La Repubblica, "Produzione industriale forte crescita a dicembre", 16/02/2000 web-site: http://www.repubblica.it/online/economia/produzione/febbraio/febbraio.html accessed 27/01/04

[16] See La Repubblica, "Industria: febbraio boom per fatturato e ordinativi", 15/05/2000 web-site: http://www.repubblica.it/online/economia/fatturatoindustria/maggio/maggio.html accessed 27/01/04

[17] See Barber, T., "World Economy 5 Europe: Determined efforts surprise the critics: GERMANY", Sep 22, 2000.

[18] About the effective mandate of the ECB there is a huge debate within the academic community. See, for example Begg et al. (2002).

Chapter 6

The Dog that Would Never Bite? What We Can Learn from the Origins of the Stability and Growth Pact

by

Martin Heipertz and Amy Verdun *

Abstract: This article analyses the creation of the Stability and Growth Pact (SGP). It examines the economic and political factors behind it, including the role of economic ideas, experts, politicians, institutional arrangements in the Maastricht Treaty, domestic politics, and the exceptional position of Germany in the realm of monetary integration. It concludes that a set of commonly held beliefs together with a corresponding power-political constellation explain the creation of the SGP. As these parameters change, they inform our understanding of the current crisis.

Keywords: budgetary discipline, Economic and Monetary Union, Germany, rules, Stability and Growth Pact, monetary integration

1. Introduction

The Stability and Growth Pact (SGP) consists of two Council regulations and a resolution of the European Council[1]. It specifies the deficit limit of the Treaty Establishing the European Community (TEC 104). In the second half of 2002, its excessive deficit procedure (EDP) was initiated in the cases of Portugal, Germany, and France. Formally, when the Council decides that an excessive deficit exists, the country concerned is obliged to reduce its deficit

[ß] Earlier versions of this article were also presented at a conference at the NYU in London, at a seminar of the Max Planck Institute for the Study of Societies (MPIfG) in Cologne, at the Oberseminar of the Jean Monnet Chair, of Wolfgang Wessels, University of Cologne, at the 19th IPSA World Congress, Durban South Africa and at the University of Leiden. The authors wish to thank participants in the 1st EUI Alumni conference, especially the discussant of this chapter, Martin Rhodes, and in all the above-mentioned conferences and seminars for their useful comments and suggestions. Special thanks go to Patrick Crowley, Bernhard Ebbinghaus, David Howarth, Kathleen R. McNamara, Britta Rehder, Armin Schäfer, Fritz W. Scharpf. The authors thank the MPIfG in Cologne and the Social Sciences and Humanities Research Council Canada (Grant 410-2002-0522 held by Amy Verdun) for financial support. This article is based in part on interviews with 35 key informants, all of whom were close to the actual creation and/or the current politics of the SGP.

below three per cent of Gross Domestic Product (GDP) or ultimately face financial sanctions. Metaphorically speaking, the 'dozing watchdog' has thus turned out rather snappish. However, on 25 November 2003 the Council of the European Union for Economic and Financial Affairs (Ecofin) suspended the EDP for France and Germany, which has plunged the Eurozone into an institutional crisis.

The present situation is not detached from the factors that led to the creation of the SGP but has to be seen in their context. From this broad perspective, the article poses the following questions: (1) Why and how was the SGP created? (2) What underlying conditions supported its creation? (3) Have they changed since? (4) How do they inform our understanding of the current situation? This article analyses the origins, process and outcome of the SGP negotiations and thereby aims to provide some background and clarification to the ongoing debate. We argue that the SGP was possible due to a convergence in basic ideas about the relationship between monetary and fiscal policies held by experts in Ministries of Finance, central banks, the Commission as well as in academia and international organisations. Yet there was no precise idea of a specific arrangement beyond the Maastricht Treaty. Ideational convergence provided the basis for a political compromise. Expert consensus on principles was a necessary though not sufficient condition for the intergovernmental agreement. The complete analysis has to include power-political factors which relate to the prominent position of Germany in the creation of Economic and Monetary Union (EMU).

The remainder of the article is structured as follows. The next section examines why the SGP was considered necessary. The third section describes the actual story of its creation. The fourth section examines the ideational context from which the SGP originated and provides an analysis of the achievement of the political compromise. The final section concludes and assesses the current situation.

2. Why might an SGP be necessary? – Lessons from economics and politics

2.1. The Economics of the SGP

The Maastricht Treaty has provided the monetary constitution for EMU. However, its specifications for the future fiscal regime are incomplete and ambivalent[2]. It only contains rather loose stipulations on the EDP and budgetary coordination. From the viewpoint of economics, several arguments speak in favour of complementing the fiscal arrangements of the Treaty (for a detailed discussion see Heipertz, 2003). The most prominent reasons behind more stringent rules are (1) a need for consolidation, (2) concerns about externalities, (3) the credibility of ECB independence and (4) the need for a more coherent framework of economic policy coordination.

A general need for consolidation results from the expansionary fiscal stance in most of the Organisation of Economic Cooperation and Development (OECD) countries since the 'golden age' of Keynesianism and welfare-state expansion. Soaring interest rates, which were the result of high inflation rates of the time, have reduced investment and contributed to weak growth and underemployment. Government revenues flow into debt servicing at the same time as ageing populations require a fundamental reallocation of public spending.

Second, there was a fear of externality problems related specifically to EMU[3]. The most prominent concern regarded the negative effects of fiscal spill-overs on increasingly interdependent participating economies. A bond-financed increase in government spending would cause the money supply in the Eurozone to rise, thereby fuelling inflationary pressures. In response the ECB would be forced to increase interest rates, depressing investment and consumption. Furthermore, the higher interest rate would cause the common currency to appreciate and the trade balance to deteriorate.[4] Another externality effect results from abandoning national exchange rates. The effect of depreciation due to fiscal profligacy now affects the whole currency zone, thereby reducing the impact on the individual 'sinner' while increasing it for everybody else. This reduced disciplinary effect on national authorities aggravates an existing deficit bias of public finance (Beetsma 1999). Member States were feared to free-ride on each other by overspending on their budgets.[5] Thus strict rules on budgetary deficits were deemed necessary. It is noteworthy that the need for limits on budgets had already been mentioned in the original EMU blueprint laid out in the 'Delors Report' (Committee for the Study of Economic and Monetary Union 1989).

A third concern is that excessive deficits could undermine central bank independence. Actors at the time were worried that ECB independence and specifically the 'no bail-out' clause[6] would be endangered by unsustainable fiscal paths of certain Member States. Sargent and Wallace's (1981) model of debt monetisation supports this view. Their study shows that an unsustainable fiscal path eventually forces the central bank to buy government bonds. The Fiscal Theory of the Price Level (FTPL) argues in a similar direction (Leeper

1991; Woodford 1994). Grossly simplified, the FTPL states that inflation control by the central bank through the interest rate is jeopardised by an excessive fiscal stance that disturbs household expectations and unsettles private sector budget constraints. Public demand substitutes private demand and artificially expands aggregate demand, eventually causing the price level to rise. Hence, monetary independence and the effectiveness and credibility of monetary policy need to be supported through the fiscal regime. The SGP appeared desirable as a way of 'safeguarding the credibility of ECB independence' (Artis and Winkler 1999).

Fourth, in a monetary union the role of economic policy coordination becomes pertinent (Begg 2002), aiming at an appropriate policy-mix between monetary and fiscal policy. The fact that the 'one-size-fits-all' monetary policy of the ECB destabilises countries with an inflation rate significantly off the Eurozone average has increased the need for strategic and coordinated fiscal policy, potentially even going beyond the automatic stabilisers. The coordination issue grows in importance with the likelihood of asymmetric shocks and increasing divergence between the participating economies. Weak economic growth in the Eurozone is due to structural rigidities but gets amplified by cyclical swings. Governments would be ill-advised to implement pro-cyclical policies of cutting (investment) expenditures and increasing (tax) revenues during a downturn. Some economists have misinterpreted the SGP in this way and strongly criticised it for hindering countercyclical moves (Eichengreen 1996, Eichengreen and Wyplosz 1998). This view is exaggerated but the SGP is still not a suitable framework for a coordinated and strategic response to the cyclical component of Europe's weakness. Coordination *à la* SGP complements the European Union (EU) economic coordination framework centred on the Broad Economic Policy Guidelines (BEPG)[7] but remains rudimentary and improvised, only asking Member States to 'keep their house in order' (Issing 2002). A more effective solution for economic policy in Europe could be a positive outcome of the current crisis.

2.2. The Politics of the SGP

The Maastricht Treaty is an incomplete contract as far as rules on EMU are concerned. Theoretically there were two options. The first would be the *status quo*, relying essentially on voluntary arrangements. The Member States would all agree to continue to meet the convergence criteria also after EMU had started. The second option was to impose explicit rules that would elaborate on and even go beyond the Treaty stipulations. This issue was left open precisely because it was highly contentious and exposed fundamentally different views on economic policy.[8] Voluntary arrangements had been the implicit road that was chosen in the Maastricht Treaty. However, particularly the Germans and the Dutch favoured a more explicit, rule-based system that would restrict budgetary deficits once EMU was fully operational. This concern seemed especially relevant with respect to a number of (Mediterranean) countries that were making strenuous efforts to be part of the first wave – against all odds at the outset.[9] The larger the future membership of EMU was appearing to become and the less likely a postponement, the more urgent grew the need for Germany to reinforce at least the deficit criterion. This situation has been described as an 'endgame' for the transition towards stage III (Crowley 2002).

The political background of the SGP can be traced back to German domestic politics. It was used to comfort public opinion and to appease the Bundesbank. The German public needed reassurance on EMU as it had become extremely anxious about giving up the well-proven Deutschmark in favour of a new single currency that would include traditionally weak economies which lacked a stability culture. Politically, there was a risk that the opposition and even Waigel's own party in Bavaria under Prime Minister Edmund Stoiber would capitalise on this sentiment and run on an anti-EMU platform.

More subtle forces were also at work. Of importance was the gradual nature of economic and monetary integration, especially the experience with the European Monetary System (EMS). Cooperation in the context of the EMS had implied that most monetary authorities had contributed to factual convergence in monetary policy with the de facto fixing of exchange rates as its result. What had been happening over the 1980s was a 'shadowing' of Bundesbank policies. The resulting convergence meant that monetary authorities had learnt lessons about economic and monetary governance (Verdun 2000a). Experts feared that national governments would become more 'relaxed' and return to old practices once EMU would be fully operational. They were keen to perpetuate the stability-orientation of economic policy in Europe.

3. Negotiating the pact

How did the SGP come about? The idea of some sort of 'stability treaty' was in the air in early 1995. The Maastricht Treaty had already stipulated the need for further legislation (see above). Since the beginning of stage two of EMU in 1994, the Monetary Committee (MC) had deliberations on this matter.

Officials in the German Ministry of Finance were also discussing this topic amongst themselves. The *Sachverständigenrat*, an advisory board to the federal government, had demanded already in its 1992 annual report to make the sanctions more precise and apply them strictly (Sachverständigenrat 1992: 433). It became the subject of public debate after Wolfgang Grüger, President of the German association of cooperative banks, proposed an intergovernmental stability treaty among the future EMU states (Handelsblatt 9 May 1995). This request was engineered by Bundesbank President Hans Tietmeyer who did not want to be publicly associated with a new initiative on hardening the EMU regime and hence suggested that Grüger, perceived as a neutral player from the private sector, should make the move.[10] The debate picked up during autumn 1995. The *Institut für Weltwirtschaft* (IfW) in Kiel published a discussion paper on how to make the Maastricht stipulations workable (Lehment and Scheide 1995). The IfW proposal suggested automatic, interest-free deposits with the ECB for countries exceeding three per cent that should be paid back as soon as the excessive deficit was removed. The paper was prominently discussed in the *Frankfurter Allgemeine Zeitung* (FAZ, 12 October 1995) and was seconded by positive comments of the Bundesbank (FAZ, 15 October 1995). The arguments re-appeared as demands for a 'budgetary pact' in the 1995 report of the *Sachverständigenrat* (Sachverständigenrat 1995: 446).

Waigel and Kohl were now under severe political pressure. As was briefly eluded to above, public opinion was turning very negative on EMU. The SPD opposition party was making populist remarks on the dangers to stability stemming from the EMU project and demanding stricter rules, thereby literally mirroring Bundesbank statements (e.g. Scharping 1995). In September 1995, Waigel had been informally talking to his colleagues about his desire to formalise the rules on budgetary policy in EMU (Milesi 1998: 95-6, Stark 2001: 89 and interviews with German Ministry of Finance officials, June 2003). The IfW paper was used as a direct input for drafting a proposal in the ministry under time pressure. On the same day that it was presented to the public (*FAZ*, 12 October 1995), the authors received a call from the ministry, asking for the paper to be faxed immediately.[11] Four weeks later (7 and 10 November 1995), Waigel announced his version of a 'Stability Pact' (Bundesministerium der Finanzen 1995) to the public during the second reading of the 1996 budget (Waigel 1995a, 1995b). Parallel to that, Waigel commissioned an official at very short notice to write up an English draft for his European colleagues. These responded with reserved support.

The idea that the Maastricht Treaty could be subject to renegotiations was out of the question. Yet, an intergovernmental agreement in the form of a new treaty *à la* Schengen, as originally envisaged by Waigel and his state secretary, Jürgen Stark, was unacceptable to the other countries. The Commission also realised the dangers of an intergovernmental solution because it would imply the marginalisation of Community institutions and procedures. The Council therefore prompted the Commission to propose a solution within the Community framework. Its proposal, released in October 1996 (COM (1996) 496), was closer to the Maastricht Treaty than to the Waigel paper. It developed the 'surveillance arm' of the SGP as a rudimentary device for economic policy coordination. However, it did not include automatic fines but reduced the sanctions to a discretionary measure of the Ecofin Council. The fact that Ecofin ministers have to judge each other poses an obvious incentive problem.

The Stability Pact dossier was discussed in the Monetary Committee (MC), the Ecofin Council, the European Council and at Franco-German meetings. The bulk of work was completed in the MC. Only very few open issues had to be referred to Ecofin. The major controversy was that Germany's partners agreed on the principle of mutual surveillance and reinforced dissuasion of excessive deficits, but did not accept automatic sanctions. The focal point of dissent became the clause that stipulates the exemptions from sanctions, since here lays the lever for political discretion. Waigel was completely isolated in requiring nothing less than an 'exceptional' GDP contraction of two per cent or worse as a qualification for an exemption. The compromise reached in Dublin during the morning hours of Friday, 13 December 1996 in parallel sessions of Ecofin and the European Council runs that a recession of less than 0.75 per cent 'as a rule' does not qualify as exceptional, whereas a recession of over two per cent automatically does. If the size of the recession is between 0.75 and 2.0 per cent, Ecofin determines whether or not it is deemed 'exceptional'.[12] Once the sanctioning procedure (TEC 104 IX) has started, only EMU Member States have a vote, excluding the country in question. A voting alliance against the SGP then becomes even more concrete and likely, as eventually occurred on 25 November 2003.

The SGP has delivered some 'added value'. It has shortened the timeline of the sanctions mechanism, defined the distribution of the fines (among the 'virtuous' Member States), clarified the notion of 'exceptional' and 'temporary' deficits as exemptions from sanctions, introduced an urgency procedure, enabled the suspension of the EDP, and improved the juridical procedures of the steps involved. Yet, due to the politicised nature of the EDP, the essence of the pact is not a mechanism of 'quasi-automatic sanctions' but the institutionalisation of a *political* pledge to aim for low deficits. It is presently unclear whether the procedures can be enforced by legal means. The Commission has tabled an appeal for annulment (TEC 230) with respect to the Ecofin decision that has effectively suspended the EDP.

4. Analysing the Birth of the Stability and Growth Pact

For the analysis of the birth of the SGP we combine an ideational approach with an actor-centred, institutionalist perspective. First, we focus on how ideas came to shape the preferences of actors and, second, on how their constellation and interaction produced the outcome. Following (Scharpf 1997), ‘actors’ are defined as individual or corporate strategic agents (mostly administrative bodies such as ministries and the Commission). They are capable of intentional action, are internally organised along hierarchical lines, and are characterised by preference orientations as well as action resources. Furthermore, they are embedded in an institutional context, which we use as explanatory shorthand for structural factors and external influences on the actors themselves, such as the influential role of financial markets at certain stages in the negotiation process. We define the executive agents of the negotiating ministries, of the Commission and of central banks as ‘experts’. They are in contact with ‘non-actor experts’ who shape ideas but not decisions, such as academics, journalists and institutions like the OECD or the IMF. On the highest levels of deliberations, we introduce ‘non-expert actors’, holding the final and democratically legitimated decision-making competence – ‘politicians’. The orientations of experts are defined by specific converging ‘ideas’ about economic policy, influenced indirectly by non-actor experts. The orientations of politicians are crucially influenced by experts. A graphical illustration summarises how experts (‘actors’ as well as ‘non-actors’) and ideas came to shape politics, thereby converging on the compromise that enabled the conclusion of the Stability and Growth Pact.

4.1. Ideational convergence

From an ideational perspective the creation of EMU can be seen as the result of policy learning and policy convergence, based on convergence in ideas about monetary policy-making. When EMU was first conceived in the late 1960s and early 1970s, ideas differed widely, i.e. on the question whether to converge policies first or whether to proceed with monetary integration and assume that convergence would result. Concepts varied on the policy objectives and on the institutional design of EMU. The 1970 Werner Plan on EMU reflected a time when governments were frequently pursuing Keynesian policies (Committee on the Realization by Stages of Economic and Monetary Union 1970).

Though the actual institutional design of EMU as envisaged by the Delors Committee in 1989 did not differ much from its 1970 design, a number of important developments occurred in the years between the two plans. First, economic and monetary integration had achieved a higher level of integration in both the areas: the process of completing the internal market was underway, financial markets had become further integrated and the EMS had been in place for a decade. Second, policy learning had taken place. Monetary policies were only successful if they were in line with that of the dominant Member State, namely Germany. Third, ideas regarding monetary policy-making had changed (see *inter alia* McNamara 1998 and Marcussen 2000). Whereas in the 1960s and 1970s Keynesian principles still lay at the heart of national government economic policies, by the late 1980s monetarist policies dominated. The change in belief was that there was no long-term trade-off between inflation and unemployment and that sound money was a precondition for growth.

In their effort to proceed with monetary integration, the governments of Member States were aided by a so-called ‘epistemic community’. Members of central banks, ministries of finance and academics held similar views about the main aim of economic and monetary policy-making. There were a few important venues where experts shared ideas and socialisation occurred. This took place above all in the Monetary Committee (MC) – now called the Economic and Financial Committee – which consists of representatives of central banks and Ministries of Finance of the EU Member States (Verdun 2000b), as well as in other influential EC committees (Rosenthal 1975, Verdun 1999) and international fora. The members of the MC meet Haas’ four principles that define the existence of an epistemic community (Haas 1992: 3). First, they shared beliefs for a value-based rationale of social action. Second, they shared causal beliefs, which are derived from their analyses of problems which then serve as the basis for understanding the linkages between policy actions and desired outcomes. Third, they have shared notions of validity – that is intersubjective understandings that help them weigh ideas within their area of competence. Fourth, they have a common policy enterprise and common practices associated with a set of problems to which competence is directed. It is no surprise that the Member States’ Heads of States or Governments relied on the MC for proposals and suggestions for action. The literature on epistemic communities indeed suggests that a group of experts is often called upon when national governments are divided on intergovernmental collaboration. The MC was an ideal group to ask for advice as its members can wear double hats. They can act as independent experts yet they are fully aware of the political issues at stake.[13] It was crucial that the actors had learnt certain lessons and held certain common beliefs. But those ideas alone were insufficient to produce the concrete SGP.

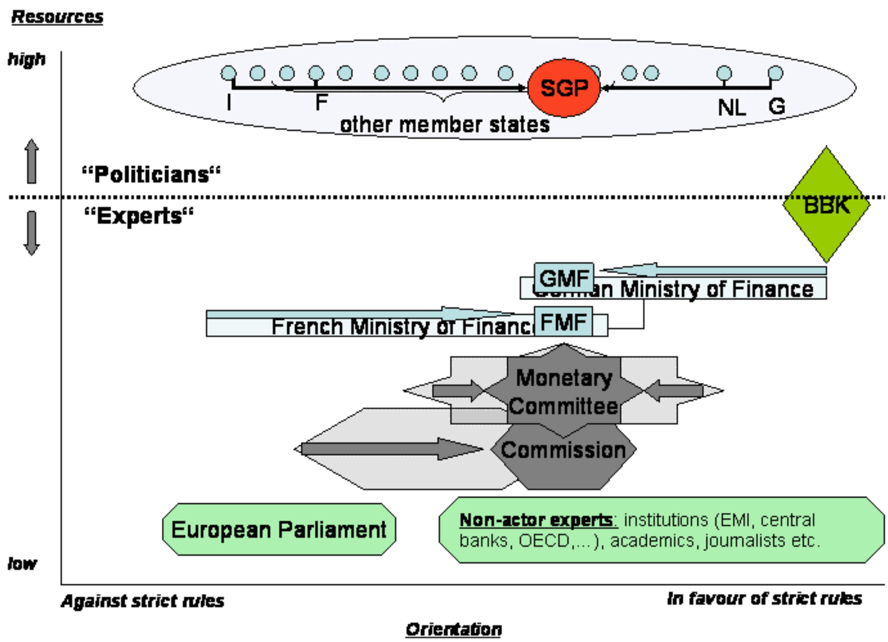
4.2. Negotiated compromise

The figure below presents an overview of the most important actors, grouped according to their resources and orientations.

It shows initial orientations in November 1995 (when Waigel issued his proposal) and the orientations in June 1997 which by then had converged. The horizontal axis depicts the actors' politico-ideologically shaped preferences for or against strict rules for fiscal discipline. The vertical dimension shows their power resources and decision-making capabilities. We distinguish between a 'political' and an 'expert' sphere. Our distinction highlights the fact that politicians – not experts – settle the most controversial issues. The stylised process is that the whole negotiation dossier is split up into a set of issues (timeline, exemptions from sanctions, distribution of fines etc.) which are discussed at the expert level. Experts receive their instructions from politicians but are free to reach agreement within these bounds. Politicians will in most cases simply tick off the agreements reached among the experts. Only issues on which there is no consensus are deliberated on at the political level. The decision-making process is hence conceived in a bottom-up manner. Experts are in a strong position to influence politicians since they possess intimate knowledge of the relevant issues and have detailed information on the bargaining positions of the others. They can indicate potential solutions and hence possibly prevent the discussion from being deadlocked. We will now briefly discuss each actor in turn.

Actors at the level with the highest resource capabilities are Member State governments. Their decisive position in the deliberation process corresponds to the concept of 'power politics' (Garrett 1994). They are the legislative body. The role of other actors is only indirect via the influence they have on the orientation of the governmental actors. The state actors are either Ministers in the Ecofin Council or Heads of State or Government in the European Council. The preference points on this level initially cover the entire range between pro and contra Waigel's proposal – Germany being on the right end,

Figure 15: Initial preferences and subsequent convergence



closely followed by the Netherlands, whereas France and other Mediterranean states initially found themselves on the other side.[14] The German Bundesbank (BBK) figures as a special actor with the resources of an informal veto. The figure displays only the two most important **national treasuries**, those of France and Germany. Each Ministry and each central bank plus the Commission had two representatives in the Monetary Committee (MC), which was crucial in preparing the ground for the compromises found in the political sphere. Its crucial role is best interpreted by the notion of an 'epistemic community' as was mentioned above. In terms of power resources, it lies below national ministries and the political level, but its importance relates to the fact that it was the actual forum in which the compromise was found. The **Commission** is placed low in terms of decision-making power but successfully achieved a solution within the Treaty framework, and thus prevented an international agreement *à la* Schengen. Another success for the Commission was the inclusion of the surveillance procedure in the SGP. It nevertheless had to depart quite considerably from its initial preference, which had been more to the left of the negotiated outcome. The European Parliament, with a rather negative stance towards a strict pact, was unable to bring substantial influence to bear on the deliberations and is therefore placed on the lowest level. Finally, a set of 'non-actor' experts was able to make its influence felt through informal and professional contacts, communication and the gradual shaping of ideas that underpinned the slow process of ideational convergence: the European Monetary Institute (EMI), precursor to the ECB, and the central banking community with a close affinity to the Bundesbank position, should be explicitly mentioned as well as institutions such as the OECD, academic think-tanks, private-sector researchers, academics etc. Their influence on the decision-making process was not direct but shaped the orientations of the actors.

Initially, actor preferences were widely dispersed. The Commission, once it had adapted its view and supported the design of a pact, was entitled to make its preference the base for the deliberations in the MC. Of course, it had to propose a pact that was still acceptable to Germany, albeit less strict and without automatic sanctions. In the MC a surprisingly rapid convergence emerged that was situated slightly more towards the right side of the preference scale, i.e. the 'German' end. One explanation of the emergence of this convergence is that a 'permissive consensus' (Lindberg and Scheingold 1970) already pre-existed in the MC, the members of which had already been in favour of a stability-oriented, rule-based model. In other words, the particular equilibrium solution was not yet determined, but the solution space and hence the type of arrangement that the solution would look like was already visible.

The final result reflects Germany's asymmetric bargaining power. The reasons for this privileged position were fourfold. First, Germany gave up the anchor-currency of the preceding regime, the EMS. Unlike the other countries, it had to accept the opportunity cost of losing monetary discretion and was able to ask for a higher price – a fact all too well known from the Maastricht negotiations (Dyson and Featherstone 1999). Second, the German position resembles Putnam's two-level game-constellation with the Bundesbank as an informal veto player (Putnam 1988). Due to its reputation and popularity, the Bundesbank had a strong influence on German public opinion towards EMU. If it were to oppose publicly the entry of a large 'wave' of countries into stage III, it would make it politically extremely costly for the Kohl government to press ahead. The creation of the SGP was a strategy to reduce public resentment by appeasing the Bundesbank. Thus the German preference set was narrowed through the informal (declaratory) veto exercised in Frankfurt, which forced others to realise that a solution would have to lie close to the German preference point.[15] Third, Germany could credibly threaten to exit the EMU process. In fact, this implicit threat has repeatedly been used by German officials in the

MC.[16] Fourth, the second-worst threat-scenario was if Germany opposed membership of the 'Club Med' countries, Italy in particular. These countries had an incentive to agree to the pact so that Germany might be more acceptant of their membership. But even though the outcome is situated towards the German preference point, the German government had to give in as well, most importantly on the issue of automatic sanctions. Turning to the institutional context, we find that three parallel processes were crucial in shaping and facilitating the agreement.

First, the Franco-German 'axis' represents a subset of the negotiations on the European scene. Its most important function is a radical reduction of the number of negotiators involved which increases the likelihood of finding a compromise solution. These summits are important as France and Germany often represent different perspectives on these issues and thereby different groups of countries. As happens in other types of bargaining, it is as if France and Germany are 'delegated' to negotiate a settlement.[17] The actual solution was often not reached during Franco-German summits or economic consultations, but the subsequent meetings on the European scene benefited from the prior exchange of views and signals.

Second, the Ecofin negotiations were seconded by a parallel political process of summit meetings in the form of European Councils. The Heads of State or Government did not confine to providing merely the initial political impetus. Instead, they punctuated and guided the negotiations throughout the process, thereby removing important obstacles to compromise, most notably in the case of the lower end of the definition of a severe recession that would constitute an exemption from the imposition of sanctions. The European Council did not only issue strategic political aims but rather defined operative solutions in surprising detail and delegated their attainment and the legal framing to the Ministers of Finance as well as to the Commission. The experience of the SGP negotiations should be seen as an important step in the institutionalisation of the European Council.

Third, financial markets were influential in forcing the negotiators to agree on highly contentious issues. The fact that the Deutschmark rocketed against all other currencies involved whenever a deadlock seemed to jeopardise the course towards Stage III of EMU imposed a substantial cost of failure on all negotiating partners. This disciplining factor contributed to the pressure to reach consensus. Actors would rather give in on issues, which were credibly posed as *conditiones sine quibus non* by their counterparts, than leave the negotiation room empty-handed. Summarising, this section has sought to explain how ideational convergence, facilitated by asymmetric bargaining power and the institutional context, enabled the political compromise.

5. Conclusion

The watchdog has begun to bark. Will it break loose and bite or will it be forced to tug its tail and whine? We started off by asking why the Stability and Growth Pact was created, what purpose it was to serve and what underlying conditions supported its creation. The Economics literature at the time stressed the importance of consolidation, externality problems in EMU, central bank independence and coordination of monetary and fiscal policies. Political factors range from the incomplete nature of the TEC to German domestic politics and policy learning Ideas on the relationship between monetary and fiscal policy and the role of monetary policy in society more generally had changed over time and enabled a broad consensus in favour of fiscal discipline. The case study indicates that the genesis of the concrete outcome lay in Germany and that its creation was due to an asymmetric power constellation. These two factors, ideas and power, together explain the origins of the SGP.

Designing rules is one thing, applying them another. A number of countries no longer act as if the SGP budgetary ceilings are to be taken seriously. In part it may be that politicians are opportunistic and underrate the repercussions of rising budgetary deficits as they pursue other domestic objectives. At the same time, it should be stressed that EMU and the SGP are likely only to have a positive effect on the economy if structural reforms are implemented. Some governments seem to have ignored the fact that without these reforms, budgets deficits may rise anew. They now wonder if the SGP can be seen as a watchdog that barks but is on a chain. Some have argued that the SGP may not be the right pact to enforce fiscal discipline. We have stressed that even though that may be the case its very effect on credibility depends on how it is treated when Member States encounter fiscal difficulties.

The introduction asked what has changed since 1995-97 and what lessons can be drawn from that negotiation period for the future of the SGP. Our analysis suggests that what matters for the SGP are bargaining power and ideas. Regarding the former, some changes have occurred. First, Germany has lost some of its bargaining power due to the start of Stage III of EMU in 1999. Germany no longer has the same possibility to threaten not to join EMU or to create barriers to keep countries out. Second, Germany itself is no longer the exemplary Member State it once was regarding budgetary discipline. As a result, partly because of the continued financial effects of reunification, partly because of changing political preferences, Germany no longer backs the SGP. It is mainly the Dutch government, aided by Austria, who now play that role but are endowed with less bargaining power than Germany before. A similar change can be observed regarding the role of ideas. The consensus among politicians on the importance of fiscal discipline may seem to be fading away under the effects of the recession or lack of considerable economic growth. However, we argue that there is still strong support for the regime among the main actors on the expert level. The SGP was created to build credibility. Irrespective of whether it is a 'smart' or 'stupid' pact (to use Commission President Romano Prodi's words) it will only be able to do its job if Member State governments do not mess too much with it – at least in the short run. It is likely that experts will influence the thinking in governments. They will also be the ones who shape the Commission's proposals for reforming the system. It is now up to the European Court of Justice to tip the balance between experts and politicians.

NOTES

[1] Resolution of the European Council on the Stability and Growth Pact, O.J. 1997, C 236/1, Council Regulation No. 1466/97 of 7 July 1997 on the strengthening of the surveillance of budgetary positions and the surveillance and coordination of economic policies, O.J. 1997, L 209/1, and Council Regulation No. 1467/97 on speeding up and clarifying the implementation of the excessive deficit procedure, O.J. L 209/6.

[2] This lacuna is related to the fact that the negotiating parties were unable to agree on a Political Union in 1991. They seem to have been aware of the shortcomings and included into the EMU Articles the task to produce further legislation (TEC 99 V, 104 XIV).

[3] Negative externalities are welfare or opportunity costs not fully accounted for in the price and market system, usually occurring to a third party not being part of the transaction.

[4] However, recent research suggests that the overall size of fiscal spill-overs within the euro area can be expected to be rather small as the several types of spill-overs to a large extent neutralise each other (Gros and Hobza 2001).

[5] The deficit bias is partially counteracted through an increase in relative prices in the expansionary country. The resulting export loss should provide and re-internalise part of the necessary discipline.

[6] The no-bailout clause implies that neither the ECB nor the Community will provide funds to or buy bonds of a national government that becomes insolvent (TEC 101, 103).

[7] According to Article 99 TEC, EU Member States "regard their economic policies as a matter of common concern". The BEPG procedure serves this end in the following way. The Commission recommends the guidelines for each country to the Council of Ministers on Economic and Financial Affairs (Ecofin), which decides on a draft by qualified majority. The draft is then put before the European Council of the Heads of State and Government. Based on the European Council conclusion, Ecofin decides on individual recommendations, again by qualified majority. Since the recommendations are not backed by sanctions, the BEPG procedure is considered as 'soft' coordination see also Hodson and Maher (2001).

[8] A third option would be to have a new economic authority make decisions about these matters (Verdun 1998). This idea was first raised in the Werner Report (Committee on the Realization by Stages of Economic and Monetary Union 1970). It referred to this organ as a "Centre of Decision for Economic Policy". In the late 1980s, the French produced a similar idea when they called for a '*gouvernement économique*' (Verdun 2003b). The creation of such a body has thus far not taken off due to the fear that that it might undermine the independence of the ECB.

[9] Ironically, in 1995 Germany itself for the first time breached the three per cent limit on budgetary deficits.

[10] Telephone interview with BVR official, 4 November 2003.

[11] Correspondence with IfW, 3 November 2003.

[12] The decision can be blocked by a minority of at least 26 out of 87 weighted votes or covering at least six Member States (TEC 104 VI and 205 II).

[13] One participant described their role as that of 'financial diplomats' (interview with the authors, 4 July 2003).

[14] Though Member States initially reacted positively to the 1995 Waigel proposal, they disagreed on important details such as automatic sanctions.

[15] According to Milesi (1998: 137), Waigel stated in the Ecofin: " Si le pacte n'est pas assez rigoureux, la Bundesbank pourrait déclencher ses foudres, ce qui risque de me déstabiliser politiquement. "

[16] Interviews, 4 July 2003.

[17] Milesi (1998: 145) quotes a delegation member of the Dublin summit: "C'est un problème franco-allemand (…) Mettez-vous d'accord entre vous et nous accepterons votre solution."

Chapter 7

The "Brussels Consensus" on Macroeconomic Stabilization Policies in the EMU. A Critical Assessment [*]

By

Roberto Tamborini

Abstract: The paper sketches what may be called the "Brussels consensus" on macroeconomic stabilization policies in Economic and MonetaryUnion (EMU), and then questions whether these policy guidelines are safe means to macroeconomic stability for well-behaving governments. With the help of a standard macroeconomic model largely used in the EMU literature, the following main issues are discussed:

- Is the policy-mix between common monetary policy and national automatic stabilizers optimal?
- Should national discretionary fiscal policies be banned or limited?

  The main conclusion is that well-behaving governments cannot take it for granted that complying with rules will deliver optimal stabilization.

Keywords: Economic and Monetary Union, Stability and Growth Pact, macroeconomic stabilization policies.

1. Introduction

It is nowadays generally believed that "stability promotes growth". In the design of the economic policy institutions of the Economic and Monetary Union (EMU) great emphasis has been laid on this guideline (Winkler, this volume). From the point of view of macroeconomic stabilization policies, however, the institutional setup of EMU displays the striking feature of asymmetry between one single monetary authority (MA) with no fiscal counterpart and many independent national fiscal authorities (FAs). This is a *unicum* in modern history, since monetary unifications have generally been built up *vis-à-vis* the centralization, to variable extent, of fiscal competences as well.

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[*] This paper summarizes a line of research developed especially with Francesco Farina, whom I thank for his co-operation and co-authorship in some published and forthcoming papers. I also wish to thank Elisabetta Croci Angelini and Christopher Gilbert for their comments. I remain fully responsbile for this paper.

This institutional mismatch between monetary and fiscal authorities has caused much concern among scholars and politicians (Feldstein (1997)). Concern arises from the traditional theory of optimal currency areas. In fact, in addition to reliquinshing control over monetary policy and exchange-rate determination, member countries have also constrained their fiscal policy within the limits set by the Stability and Growth Pact (SGP), whereas the optimal currency areas theory stresses that national fiscal policy should have more, not less, room for manoeuvre in coping with domestic shocks (see e.g. Goodhart and Smith (1993), Kenen (1995), Hughes Hallet and McAdam (1999)). Under EMU fiscal constraints, exposure to asymmetric shocks or structural asymmetries across countries may exacerbate local macroeconomic fluctuations and trigger divergent cycles.

This concern is by no means universally shared, however. After almost two decades of lively theoretical and political debates in preparation for the epoch-making creation of the single currency in Europe, an almost settled and self-contained view has materialized with regard to “well-behaved” economic policy conduct in EMU. The thrust of this “Brussels consensus” is that a ‘monetary giant’ surrounded by ‘fiscal dwarfs’ is a better guarantee of the independence of the central bank, of monetary and financial stability, of restricted growth of the public sector, and of fiscal discipline. Thus the EMU institutional design does not create a trade-off between “rigour and flexibility”, but is inducive to stability and growth (see e.g. Artis and Winkler, 1999, Winkler, this volume).

The Brussels consensus on the European economy, like the “Washington consensus” on the world economy as a whole, is a successful mix of various ingredients: an orthodox theoretical background, some commonly shared statements about the economy, a collection of reccomendations and prescriptions (some of which enforced by institutional agencies).

Its theoretical background can be summarized as follows. 1) Output and employment fluctuate in response to unexpected shocks in the determinants of aggregate demand and supply around a long-period trend of output (“potential output”) corresponding to full use of factors up to “structural unemployment”. 2) The economic system responds to shocks with variations in quantities in the short run because of imperfections in the organization of markets, in the transmission of information, or because of disincentives by economic agents against price changes. 3) Neither fiscal nor monetary interventions on aggregate demand are able to alter the level of potential output and the structural rate of unemployment permanently; their only effect would be to raise the average level of inflation above “core inflation”.

The other ingredients, in particular the core of the policy recommendations and prescriptions for EMU member-countries examined by this paper, apparently follow from the foregoing framework. 1) Policy makers should respond to an objective function such that (or they must be constrained so that) *fluctuations* around potential output and core inflation are minimized, without tampering with the “market” combination of potential output and core inflation. 2) European governments have shown a historical tendency towards “fiscal indiscipline”, namely a tendency i) to violate the previous general principle, ii) to fail to correct fiscal imbalances during expansions, iii) to accumulate large public debts that threaten monetary stability. 3) The creation of a common single currency has thus required a specially tailored institutional setup based on two pillars: i) a single and constitutionally independent MA *vis-à-vis* national fiscal FAs, ii) the constitutional constraints on national public budgets envisaged by the Maastricht Treaty and enforced by the SGP. 4) These constraints do not impair, indeed they are conducive to, macroeconomic stabilization at the national level because i) symmetric shocks are tackled by centralized monetary policy; ii) asymmetric shocks can be adequately managed by “letting the automatic stabilizers work”; iii) historical evidence suggests that the existing stabilizers in EMU countries enable them to manage most of the shocks within the budget limits set by the SGP, provided that the budget is on average “close to balance or in surplus”.[1]

My aim is to assess this EMU *Weltanschaaung*. In particular, since macroeconomic stability figures prominently on the Brussels agenda, I will examine whether its policy guidelines can indeed ensure macroeconomic stability for well-behaving governments. Though a number of empirical questions are involved, I will focus mainly on theoretical foundations with the help of a macroeconomic model, put forward in section 2, which reproduces the essential features of the Brussels consensus recalled above. Subsequently, in sections 3 and 4 I will address two key questions among the Brussels policy guidelines:

- Is the policy-mix between common monetary policy and national automatic stabilizers optimal?
- Should national discretionary fiscal policies be banned or constrained?

Section 5 concludes the paper with my main contention, namely that well-behaving governments cannot take it for granted that complying with rules will deliver optimal stabilization. The euro-area institutional apparatus may well be the right shelter against fiscally irresponsible governments - a point which is not discussed here - yet the Brussels consensus underestimates its costs *vis-à-vis* its alleged benefits.

2. The background model

2.1. Economic structures

The macroeconomic stabilization issues in the EMU will be discussed by means of a model of the so-called AD-LM-AS type[2]. The EMU consists of two representative countries (i = 1, 2). The two countries have the following common characteristics:

- each produces a single good – partly consumed, partly exported. The two goods are differentiated and each may be exported within the EMU or to the rest of the world (ROW)
- perfect capital mobility
- no labour mobility, and structural unemployment (NAIRU > 0) in each country, with a degree of stickiness of nominal wage adjustment after unexpected inflation changes
- a common currency and monetary authority (MA) and a common money market, but independent fiscal authorities (FA).

  The ROW is not specified except for the following characteristics in relation to the EMU:
- mobility of commodities and capital;
- absence of labour mobility;
- free floating currency regime;
- uncovered interest parity.

The model is fully specified in the Appendix, whereas only the essential elements for the analysis that follows are set out in the main text. All the variables are defined as log-linear *stochastic deviations from long-period equilibrium values* due to demand (δ) or supply (ε) random shocks[3]. The model encompasses six equilibrium conditions: for output and money in each country, for money in the EMU as a whole, and uncovered interest parity with the ROW. Therefore, six endogenous variables can be determined:

- output (z_i) and inflation (π_i) short-run fluctuations (“gaps” for short) for each country
- the interest rate (r) and euro rate (x) fluctuations for the EMU as a whole

2.2. Institutions

Experts in this field may note that assessment of economic policy and institution design in EMU has thus far focused mostly on the assumption that policy-makers are *not* “naturally” disciplined, and that the EMU institutional design must therefore be assessed in its capacity to prevent the distortions that may be created by “undisciplined” policy makers. In particular, the MA and the FAs may have conflicting preferences and/or targets in the inflation-employment dilemma. The FAs are typically portrayed as being less (or not) inflation-averse and more (or totally) unemployment-averse relative to the MA, and/or as having an output (employment) target greater than the equilibrium potential output (employment). Assuming that policy makers pursue their goals by means of aggregate demand instruments, policy games may result in macroeconomic equilibria which are sub-optimal for the economy.[5] Only recently has research started to investigate how EMU might perform under the stabilization profile once all policy makers have indeed been “disciplined”: examples are the papers by De Grauwe (2000b), Dixit and Lambertini (2001), Buti et al. (2001).

This new approach is important for various reasons. Firstly, EMU is, hopefully, an enduring institution, and in the long run actors’ preferences may evolve under the effect of a given set of rules. If it is true that an insititution like the SGP supports macroeconomic equilibria that are Pareto superior to those that would emerge under undisciplined policy makers, one may expect that in the long run the democratic process will eliminate them from the system. Will that same institution then still ensure optimal macroeconomic equilibria?[6] Secondly, and more informally, the Brussels consensus is a collection of practical recommendations aimed at reassuring governments that the EMU rules are not in conflict with – and indeed are a precondition for – successful macroeconomic stabilization. As emerges quite clearly from a recent paper by Buti et al. (2003), these recommendations are, roughly speaking, part of a “stick and carrot” pedagogical strategy towards governments. Hence, public opinion is rightly interested in seeing whether, after the stick, the carrot will in fact be delivered.

Therefore the model further characterizes the EMU system with two stylized institutional features. First, it is assumed that all policy-makers operate in a *pure stabilization regime*. That is, they agree upon the levels of potential output and core inflation, and they only pursue stabilization of relative output and inflation gaps (they are free from “inflation bias”), though they may differ as to the relative weight of the two targets (Dixit and Lambertini (2001) call this regime “monetary-fiscal symbiosis”). Second, government budgets in each country are structurally balanced and only temporary deviations are allowed within the limits set by the SGP.

As regards the central MA, we simply assume a standard quadratic loss function

(2.1) $L^M = \pi^2 + \beta z^2$

where $\pi = \Sigma\pi_i/2$ and $z = \Sigma z_i$ are the inflation and output gaps in EMU as a whole, and β measures the weight of output instability relative to the weight of price instability normalized to 1. Hence $1/\beta$ measures inflation aversion.

The MA controls the EMU money market, the equilibrium condition of which requires equality between changes in aggregate money demand, $\Sigma m^d_i = \Sigma(\pi_i + m_z z_i - m_r r)$ and money supply. The latter is the change in the stock of outside money m net of the aggregate supply of bonds, which is given by government budget imbalances g_i ($g_i > 0$ denotes a surplus). Hence, monetary requilibrium requires (see Appendix)

(2.2) $\Sigma(\pi_i + m_z z_i - m_r r) = m + \Sigma g_i$

The MA can either control m or control r directly by means of the official discount rate. Here this level of detail is not necessary, and I shall treat r as the control variable. In turn, r affects aggregate demand through two channels: the interest-sensitive component of domestic demand and the euro-sensitive component of extra-EMU exports.

As regards national FAs, these have two instruments that can be activated in response to shocks: “automatic stabilizers” and “discretionary” budget policies. The automatic stabilizers are such that the budget has an elasticity g_z relative to fluctuations in economic activity z_i. Discretionary policies are simply specific post-shock budget measures denoted with g'. Therefore, deviations of each country’s government budget from structural balance can be written as:

(2.3) $g_i = g' + g_z z_i$

and added one to one to aggregate demand. The FAs share the same loss function as the MA up to a possible difference in the relative weight of the two targets, i.e.

(2.4) $L^F = \pi^2 + \phi z^2$

Finally, a convenient property of the pure stabilization regime is that, whatever the policy-makers preferences, the rational expectation of future values of output and inflation coincide with their “committed” long-run values. Consequently, under the above assumption, the rational expectation of inflation gaps in EMU is zero.

2.3. The core equations

After a shock, the markets for output in each country equate (shifts of) aggregate demand and supply and determine the ensuing (unanticipated) inflation and output gaps, π_i and z_i which are given by the following equations ($i = 1, 2; j \neq i$)

(2.5) $z_i = -\Theta_1 g'_i - \Theta_2 g'_j - \Theta_3 r + \Theta_1 \delta_i + \Theta_2 \delta_j + \Theta_4 \varepsilon_i$

(2.6) $\pi_i = -\Theta_1 g'_i - \Theta_2 g'_j - \Theta_3 r + \Theta_1 \delta_i + \Theta_2 \delta_j - \Theta_5 \varepsilon_i$

where Θ_1 is the domestic demand multiplier, Θ_2 is the foreign demand spillover, Θ_3 is the interest-rate elasticity of output, Θ_4 is the domestic-supply output multiplier, Θ_5 is the domestic-supply price multiplier[7], and are all positive.

Therefore, in case of demand shocks,

- the output gap in each country has the same sign as the shock
- the inflation gap in each country is equal to the output gap
- a shock in one country is transmitted to the other through the foreign demand spillover Θ_2; thus, even a shock in one single country ($\delta_i = 0$, $\delta_j \neq 0$) has effects on both.

In the case of supply shocks,

- the output and inflation gaps in each country move in opposite directions on impact of the domestic shock

The above equations include unspecified changes in each government's discretionary budget, g'_i, and in the EMU interest rate, r. These variables are left to further analysis of stabilization policies.

3. Is the policy-mix between common monetary policy and national automatic stabilizers optimal?[8]

The recommended policy mix by the Brussels consensus hinges on two well-known claims. 1) The ECB will cope with symmetric shocks leaving the task of coping with domestic asymmetric shocks to national governments. 2) National governments will have sufficient scope for fiscal stabilization within the SGP limits if they "set sufficiently ambitious budget targets and let the automatic stabilizers work" (Buti et al. (1998), Buti and Sapir (1998), Artis and Buti (2001))[9].

The strong preference for automatic stabilizers has been clearly spelt out in a recent paper by Brunila et al. (2002). The theory of macroeconomic policy of the last two decades challenges the traditional prescriptions of optimal currency areas, vigorously stressing the need to enforce fiscal discipline by means of constitutional constraints and rule-based policy schemes. Moreover, a number of influential - though controversial - studies have tried to show that the alleged “Keynesian” stabilization effects of fiscal macro-policies are almost non-existent in the short run and are negative in the long run. In a monetary union, it has been added, a budget deficit in one member country exerts negative spillovers in all the others also in the short run, because it forces the common interest rate to rise. The Maastricht Treaty and the SGP are patently debtors to this intellectual climate, and the recommendation to rely on automatic stabilizers for domestic stabilization purposes is presented as a sort of compromise which keeps counter-cyclical fiscal policy within the boundaries of rule-based policy schemes.

The Brussels recipe has, surprisingly, been subject to scant theoretical investigation. Confidence that it will work mainly rests upon empirical arguments put forward, first, by various studies reassessing the stabilizing capacity of fiscal endogenous mechanisms (which have, however, produced controversial results: see e.g. Wyplosz (1999), Mélitz (2002), Brunila et al. (2002)), and second, by the so-called “counterfactual” studies showing that, had the SGP rules been in place in the past decades, the present members of the EMU would have found no major difficulty in stabilizing their economies in most of the observed recessions (e.g. Buti et al. (1997), Buti and Sapir (1998), Eichengreen and Wyplosz (1998)). At any rate, it is added, in case of unusual recessions escape clauses have been devised in the SGP.

Despite its apparent appeal, this practical approach to the problem has several pitfalls. The most serious one is that it projects the past experience of the EMU countries into a completely different institutional setup and macroeconomic structure. To say the least, in the past these countries have been able to rely on fiscal policy as well as on independent monetary policy and exchange-rate fluctuations or realignments. Moreover, their fiscal systems were more pervasive than they are now and will be in the future. Hence, a country’s fiscal stabilization capacity that proved adequate in the past may no longer be such in EMU. Secondly, a mere quantitative measure of stabilization capacity is of little interest if it is not assessed against the policy-makers’ objectives, and this reqiures a more careful theoretical investigation of the problem. Finally, the above-mentioned studies focus on domestic stabilization alone, whereas participation in an economic and currency union adds minimization, after shocks, of the dispersion of national incomes around the EMU average. Since this typical task of federal fiscal systems - “cohesion” in the Brussels jargon - seems to be left unattended in EMU, prevention of divergence among the EMU economies may be lacking.[10] In the subsequent part of the paper I will substantiate these weaknesses by means of the macro-model presented previously.

3.1. Asymmetric shocks and national automatic stabilizers

A crucial issue in currency-areas analysis is the extent of dissimilarity in economic structures across countries. Two main dimensions of comparison are relevant: the first is the degree of asymmetry in exposure to shocks, the second is asymmetric transmission mechanisms of shocks or policy variables. Here I will focus on the first aspect only[11], so that the two countries are assumed to be structurally identical though subject to shocks that may differ in amplitude. Most of the literature considers two polar cases: the same shock in all countries ("symmetric shock") or one shock in one country ("asymmetric shock"). More recent works (e.g. De Grauwe (2000b), Cooper and Kempf (2001), Dixit and Lambertini (2001)), allow for a more general representation of shocks distribution across the EMU by introducing the degree of correlation of shocks. If var(ω_i), $\omega_i = \delta_i$, ε_i, is the variance of demand or supply shocks in country *i*, and cov($\omega_i\omega_j$) is the covariance of the same shocks in two countries, then if we observe ω_1 in country 1, we may expect, up to some random error, to observe also

$$E(\omega_2) = \rho\omega_1$$

in country 2[12]. Consequently, shocks may be

- *symmetric*: $\omega_i \neq 0$, $\rho = 1$
- *asymmetric*: $\omega_i \neq 0$, $-1 < \rho < 1$
- *unilateral*: $\omega_i \neq 0$, $\rho = 0$

To begin with, let us focus on automatic stabilizers alone as prescribed by the Brussels recipe ($g'_i = 0$). As can be checked in the Appendix, automatic stabilizers operate through their elasticity g_z to output fluctuations in the shock multipliers, with different effects on output and inflation in the case of demand or supply shocks. A larger g_z dampens the effect of a demand shock on both output and inflation, whereas it dampens the effect of a supply shock on output at the cost of amplifying the effect on inflation. It is worth noting that automatic stabilizers respond to changes in output, employment and incomes and not to the shocks themselves. Hence they may smooth output fluctations *once they are in progress*, but they cannot counteract the shocks that give rise to fluctuations.[13]

As argued above, the quantitative degree of stabilization per se yields little information if it is not assessed against the policy-makers' objective functions. The central MA’s objectives are represented by the loss function (2.1). On the other hand, automatic stabilizers exclude discretionary fiscal policy by definition, so that it is pointless to assume an explicit loss function for national governments. Yet it would be misleading to proceed as if any degree of stabilization would be fine. To grasp this critical point, let us consider the following thought experiment.

Let us assume that, for stabilization purposes, the *existing* automatic stabilizers in each member country, as measured by the parameter g_z, reflect the historical institutional equilibrium between the FA and its respective *national* MA. Also, let the latter’s objective function be equal across countries and no less inflation-averse than the central MA. Thus, the only relevant difference in the transition to the EMU is the exchange of the national for the common central bank (the stabilization tool kit still being automatic stabilizers and monetary policy). Hence, given equations (2.5)-(2.6), we can take as the stabilization benchmark for each country the (Nash) optimal interest-rate policy that would be obtained by minimizing the following loss function

(3.1) $$L_i^{\,M} = \pi_i^2 + \beta_i z_i^2$$

where $\beta_i = \beta$.

As far as demand shocks are concerned, the optimal stabilization of output and inflation in the two countries would be

(3.2) $$z^*_1 = \pi^*_1 = 0$$

(3.3) $$z^*_2 = \pi^*_2 = 0$$

which implies the following interest rate adjustments:

(3.4) $$r^*_1 = \frac{\Theta_1 + \rho\Theta_2}{\Theta_3}\delta_1$$

(3.5) $$r^*_2 = \frac{\rho\Theta_1 + \Theta_2}{\Theta_3}\delta_1$$

That is, in case of a correlated demand fall in the two countries ($\delta_1 < 0$, $\rho > 0$), each would choose to cut the interest rate proportionally to the domestic and the imported shock.

Turning to supply shocks, the optimal stabilization in the two countries would be:

(3.6) $$z^*_1 = \frac{1}{1+\beta}\varepsilon_1 \quad , \quad \pi^*_1 = -\frac{\beta}{1+\beta}\varepsilon_1$$

(3.7) $$z^*_2 = \frac{1}{1+\beta}\rho\varepsilon_1 \quad , \quad \pi^*_2 = -\frac{\beta}{1+\beta}\rho\varepsilon_1$$

with the following interest-rate adjustments:

$$(3.8) \qquad r^*_1 = \left[\frac{\beta\Theta_4 - \Theta_5}{\Theta_3(1+\beta)}\right]\varepsilon_1$$

$$(3.9) \qquad r^*_2 = \left[\frac{\beta\Theta_4 - \Theta_5}{\Theta_3(1+\beta)}\right]\rho\varepsilon_1$$

Hence in the case of a correlated negative supply shock, both countries would choose to raise the interest rate proportionally to the domestic shock trading off the fall in output with the rise in inflation according to the parameter β.

These results clarify the point made in the previous paragraph. The degree of stabilization induced by the automatic stabilizers, no matter whether it is “high” or “low”, should be regarded as *one component* of the optimal stabilization process, which would require the joint activation of national monetary policy. Comparison of the resulting values of z^*_i and π^*_i with those obtained with automatic stabilizers alone (equations (2.5)-(2.6)) measures the extent to which the latter are sub-optimal. We therefore reach our first conclusion, namely that *automatic stabilizers cannot by themselves optimally stabilize either output or inflation at the country level, under both types of shocks and for any degree of cross-country correlation of shocks.*

In other words, this conclusion extends the central claim of optimal currency areas to automatic stabilizers: if a country is deprived of the monetary policy-instrument it cannot stabilize optimally in the face of asymmetric shocks, unless an appropriate fiscal instrument is activated. Contrary to the Brussels consensus, this instrument does not consist in automatic stabilizers alone.

3.2. Common monetary policy and optimal stabilization

Closer inspection of the model reveals that it is unlikely that national governments are left alone even in the face of unilateral shocks. This, notice, fortunately contradicts the Brussels view that there should be a clear-cut division of tasks between the ECB and national governments. It is true that the ECB has the statutory mandate to abstain from country-specific interventions, but, as pointed out in paragraph 3.1, cross-country spillovers spread shocks throughout the euro-area, even those originating in one single country. This phenomenon can easily be seen by computing EMU aggregate values of output and inflation gaps from equations (2.5)-(2.6). Since $z = \Sigma z_i$ and $\pi = \Sigma\pi_i/2$, we obtain, in the case of demand shocks

(3.10) $z = -2\Theta_3 r + (\Theta_1 + \Theta_2)(1 + \rho)\delta_1$

(3.11) $\pi = -\Theta_3 r + (\Theta_1 + \Theta_2)\frac{1+\rho}{2}\delta_1$

and in the case of supply shocks

(3.12) $z = -2\Theta_3 r + \Theta_4(1 + \rho)\varepsilon_1$

(3.13) $\pi = -\Theta_3 r - \Theta_5 \frac{1+\rho}{2}\varepsilon_1$

Consequently, the EMU-wide impact of *asymmetric* shocks ($\rho < 1$) is never nil, not even in the case of a unilateral shock ($\rho = 0$). Of course, the impact is highest in the case of symmetric shocks ($\rho = 1$)[14]. Therefore, we should expect the ECB to intervene even within its statutory mandate. Miminization of the relevant loss function yields, in the case of demand shocks,

(3.14) $z^* = \pi^* = 0$

(3.15) $$r^* = -\left(\frac{\Theta_1 + \Theta_2}{\Theta_3}\right)\frac{(1+\rho)}{2}\delta_1$$

and in the case of supply shocks,

(3.16) $$z^* = \left(\frac{1}{1+\beta}\right)\frac{1+\rho}{2}\varepsilon_1, \quad \pi^* = -\left(\frac{\beta}{1+\beta}\right)\frac{1+\rho}{2}\varepsilon_1$$

(3.17) $$r^* = \left[\frac{\beta\Theta_4 - \Theta_5}{\Theta_3(1+\beta)}\right]\frac{1+\rho}{2}\varepsilon_1$$

The result of the central MA’s intervention is twofold. On the one hand, it supplements national automatic stabilizers. Consider the simple case of a demand fall in country 1 ($\delta_1 < 0$, $\rho = 0$) in equation (2.5). Domestic automatic stabilizers smooth the impact of δ_1 by downsizing the relevant parameter Θ_1. Then, the MA also reduces r^* according to equation (3.15). This reduction of r^* sustains z_1 as shown by equation (2.5). On the other hand, from country 1’s viewpoint stabilization is still sub-optimal. In fact, substituting r^* in equation (2.5) yields $z_1 = (\Theta_1 - \Theta_2)\delta_1 < 0$. The reason can be seen by comparing r^* in equation (3.15) with r^*_1 in equation (3.4): the interest-rate cut which is optimal for the EMU is too small for country 1. Not surprisingly, the opposite occurs in country 2.

The reader can easily check that this pattern can be extended to supply shocks and to any degree of asymmetry up to perfect symmetry ($\rho = 1$), when the MA's optimal stabilization coincides with those of each single country. We thus obtain a second important conclusion. *In the event of asymmetric shocks of any degree, cross-country spillovers elicit monetary stabilization of EMU variables with positive feedback on domestic variables; yet the joint operation of common monetary policy and national automatic stabilizers is still insufficient to stabilize each single country optimally.*

Also this conclusion can be traced back to the optimal currency areas debate as an instance of the problem known as "one-size policy may not fit all". We have seen that this problem is important for EMU too (see also Dornbusch et al., 1998, and De Grauwe, 2000b). Common monetary policy is able to offer some relief to the economies under asymmetric shock but not up to the optimal extent. How harmful the deviation from optimality may be is largely a country-specific empirical matter. Thus, in practice, the Brussels optimism about stabilization capacity in the EMU might be rescued, albeit in an unintended way that circumvents the alleged division of tasks between ECB and national governments. However, the model shows that the more asymmetric the shock (the smaller is ρ), the weaker the signal received by the ECB at the EMU level, and hence the weaker its response. Hence smaller, idiosyncratic countries are more likely to be left alone in the face of asymmetric shocks, in which case the conclusion of paragraph 3.1 applies.

3.3. The "cohesion" problem

Little attention has been paid in the literature to the fact that sub-optimality of stabilization at country level is undesireable not only for the countries involved but also for the EMU as a whole. One implication of the result presented above is that output gaps tend to be divergent across countries over the cycle threatening "cohesion" acroos the union.

Farina and Tamborini (2004), presents a statistical estimate of the degree of "cohesion" provided by the existing fiscal systems of EMU member countries. We have followed the methodology developed by the literature on fiscal stabilization in multi-level fiscal systems (see e.g. Von Hagen (1992), Goodhart and Smith (1993), Bayoumi and Masson (1995)). In our case, we have regressed the per-capita national *disposable* income in each country *relative to the average of per-capita income* on the same ratio computed with gross income. The estimated coefficient yields the statistical correlation between the two variables: high correlation indicates the "after-state-intervention" persistence of a shock to the initial relative income position of each country; low correlation indicates that the initial shock is absorbed by national fiscal stabilization *vis-à-vis* all other countries. We have employed different econometric techniques and different specifications of fiscal stabilization on a sample of euro and non-euro EU countries over the last thirty years.

If we consider the estimated coefficients associated with overall fiscal interventions (taxes + social contributions - transfers), we cannot reject the hypothesis that for the large majority of EU countries - with the exception of Sweden, Denmark, Germany and the United Kingdom - the coefficient is statistically equal to, or greater than, unity. Hence, in these countries, the overall impact of fiscal stabilization preserves negligible cohesion over the cycle or may even magnify, rather than reduce, post-shock per-capita income divergence *vis-à-vis* the EU average. This finding warns that the extension of past “do-it-yourself” fiscal stabilization in EMU without a proper cross-country stabilizing system may yield insuffcient “cohesion” of relative incomes over the cycle.

4. Should discretionary national fiscal policies be banned or limited?[15]

The flimsiness of the anti-cyclical shield provided by automatic stabilizers has revived scientific interest in, and the dignity of, “discretionary” fiscal policies for EMU members[16]. This change of attitude has also been favoured by empirical studies, already mentioned in previous parts of the paper, which have eroded the premises of the Brussels consensus by showing that i) there is no strong evidence of systematic pro-cyclical mismanagement of public budgets, nor of a persistent tendency for monetary-fiscal policies to conflict, ii) the so-called “non-Keynesian” effects of active fiscal policies cannot be generalized, iii) the stabilization capacity of automatic stabilizers alone is limited. It should be added that, while the distinction between automatic stabilizers and “discretionary” interventions is clear in theory, in practice it is not so easy to detect,[17] so that it seems more sensible to assess overall anti-cyclical fiscal measures as related to governments’ budget choices. Of course, the traditional technical limits attributed to this kind of policies (long and variable lags, etc.) should not be overlooked. However, these limits on the grounds of efficacy are different in nature from the objections raised *in principle* against discretionary fiscal policies in the EMU literature. The latter are my aim in this section. Since the problem of optimal stabilization at the country level arises for asymmetric shocks, I will focus on this case only.

The theoretical benchmark is now offered by the above-mentioned works by Dixit and Lambertini, who have set the conditions whereby discretionary fiscal policy is consistent with optimal global-local stabilization in a monetary union. They show that the essential point is agreement between the central bank and the national governments on "ideal output and inflation", even though they may disagree on the relative weight of the two objectives (Dixit and Lambertini (2001, p.977)). Analogous conclusion has been reached by Buti et al. (2001). Relative to the Brussels consensus, this result has a twofold implication. On the one hand, it (conditionally) re-habilitates national discretionary fiscal policies as an optimal stabilization instrument in a monetary union. On the other, it restores confidence in the stabilization capacity built into the present EMU institutional design. I will discuss these two points in turn.

4.1. Optimal discretionary national fiscal policies

In the first place, let us re-examine the issue of optimality of stabilization in this new setup where the discretionary part of the public budget (g'_i) can be activated. The main difference with respect to only automatic stabilizers is that the national FAs can now choose the optimal budget g^*_i *in relation to the observed shock*, which will thus consist of the endogenous part $g_z z_i$ and the discretionary part g'_i. For simplicity we can drop the former part and treat the whole optimal budget as subject to government's choice. Consequently, we should now introduce the FA's objective function (2.4).

Let us consider the post-shock equations (2.5)-(2.6). As long as the central bank does not intervene, the common interest rate r is affected endogenously by the aggregate budget imbalances, Σg_i (see equation (2.2)). Upon endogenizing r, equations (2.5)-(2.6) are as follows:

(4.1) $$z_i = -\Delta_1 g_i - \Delta_2 g_j + \Delta_3 g + \Delta_1\delta_i + \Delta_2\delta_j + \Delta_4\varepsilon_i$$

(4.2) $$\mathrm{p}_i = -\Delta_1 g_i - \Delta_2 g_j + \Delta_3 g + \Delta_1\delta_i + \Delta_2\delta_j - \Delta_5\varepsilon_i$$

where $g = \Sigma g_i$, and all parameters are positive.

Now the overall effect, internal and external, of a budget imbalance depends on two crucial factors: i) a demand effect (Δ_1 internally and Δ_2 externally), ii) a financial effect via common interest rate (Δ_3 both internally and externally), inclusive of a composition effect due to the other country's fiscal stance.[18]

After substituting the expressions of z_i and π_i for each type of shock into the loss function, minimization of this function with respect to g_i yields the vector of national optimal budgets g^*_i. In the case of demand shocks, we obtain

(4.3) $z^*_1 = \pi^*_1 = 0$

(4.4) $z^*_2 = \pi^*_2 = 0$

(4.5) $$g^*_1 = \frac{2m_r - y_{rq}(1-\rho)}{2(m_r - y_{rq})}\delta_1$$

(4.6) $$g^*_2 = \frac{2\rho m_r + y_{rq}(1-\rho)}{2(m_r - y_{rq})}\delta_1$$

where m_r is the interest elasticity of money demand and $y_{rq} = y_r + y_q(1 - \alpha)$ is the crowding-out coefficient that determines the financial effect of budget imbalances (see fn. 18).

This result proves that, *with no central-bank intervention, the optimal stabilization problem has a simultaneous (Nash) solution for all countries, for any kind of shock and any degree of correlation of shocks*.

First, if $m_r > y_{rq}$, a condition which is likely to occur in a currency union (see again fn. 18), then "Keynesian" policies are the optimal choice in both countries - i.e. policies such that a negative schock calls for a budget deficit. Second, the extent of optimal fiscal imbalances in turn depends on the magnitude of ρ, with the absolute value of g^*_i *increasing* with *r* in both countries. This means that highly correlated negative demand shocks across countries require *larger* deficits in all countries. Third, if any one government faces a budget constraint, the other is *damaged* by the excess demand shock transmitted by the former and is forced to have a *larger* deficit in order to counteract it. Note, therefore, that the pro-SGP argument that deficit ceilings are beneficial to all because they limit negative fiscal spillovers cannot be accepted *a priopri*.[19]

4.2. Common monetary policy vs national fiscal policies

The foregoing considerations can, *mutatis mutandi*, be extended to supply shocks. However, under these events, an interesting additional question is whether the *aggregate outcome* of optimal discretionary fiscal policies is also optimal for the central MA. In the case of demand shocks just examined the answer is yes, as the MA would also choose $z = 0$, $\pi = 0$. Yet one may wonder whether this holds true also when supply shocks raise the output-inflation trade-off. Repeating the previous exercise for supply shocks, the aggregate values of the output and inflation gaps after national fiscal stabilization are:

(4.7) $$z^F = \left(\frac{1}{1+\phi}\right)\frac{1+\rho}{2}\varepsilon_1,\ \pi^F = -\left(\frac{\phi}{1+\phi}\right)\frac{1+\rho}{2}\varepsilon_1$$

Two observations are in order.

The first is that these values are identical to those obtained by the central MA *provided that the relative weight of the two targets is equal in the respective objective functions* (compare with equations (3.16)). This is at variance with Dixit-Lambertini's claim that the relative weight is irrelevant. However, what kind of conflict would then arise between national FAs and central MA? Comparison of equations (3.16) and (4.7) shows that, were the weights ϕ and β different, the sole discrepancy would be in the relative *variability* of output and inflation, with no long-lasting effects on core inflation and potential output.[20] The problem therefore concerns not the determination of core inflation but what Taylor (1998) calls the output-inflation *variability* trade-off. According to Taylor, economic policies should *first and foremost* be ranked for their ability to minimize core inflation and miximize potential output[21], and *secondly* for their location along the best variability trade-off curve. Hence, if the focus falls on long-run *levels* of output and inflation, it is indeed correct to conclude that *no distortion*, in Taylor's sense, would arise from discretionary national fiscal polices in a pure stabilization EMU regime.

Is the remaining potential conflict about variability important? Since the alternative is between two non-distortionary policies as regards core inflation and potential output, the question has no uncontroversial answer, nor are there solid grounds for restraining national governments. In principle, the Brussels recipe (with the more general principle of subsidiarity enshrined in the Maastricht Treaty) cuts the knot: the ECB should refrain from intervening in asymmetric shocks, hence governments' preferences about domestic output-inflation variability would prevail. Yet I have argued above that this is an abstract principle which may not be followed in practice. If the ECB dislikes the variability of aggregate output and inflation generated by national fiscal policies, it may be induced, and legitimated, to intervene. The consequence of all policy-makers trying to optimize simultaneously can be examined by solving the system

$$\text{(4.8)} \qquad \begin{array}{l} min_{g_i} \quad \pi_i^2 + \phi z_i^2 \\ min_r \quad \pi^2 + \beta z^2 \end{array}$$

The unpleasant result of the model is that *there is no solution*. Suppose $\phi>\beta$; then, if the ECB does not intervene, $\pi^F > \pi^M$, that is, national fiscal policies create excess variability of EMU inflation according to the ECB. As is intuitive, the latter reacts by raising the interest rate. This, in turn, induces governments to counter-act by expanding fiscal deficits. The result of the model means that this process does not converge, with the common interest rate and national fiscal deficits being under unbounded pressure.

From this point of view, insisting on solipsistic and single-minded central bankers may be unwise (Blinder (1996)). Likewise, the presence of many national FAs, to the extent that they have different preferences regarding variability, makes the search for the EMU bliss point harder. On the other hand, one may hope that Taylor (1998) is right in arguing that conflicts about the output-inflation variability trade-off may, in practice, not be dramatically important, since world-wide historical evidence suggests that policy-makers’ preferences in developed countries are quite close and lead, in the long-run, to balanced patterns of output and inflation variability.

5. Conclusions

Let me simply summarize the main points of this chapter as answers to the questions put forward in the introduction.

1) The “division of labour” between the ECB coping with symmetric shocks and national governments relying on fiscal automatic stabilizers to handle asymmetric shocks may well have many virtues, but it cannot be recommended as an effective stabilization policy mix. In fact:

- in the event of any kind of shock with any degree of correlation among countries, automatic stabilizers alone cannot guarantee optimal stabilization at the country level
- even the joint operation of central monetary stabilization and national automatic stabilizers delivers optimal stabilization to each economy only if a symmetric shock occurs
- in all other cases, national inflation and output gaps remain sub-optimal, and may tend to be divergent in sign, threatening EMU “cohesion” over the cycle.

2) As an alternative, I have examined the stabilization problem under asymmetric shocks if allowance is made for discretionary national fiscal policies. In principle, if national governments share the same objective function with the ECB, and if they are free to optimize their budget choices after a shock is observed, all countries will be able to achieve optimal stabilization for any kind of shock and degree of correlation of shocks, with no need for ECB intervention and policy co-ordination. Any budget constraint imposed onto governments would lead to sub-optimal outcomes either locally or globally.

3) My answer to the question whether complying with the stick of

recommended policy guidelines will earn the carrot of optimal stabilization is that, theoretically, it will not. Confidence that in practice the whole system may operate reasonably well has so far been based on highly questionable, backward looking, empirical arguments. The first serious road test represented by the euro-area's response to the post-2001 world downturn, with two "virtuous" members like France and Germany being unable to meet the SGP requirements, does not seem encouraging.

A natural further question arises, however: Why does the EMU apparatus inhibit and constrain discretionary national fiscal policies if these are the sole consistent solution to optimal stabilization? The strong preference for automatic stabilizers *versus* discretionary fiscal policies, and the imposition of deficit ceilings, only rely on the presumption that governments typically have objective functions inconsistent with monetary stability and fiscal discipline. The model has shown that it is necessary to consider what this alleged inconsistency is all about. If national governments attach, say, more weight to output *variability* than does the ECB, but if they all still share with the ECB the same targets of core inflation and potential output, no distortion arises in the determination of the long-run *levels* of inflation and otuput in EMU as a whole. Eventually, there only remains the case that governments are indeed not well-behaved in that they endemically aim at output target(s) inconsistent with the ECB core-inflation target in the long run. In other words, the EMU system has not been designed to host well-behaved national governments, and the sole serious argument for preserving it in its present form is that the architecture of the system provides the best shield against bad fiscal behaviour. My aim here has not been to tackle this view. Though still controversial both theoretically and empirically, it has to be taken seriously and may prove to be right. My only final contention is that the EMU institutions have the duty to be more explicit about i) the *existence* of a trade-off between "rigour and flexibility" in EMU, and ii) the *actual exchange of flexibility for rigour* of which member countries should be aware and ready to accept.

Appendix

A1. List of variables

All variables are log-linear stochastic deviations from long-run equilibrium values. All shocks are i.i.d. with zero mean. Countries are indexed with $i = 1, 2$:

π_i inflation rate
y_i aggregate demand
g_i government budget imbalances
δ_i demand shock
z_i output
m^d_i money demand
m_i money stock
λ_i money demand shock
μ_i money supply shock
q_i terms of trade (effective real exchange rate)

EMU:
r interest rate
π, π^e inflation and expected inflation
z output
m money supply
x, x^e change, and expected change, in the euro exchange rate (euro price foreign currency)

ROW:
r_w interest rate
π_w, π^e_w inflation and expected inflation

A2. The model

The core of the model consists of the following stochastic-deviation equations for each country $i = 1, 2$, $i \neq j$

Aggregate demand

(A1.) $$y_i = - y_q q_i + y_z z_j - y_r(r_i - \pi^e) - g_i + \delta_i$$

which depends on terms of trade q_i, foreign output gaps z_j, real interest rate $(r_i - \pi^e)$, government imbalances g_i, exogenous shocks δ_i.

Terms of trade (effective real exchange rate)

(A2.) $q_i = \alpha(\pi_i - \pi_j) + (1 - \alpha)(\pi_i - (x + \pi_w))$

which is calculated as the weighted average of the terms of intra-EMU trade, $\pi_i - \pi_j$, and extra-EMU trade, $\pi_i - (x + \pi_w)$, where α is the weight of intra-EMU trade. Fluctuations in the euro exchange rate x are ruled by uncovered interest parity with the ROW, $x = r_w - r + x^e$. Expected fluctuations are driven by deviations from PPP, $x^e = \pi^e - \pi^e_w$. Letting r_w and π^e_w be at their steady-state level ($r_w = \pi^e_w = 0$), the result is that $x = -r$.

Output

(A3.) $z_i = z_\pi(\pi_i - \pi^e) + \varepsilon_i$

which responds to unexpected domestic inflation (deflation), and exogenous shocks ε_i. Without loss of generality we set $z_\pi = 1$.

Money demand

(A4.) $m^d_i = \pi_i + m_z z_i - m_r r + \lambda_i$

which depends on domestic inflation π_i, domestic output gap z_i, the rate of interest r, and exogenous shocks λ_i.

Domestic money stock

(A5.) $m_i = - y_q\alpha(\pi_i - \pi_j) + y_z(z_j - z_i) + \mu_i$

which reflects the only two channels of money creation for a country in a monetary union: its balance of payments $- y_q\alpha(\pi_i - \pi_j) + y_z(z_j - z_i))$[22], and the banking channel, i.e. financing of the domestic banks by the ECB, which is here treated as exogenous shocks μ_i .

Domestic output market equilibrium in each country yields the output and inflation gaps equations:

(A6.) $z_i = -\Theta_1 g'_i - \Theta_2 g'_j - \Theta_3 r + \Theta_1\delta_i + \Theta_2\delta_j + \Theta_4\varepsilon_i + \Theta_6\varepsilon_j$

(A7.) $p_i = -\Theta_1 g'_i - \Theta_2 g'_j + \Theta_3 r + \Theta_1 d_i + \Theta_2\delta_j - \Theta_5\varepsilon_i + \Theta_6\varepsilon_j$

where

$\Theta_1 \equiv \Lambda_1[\Lambda_1^2 - \Lambda_2^2]^{-1}$

$\Theta_2 \equiv \Lambda_2[\Lambda_1^2 - \Lambda_2^2]^{-1}$

$\Theta_3 \equiv y_{rq}[\Lambda_1 - \Lambda_2]^{-1}$

$\Theta_4 \equiv y_q[\Lambda_1 - \alpha\Lambda_2][\Lambda_1^2 - \Lambda_2^2]^{-1}$

$\Theta_5 \equiv [(1+ g_z)\Lambda_1 - \alpha\Lambda_2][\Lambda_1^2 - \Lambda_2^2]^{-1}$

$\Theta_6 \equiv y_q[\alpha(1 + g_z) - y_z][\Lambda_1^2 - \Lambda_2^2]^{-1}$?

$\Lambda_1 \equiv 1 + y_q + g_z$

$$\Lambda_2 \equiv \alpha y_q + y_z$$
$$y_{rq} \equiv y_r + y_q(1 - \alpha)$$

The parameter Θ_6 rules the cross-country supply spillovers. These result from the impact of the supply shock in country *j* on exports of country *i* via i) the change in foreign output, ii) the change in the foreign inflation rate. Since output and inflation move in opposite directions exerting countervailing effects on exports, the net outcome is undetermined. To simplify an inessential part of the model, it assumed that the income and price effects are balanced, i.e. $\alpha(1 + g_z) = y_z$

NOTES

[1] See e.g. Buti and Sapir (1998) for detailed treatment of each of these points. Further relevant references will be given in the course of the paper.

[2] This class of models has been widely used by current research on stabilization policies in exchange-rate systems and currency unions. See in particular Eichengreen and Wyplosz (1993), Allsopp and Vines (1996, 1998), Allsopp et al. (1999), De Grauwe (2000b), Dixit and Lambertini (2001) to mention only a few. An earlier version of the present model has appeared in Farina and Tamborini (2002).

[3] That is, $x \equiv \log(X/X^*)$, where X^* is the log-run equilibrium value. For details on this technique see also Allsopp and Vines (1996).

[4] Given a single currency and perfect capital mobility, a single money market exists where the money stock determined by the ECB is distributed among all countries through their balance of payments. Hence payments imbalances determine changes in domestic money stocks that must be in line with domestic changes in money demand.

[5] Dixit (2001) and Dixit and Lambertini (2001) provide one of the most up-to-date treatments of the consequences of various combinations of preferences/targets conflicts among policy makers in EMU.

[6] Recent empirical studies on the so-called “monetary-fiscal policy mix” in Europe over recent decades also suggest that the theoretical concentration on targets/preferences conflicts between MAs and FAs may be due to the particular historical experience of the late 1970s and early 1980s. More generally, Buti et al. (2001) suggest that whether the monetary and fiscal instrument are used in a complementary or conflicting way depends not so much on the underlying preferences as on the nature of shocks. Muscatelli et al. (2003) find evidence in support of this view by way of econometric estimation and simulation of structural macro-policy models. The evidence examined by Mélitz (1997), Wyplosz (1999), Hughes Hallet et al. (2000) supports the view that the two policy arms have mostly been used complementarily. Farina and Tamborini (2002) have computed a measure of structural changes in the fiscal stance of the EU countries and have shown that a conflict of policy stance with the MAs probably arose between the second oil shock and the advent of the EMS, whereas the FAs returned to fiscal discipline as early as the mid-1980s.

[7] Cross-country supply spillover effects, $\Theta_6\varepsilon_j$, could also be added to each equation (see Farina and Tamborini (2004)). For simplicity, these effects are sterilized here (see Appendix).

[8] This part of the paper draws on Farina and Tamborini (2004).

[9] I will not examine here arguments based on long-run structural considerations according to which the process itself of European integration will reduce exposure to external shocks, and will foster a harmonized EU-wide business cycle with negligible local asymmetries. At any rate, this prediction is far from being uncontroversial: see e.g. Weber (1991), Bayoumi and Eichengreen (1993), Obstfeld and Peri (1998).

[10] This goal may not be strictly necessary in theory, although it is in practice pursued in all federal systems, mostly by means of inter-regional insurance and redistribution schemes, and it is in fact on the EU agenda under the heading of "social and economic cohesion" (see e.g. McDougal Report (1977), Graham and Smith (1993), Abraham et al. (1991).

[11] The second aspect is no less important than the former (and to some authors it may well be more important in EMU, especially in connection with monetary policy: see e.g. Dornbusch et al. (1998)). However, my choice is mainly dictated by the consideration that most of the curency-areas literature has concentrated on asymmetric shocks, and by the fact that, owing to the log-linear specification of the model, the difference between asymmetric shocks transmitted through symmetric structures and symmetric (policy) shocks transmitted through asymmetric structures is mainly quantitative with no major theoretical implications. For an extension of the present model to asymmetric transmission mechanisms see Farina and Tamborini (2004).

[12] For analytical tractability, demand *and* supply shocks are treated as uncorrelated both within each country and across countries. Hence, one single type of shock at a time will be examined.

[13] In this respect, this model differs from the otherwise similar (but single-country) one employed by Brunila et al. (2002). They do not include the endogenous component of the budget, but relate budgetary changes directly to observed shocks. Thus, technically, they call "automatic" what is indeed a "discretionary" variable. See also paragraph 4.3 below.

[14] There is one single case in which the EMU-wide impact is zero: $\rho = -1$. This is an interesting case, almost unnoticed in the literature, where aggregate demand or supply shift from one country to the other. A typical example on the demand side is bilateral trade (e.g. domestic demand is substituted with imports), whereas on the supply side one may think of factors movements (e.g. capital is relocated from one country to the other). For discussion of the former case see Tamborini (2001).

[15] See also Tamborini (2002).

[16] This is a more general tendency in the literature: see Taylor (2000).

[17] The output elasticity of the budget can be changed quite easily *after* a particular shock has been observed, for instance by raising the unemployment grant mechanisms or lowering marginal tax rates.

[18] The financial effect entails that a deficit in one country has a contractionary effect both domestically and abroad. This effect, which figures prominently in the pro-SGP arguments, is a traditional Mundell-Fleming open-economy crowding out. A fiscal deficit in one country raises the common interest rate and appreciates the euro rate thereby displacing domestic and foreign demand in all countries. It should be noted that there are two factors that may limit the crowding out effect in a currency union. The first is that the marginal impact of a single country's deficit on the coomon interest rate may be small. The second is that a share of the exports of each country remains within the union and is therefore unaffected by the common exchange rate (see e.g. Buiter et al., 1993, Masson and Taylor, 1993).

[19] See also Tamborini (2002), sec. 3.3.

[20] In fact, let e_i follow a normal distribution $N(0, \sigma^2 e_i)$. Then, equations (4.7) imply the following standard deviations for output and inflation

$$\sigma^F{}_z = \frac{(1+\rho)}{2(1+\phi)}\sigma_\varepsilon \quad , \quad \sigma^F{}_\pi = -\frac{(1+\rho)\phi}{2(1+\phi)}\sigma_\varepsilon$$

Analogously, equations (3.16) yield the the standard deviations for output and inflation under monetary stabilization. The four statistics are equal only if $\phi = \beta$.

[21] Taylor argues that no long-run trade-off, and possibly synergy, exists between these two targets. The issue is notoriously controversial and falls outside the scope of this paper.

[22] The above expression is the intra-EMU trade balance. In general, the overall balance of payments should be considered. However, in order to make the model more compact and manageable, we assume that the reserves in extra-EMU currency are entirely centralized at the ECB, so that imbalances in a country's extra-EMU payments do not have effects on the domestic money stock. As far as capital movements are concerned, we assume complete financial integration, so that all EMU bonds are perfect substitutes and in equilibrium pay the same interest. Consequently, only intra-EMU trade imbalances matter for domestic money creation.

Chapter 8

Stability and Growth: the Role of Monetary Policy and Other Policy Actors in EMU *

by

Bernhard Winkler

Abstract: This paper reviews some of the key principles of macroeconomic governance underlying the policy framework established under Economic and Monetary Union (EMU). This framework is based on the notion that stability is a prerequisite for sustainable growth and that both goals are best served by a clear assignment of responsibilities across different policy actors. Its conceptual underpinnings reflect both the revival of new classical ideas in the theoretical literature since the 1970s and the lessons drawn from the policy experience over recent decades. Against this background, the paper dismisses calls for a more activist approach to macroeconomic management and greater policy co-ordination.

Keywords: Macroeconomic Governance, Economic and Monetary Union, Stability and Growth Pact, monetary policy

1. Introduction

The Maastricht Treaty (and subsequent Treaty amendments and regulations) have laid down sound institutional foundations for economic policy-making in Europe. These have been essentially confirmed in the draft constitution produced by the European Convention. The competence for monetary policy is allocated to the Union level and delegated to an independent institution, the European Central Bank (ECB), which has been assigned the primary objective of maintaining price stability. Responsibilities for fiscal policies, labour market policies and structural policies – which primarily affect the determinants of output, growth and employment – largely remain rooted at the national level. At the same time, the Treaty – in conjunction with the Stability

ß The views expressed in this paper are the author's and do not necessarily reflect those of the European Central Bank.

and Growth Pact – subjects national fiscal policies to a set of common rules and surveillance procedures. This reflects the need for a common framework for sound public finances inside the currency union as an essential complement to lasting monetary stability.

Over recent years a number of observers have explicitly or implicitly challenged this basic allocation of responsibilities and objectives to different policy actors in Economic and Monetary Union (EMU). Critics of the current framework often put forth three strands of proposals. First, there are calls for monetary policy to redirect priorities to pursuing growth rather than focusing on the objective of price stability. In a similar vein it is suggested to relax the constraints of the Stability of Growth Pact in order to liberate fiscal policy to boost output. A second route to softening the clear separation of roles under the "Maastricht assignment" takes the form of calls for closer co-ordination across different policy-makers in order to achieve a balanced "policy-mix". Underlying both lines of reasoning is the notion of a trade-off between stability and growth, which would need to be taken into account either by adopting multiple objectives or via the co-ordination of policies. Finally, some observers advocate more generally a renaissance of activist stabilisation policies as opposed to the medium-term oriented rules-based framework in place, which has been dubbed the "Brussels consensus" (Tamborini, 2004) or the "Brussels-Frankfurt consensus" (Sapir et al., 2003). My own preference is to denote as "Maastricht consensus" the intellectual and legal foundations shaping the framework agreed in the early 1990s.[1]

The paper reviews the main arguments underlying the "Maastricht consensus" related to the appropriate assignment of policy objectives as well as the issues of policy co-ordination and activist macroeconomic stabilisation. Section two recalls the key issues in the long-standing debate between Keynesian and new-classical prescriptions for economic policy-making and the experience of recent decades. Section three examines the relationship between stability and growth and concludes that any trade-off – to the extent that it exists at all – cannot be exploited systematically either in the short or the long run. As regards the role of monetary policy, maintaining price stability is an essential pre-condition for the efficient allocation of resources, for sustainable growth and employment creation in the longer run. In firmly pursuing price stability with a medium-term perspective, monetary policy, at the same time, also makes its best contribution to the stabilisation of output and employment in the shorter run. As regards fiscal policy, a credible commitment to sound public finances promotes confidence, investment and growth and also allows fiscal stabilisers to work most effectively over the cycle. Section four looks at how a set-up for macroeconomic governance reflecting these ideas has been implemented in the case of European Monetary Union. Section five offers some concluding remarks.

2. Key issues for macroeconomic governance

In order to make sense of the basic institutional framework for macroeconomic governance[2] established by the Maastricht Treaty and of the continuing debate about growth vs. stability ever since, it is useful to briefly revisit some of the underlying economic concepts and implicit assumptions about the role of economic policy-making.

At the risk of gross oversimplification two main schools of thought can be distinguished. Observers steeped in the Keynesian tradition tend to espouse an “optimistic” view of policy intervention. They emphasise market failures and thus the need and scope for an activist management of the economy. Price stability and growth are seen as conflicting objectives at least in the short term (or even in the long-run) and macroeconomic policies are directed at steering aggregate demand in order to achieve an optimal trade-off. The focus is on cyclical stabilisation of the economy. Both monetary policy and fiscal policy (as well as wage policies) are seen as contributing to this task, which suggests a need for close co-ordination.

By contrast, the camp of policy “pessimists” highlights the potential for government failure rather than market failure. Drawing on new-classical propositions they are more sceptical about the effectiveness of policy intervention. Moreover, cyclical fluctuations are sometimes regarded as a natural or even beneficial feature of market economies. The long-run neutrality of money is stressed. Instead of short-run stabilisation greater emphasis is placed on appropriate incentives and credible institutional design for long-run stability. From this perspective a stable economic environment – and price stability in particular – are regarded as pre-conditions for growth. Any short-run trade-off that may exist cannot be exploited systematically and the primary responsibilities for the two objectives are best assigned to different policy makers.

The influence of these two main schools of thought has varied over time both within the economics profession and in policy circles. The 1960s were no doubt the heyday of policy optimism. Faith in macroeconomic demand management – based on the presumption of an exploitable Phillips Curve trade-off – was then severely battered in the 1970s and 1980s both by the theoretical assault of new classical economics and the dismal experience of stagflation. The Maastricht Treaty and reforms aimed at central bank independence and better control of public finances in a number of countries around the world in the 1990s reflect the new consensus and the lessons learned from the earlier experience.[3]

2.1 The assignment problem

The first fundamental issue is the assignment of different policy objectives to different policy-makers. Under the presumption of a long-run trade-off between inflation and growth, widely held until the 1970s (or if macroeconomic policies are mainly focussing on the short-run stabilisation of aggregate demand), it was regarded as natural to see monetary and fiscal policies as instruments to be used jointly and as serving the same shared macroeconomic objectives. In addition, the responsibility for keeping inflation in check was often extended or passed on to wage and income policies, in which governments were also seeking to be involved in this period. The practical experience with the Keynesian paradigm of macroeconomic demand management was disillusioning. Attempts to exploit perceived Philipps curve trade-offs typically resulted in higher inflation as well as higher unemployment in the longer run. Wage and incomes policies usually proved ineffective in holding down inflation in a sustained manner. Short-run concerns over output and employment by governments tended to crowd out the longer-run requirements for stability in the absence of strong institutional counter-weights provided by independent central banks or sufficient discipline imported via exchange rate pegs.

By contrast, the (new) classical assignment that gained currency in the 1980s and 1990s is ultimately based on the long-run neutrality of money and reflects a conceptual dichotomy between the real and the nominal side of the economy. The primary objective of price stability is assigned to monetary policy since it determines the price level but cannot affect real variables in the longer run. The growth of output is fundamentally determined by technological factors and the incentives to invest, save and consume by all agents in the economy. These factors can be influenced by fiscal policies as well as a range of structural policies. The promotion of conditions for long-term growth is thus the task of governments. Finally, autonomous wage policies determine the price and conditions in the labour market and thus the level of employment in the economy. This classical assignment – with a focus on long-run relationships – suggests a clear division of responsibilities among independent institutions. A number of arguments reviewed in the following support this assignment also as a basis for a sound medium-term framework for macroeconomic policy, even if Keynesian features of the economy mean that over shorter horizons macroeconomic variables are interdependent.

2.2. The role of credibility, rules and expectations

A first set of challenges to the traditional Keynesian paradigm of demand management – in conjunction with the reaffirmation of the long-run vertical Phillips curve and the natural rate hypothesis – relates to the role of credibility and expectations. As stressed in the new-classical models revolutionising macroeconomics in the 1970s and 1980s forward-looking economic agents forming rational expectations could in many cases counteract or neutralise the impact of macroeconomic policies. More generally, as captured in the well-know Lucas Critique, the effects of specific policy actions on the economy depend on the nature of the economic policy regime in place. For example, attempts to exploit a particular pre-existing economic relationship could become self-defeating if economic agents adapt their expectations and behaviour to take the policy makers' actions into account and thus the earlier relationship can disappear or be substantially altered. In the extreme, only idiosyncratic unanticipated policy actions have an impact on the economy, but not the systematic component of stabilisation policy.[4]

The critical role of expectations in the transmission underlines the importance of credibility for policy making. Central bank independence, a strict commitment to policy rules and a clear focus on the single overriding objective of price stability have been offered as solutions to potential time inconsistency problems in the field of monetary policy, which could arise if a single authority pursues multiple objectives in a discretionary manner (Barro and Gordon, 1983). In a similar vein the effectiveness of fiscal policy also depends on expectations in the context of intertemporal models with optimising private agents. For example, in the extreme case of Ricardian equivalence, any intended Keynesian stimulus by public deficit spending will be offset by increased private saving in anticipation of higher taxes in the future (Barro, 1974). Both for monetary and fiscal policies, potential credibility problems of discretionary actions support policy frameworks designed to discipline and constrain policymakers' freedom.

2.3. The nature of business cycles

Further doubts on the need for active stabilisation policy have come from economists emphasising real business cycles drawing on evidence that a significant part of cyclical output variability can be attributed to real rather than nominal or demand shocks (Lucas, 2003). Such real shocks are driven by innovations in technology and cannot be effectively offset by monetary policy. From this perspective, business cycle fluctuations are equilibrium phenomena that do not warrant policy intervention. On the contrary, it could even be argued that a smoothing of the cycle could be detrimental to innovation and growth if it contributes to delaying necessary structural adjustments or to the prolonging of macroeconomic imbalances.

2.4. Short-run stabilisation vs long-run stability

Apart from the advances in economic modelling through the use of intertemporal optimising models, the greater role of forward-looking financial markets and asset prices in the economy as well as the experience of accelerating deficit and debt dynamics in the 1970s and 1980s have also led to increased attention to the issue of sustainability of macroeconomic developments relative to the emphasis on cyclical stabilisation. For monetary policy the sensitivity of forward-looking financial markets underscores the need to maintain confidence and to focus on providing a reliable anchor for long-run inflation expectations. This limits the leeway to exploit any short-term trade-offs. Likewise it is increasingly recognised that sustainable public finances are a precondition of an effective working of fiscal stabilisers in the economy. If debt or deficit levels are seen as excessive and unsustainable by markets and the public at large, negative confidence effects can easily outweigh the traditional Keynesian impact from counter-cyclical policies. Again, the design of a credible and lasting policy regime becomes the dominant concern from this perspective.

2.5. Uncertainty and policy activism

In recent times, economists have started to examine more closely the role of uncertainty for policy making and the substantial informational requirements needed for a successful implementation of active demand management policies. Long, variable and uncertain lags in the policy transmission stressed by Milton Friedman have long been regarded as the key impediment to activist policies and as reasons to advocate rule-based approaches to macro-economic governance. The difficulty of “fine-tuning” the timing of economic policy measures with respect to the business cycle is also confirmed by the practical experience from the 1960s and 1970s. Recent work has focused in particular on data uncertainty regarding the measurement of key concepts like the output gap or the Philipps curve relationship as well as more fundamental model uncertainty as to the true functioning of the economy. In an environment of limited knowledge about economic relationships and parameters an activist approach to policy could easily introduce additional uncertainty into the system rather than perform a stabilising function.[5]

2.6. Political economy and institutional design

In addition to advances in the theoretical macroeconomic literature over recent decades increasing attention has also been paid to institutional details and to imperfections in the political process. Public choice theorists have long departed from the traditional assumption of a benign welfare-maximising government but institutional analysis and a greater focus on incentive structures and procedures in the policy process has only recently become more common in mainstream macroeconomic discussions. This has led to a better understanding of why experiments with text-book cyclical stabilisation have often not fulfilled expectations in practice, but have usually produced undesirable long-run effects, such as an inherent deficit bias over the cycle leading to debt accumulation over time.[6]

2.7. Accountability, transparency and policy co-ordination

The clear division of responsibilities and primary policy objectives under the classical rather than the Keynesian policy assignment and a rules-based, minimalist and medium-term approach to policy-co-ordination can also be seen as beneficial from the perspective of accountability and transparency. It should enhance performance incentives and facilitate monitoring by the public. By contrast, more ambitious attempts to co-ordinate policies in view of shorter-run interdependencies would suffer from the general shortcomings of demand management identified before. Activist policy co-ordination exacerbates information requirements regarding the timely identification of the relevant spillovers. It also raises the additional issue of credible enforcement of jointly agreed policies as well as complicating communication and diluting responsibilities. These problems would seem to be especially severe in the European context of macroeconomic governance exercised by multiple layers of responsibilities interacting at European, national and subnational levels.

3. The relationship between stability and growth: theory and evidence

The choice of the appropriate framework for macroeconomic governance depends on the relationship between the main economic variables pursued as policy objectives and how they are influenced by different policy actors. In particular, the first question is in which way monetary policy can contribute to growth as well as price stability. The second question regards the role of fiscal policy for economic growth and output stabilisation as well as its possible contribution in sustaining an environment of price stability.

3.1. The role of monetary policy

It is commonly accepted that monetary policy determines the price level in the long run, but influences both prices and real activity at shorter horizon. There is a somewhat more limited consensus that inflation affects growth adversely in the longer run and there are different views on how monetary policy should take shorter-term trade-offs into account.

As regards the long-run, the theoretical benchmark position is the long-run, neutrality of money and thus a vertical Phillips curve as posited by Friedman and Phelps. Some earlier theoretical contributions had argued for a positive relationship between inflation and long run growth based on increased capital accumulation due to portfolio shifts out of money into real capital (Tobin, 1965). In general, the theoretical results crucially depend on the way the functions of money are introduced. E.g. when the role of money as a transactions medium is highlighted – such as in cash-in-advance models (e.g. in Cooley and Hansen, 1989) or in models with money as a factor of production (Danthine, 1985) – higher inflation usually leads to lower output growth in the long run.

Overall, empirical work has not given support to the view of a long-run trade-off between growth and inflation and most studies, such as Barro (1997) and Andres and Hernando (1999), find that inflation is detrimental to growth. Evidence regarding very low rates of inflation, however, is scarce and somewhat more controversial. An environment of price stability should, in general, be conducive to growth and employment, since it allows the price mechanism to operate most efficiently in allocating resources in the economy. Price stability reduces inflation risk premia incorporated in long-term bond yields and other contracts, thereby also contributing to lower financing costs for investment and growth. Maintaining price stability also avoids unwelcome distortions due to nominal tax systems and arbitrary redistribution between debtors and creditors as argued in the overview by Issing (2001).

On the basis of the above, maintaining an environment of price stability – at least over the longer term – provides the best foundation for lasting growth and employment creation and is a pre-condition for a well-functioning market economy. The recognition of the fundamental common good characteristic of stable money in the interest of all citizens is the basis for delegating monetary policy to an independent central bank and assigning it the primary objective of price stability. If there were a durable trade-off between growth and stability – possibly associated with partisan interests – it would be harder to justify taking decisions on such trade-offs outside the regular democratic process.

This leaves the issue of how to best deal with shorter-term trade-offs between stability and growth. From the arguments reviewed in the previous section it is doubtful that such trade-offs could be systematically exploited. Moreover, there are reasons to believe that, first, such trade-offs might in general be rather limited in scope and, second, that they can well be taken into account within a framework of monetary policy geared to maintaining price stability over the medium term.

Conducting monetary policy in order to maintaining price stability over the medium term will in many cases at the same time contribute to cyclical output smoothing. In particular, in the case of demand shocks the appropriate response of monetary policy in order to stabilise price developments will tend to also stabilise demand and output. Moreover, a credible commitment to keeping prices stable, i.e. pre-empting inflationary and deflationary departures from price stability, will stabilise expectations, promote confidence, safeguard real purchasing power of consumers and promote investment via low and stable long-term interest rates. Through these channels monetary policy aiming at price stability can also make a contribution to stabilising economic activity even in the shorter run. In the case of pure supply shocks a short-term trade-off could, in principle, appear. However, if monetary policy reacts gradually with a view to medium term price stability effects on output remain limited. By contrast, a monetary policy aiming actively at fine-tuning economic activity in the short-term could often end up becoming itself a destabilising factor.

3.2. The role of fiscal policy

Also with regard to fiscal policy longer-term and shorter-term effects on growth as well as on price stability can be distinguished. Governments (reflecting inter alia electorate's preferences on the provision of public goods and income distribution) decide on spending and taxation priorities which affect incentives for innovation and long-run growth in the economy. Fiscal policy can also perform an important role for cyclical smoothing, partly due to automatic built-in stabilisers, partly through discretionary decisions.

The effects of fiscal policy on growth operate both via the structure and quality of expenditures and revenues as well as through the levels and the corresponding deficit and debt dynamics. The experience of the 1970s and 1980s has led to a shift of emphasis away from demand management to supply side considerations and heightened attention to the longer-term costs of deficits and debt accumulation. There are several arguments for adopting a framework for sound and sustainable public finances over the medium and longer term. Sound public finances avoid crowding out of private investment, they limit uncertainty and risk premia in the long-term planning of private agents and thereby also promote growth and investment. In addition, longer-run budgetary discipline avoids passing the tax burden on to future generations and thus supports confidence in the economy and intergenerational justice.

Such non-Keynesian effects can counteract the conventional impact of deficit spending in the short-run and even lead to a non-standard negative fiscal multiplier, which dampens growth and employment. Conversely, credible consolidation of public finance could be growth-positive. Such effects are most likely if the initial state of public finances is unhealthy and further deficits raise doubts on sustainability, thereby increasing risk premia and interest rates, depressing investment and consumption. There is evidence of significant non-Keynesian effects in particular episodes of consolidation. Even if fiscal multipliers are usually still positive in most cases they are quite small, suggesting a limited effectiveness of fiscal policies or largely offsetting influences from traditional Keynesian and non-Keynesian channels.[7]

In conclusion, a medium-term framework for fiscal discipline can be seen as useful from a Keyensian perspective in order to restore room for manoeuvre and enhance the effectiveness of counter-cyclical stabilisation. It can also be championed by those who are sceptical of activist policies given the lags and uncertainties in the economic transmission as well as in the political process. From this perspective emphasis would be placed on letting built-in stabilisers operate effectively instead of pursuing discretionary policy intervention. In either case, stability and growth are not in conflict but complementary objectives over the longer term and, in many cases, also in the shorter term. Sound public finances are a pre-requisite for longer-term growth as well as contributing to successful cyclical stabilisation. Finally, a credible medium-term framework for public finances also facilitates the task of monetary policy of maintaining price stability. Without fiscal constraints doubts over longer-term fiscal sustainability could spill-over into long-run inflation expectations. In the extreme, as posited by the controversial fiscal theory of the price level, the price level could become driven by undisciplined fiscal policy rather than being pinned down by monetary policy, as in traditional models (Woodford, 2001). A rule-based medium-term approach to fiscal policy should also limit shorter-term price pressures and render fiscal policies more steady and thus easier to take into account in the conduct of monetary policy.

4. The framework for macroeconomic governance in the euro area

The formation of EMU has created a framework for economic policy-making in Europe which is unique in history. The single monetary policy conducted by the European Central Bank is oriented towards a union-wide objective. Other areas of economic policies largely remain a national responsibility but, in the case of fiscal policies, are constrained by a set of common rules and surveillance procedures. Overall the Treaty provides for a clear allocation of basic policy responsibilities subject to a set of shared objectives and guiding principles for the conduct of economic policies in Europe. The framework rests on the recognition that stability – in terms of price stability and stable public finances – is an essential precondition for sustainable growth and also the best contribution to dampen cyclical fluctuations as discussed in section 3. This “Maastricht consensus” thus can be seen to broadly correspond to the basic “new-classical” solution to the assignment problem and takes into account many of the issues in macroeconomic governance discussed in section 2. The framework also reflects the practical experience and the disillusionment with the earlier Keynesian paradigm during the 1970s and 1980s.

4.1. Monetary policy

The cornerstones of the monetary constitution adopted at Maastricht and confirmed in the draft constitution by the Convention are central bank independence and the clear focus on price stability. The Treaty has unambiguously assigned to the ECB and the single monetary policy the maintenance of price stability in the euro area as its primary objective (Article 105). To fulfil its mandate effectively, the Treaty has granted the ECB and the national central banks of independence from political interference and foresees a clear institutional separation from other economic policy actors. Article 101 prohibits the monetary financing of public deficits and Article 108 safeguards institutional, personal, functional and financial independence of the ECB’s decision-making bodies. The Treaty stipulates that the ECB and its decision-making bodies shall not seek or take instructions from Community institutions or bodies, from any government of a Member State or from any other body. Conversely it states that community institutions and governments undertake not to seek to influence the members of the decision-making bodies of the ECB.

The Treaty clearly separates the chapter on monetary policy from the chapter on economic policies. It does not refer to policy co-ordination between monetary policy and fiscal policy, in contrast to the co-ordination of economic policies among Member States under Article 99. At the same time, the Treaty takes into account interdependencies between policies. Article 105 states that "the primary objective of the ECB shall be to maintain price stability. Without prejudice to the objective of price stability, the ECB shall support the general economic policies in the Community with a view to contributing to the objectives of the Community as laid down in Article 2." These Community objectives include a harmonious, balanced and sustainable development of economic activities, a high level of employment, sustainable and non-inflationary growth, a high degree of competitiveness and convergence of economic performance.[8]

This formulation of the mandate is consistent with the notion that the ECB's monetary policy contributes to the wider Community objectives through the maintenance of price stability and may to some extent take other objectives into account in the pursuit of its primary objective. It reflects the new-classical assignment and an explicit rejection of a long-run trade-off between stability and growth. The formulation of the mandate is in line with most modern central bank legislation, for example in countries that have adopted a formal inflation targeting regime in the 1990s. It is different from the multiple goals – including a high level of employment and stable interest rates in addition to stable prices – which were assigned to the US Federal Reserve in a much earlier period. However, in practice the Fed has, at least since the 1970s – in practice also stressed that price stability is regarded as a precondition for sustainable growth thereby refuting the notion of rival long-run objectives.

Overall the ECB has been successful in delivering on its primary objective of price stability during the first five years of its operation. Despite repeated adverse price shocks longer-term inflation expectations have been firmly anchored at levels consistent with the definition of price stability announced by the ECB in 1998. Against this background, the disappointing growth performance in the euro area has led some observers to call on the ECB to focus more on growth rather than price stability. This neglects the fact that monetary policy has only a single policy instrument at its disposal which can only be directed at a single policy objective in a consistent manner. In addition, attempting to use monetary policy for active output stabilisation could easily become counterproductive if this introduces additional volatility into interest rates or if credibility is reduced. This could worsen any short-run trade off and lead to higher long-term interest rates and lower growth.

By contrast a monetary policy, which maintains a clear focus on price stability over the medium term already takes growth into account in several ways. First, an environment of price stability is the best precondition for an effective functioning of the price mechanism, safeguards the purchasing power of income and the value of savings, promotes confidence and thus consumption and investment. Second, output developments and other indicators of the real economy are naturally among the factors influencing future price developments.

Third, a medium-term orientation of monetary policy implies gradual and measured responses to economic shocks that lead to temporary deviations from price stability and thus contributes to dampening output fluctuations while maintaining a clear focus on the primary objective at all times (ECB, 2003). Fourth, focusing on medium-term price stability underlines the primary responsibility of other policy makers, namely in the field of structural policies, to undertake reforms that strengthen the long-run growth potential of the economy and the capacity to create profitable opportunities for investment and employment creation. The weak growth and employment performance of many European countries is largely not of a cyclical nature but reflects structural deficiencies. These cannot be addressed by monetary policy, but – by affecting the “speed limit” of non-inflationary growth – are naturally taken into account in the setting of monetary policy.

4.2. Fiscal policy

Also on the side of fiscal policy the emphasis of the “Maastricht consensus” is on a medium-term, rules-based framework for stability. The Treaty reflects the experience that budgetary constraints may be needed as a disciplinary device in order to safeguard sound public finances within single countries and also to limit negative externalities for the euro area as a whole (Beetsma and Uhlig, 1999). In particular, excessive budget deficits are to be avoided according to Article 104 of the Treaty and the provisions of the Stability and Growth Pact. In addition, a ‘non bail-out clause’ rules out that either the Community or governments can take on liabilities for the debts incurred by an individual Member State (Article 103). This should help to limit the risk that governments accumulate excessive debt and shift part of the burden of debt and deficits to their partners in the euro area or that unsound fiscal policies in one country lead to higher risk premia and interest rates in the area as a whole.[9]

The framework for fiscal policy stresses a medium-term orientation and also directs attention to long-term objectives and sustainability. Article 104 of the Treaty assesses the soundness of public finance positions against the benchmark of two numerical criteria: the 3% deficit ceiling and a 60% reference value for the debt-to-Gross Domestic Product (GDP) ratio. The Stability and Growth Pact requires that countries aim at a 'medium-term objective for the budgetary position of close to balance or in surplus'. This medium-term objective should allow for sufficient breathing room to allow Member States to deal with normal cyclical fluctuations without breaching the 3% of GDP reference value. The Pact also specifies circumstances in which an excess over the 3% of GDP deficit limit can be considered 'exceptional'. It backs up the obligations already contained in the Treaty. On the one hand it contains *preventive* measures of soft co-ordination and multilateral surveillance, in particular by requiring that the euro area countries submit stability programmes on a yearly basis. On the other hand, it provides for *deterrence* by foreseeing sanctions to be imposed in case of continued breaches of the deficit ceiling. The fiscal rules, in this way, intend to combine medium-term discipline with a degree of flexibility. They incorporate a soft from of a balanced-budget constraint with significant room for manoeuvre within agreed limits. Like the monetary policy framework the fiscal set-up reflects the key feature of the "Maastricht consensus" that stability is regarded as a precondition for sustainable growth.

From a longer-term historical perspective the Maastricht criteria on public finance have been instrumental in spurring remarkable progress in consolidation in the run-up to Monetary Union. A large majority of – mainly smaller – Member States in the euro area has, until recently, been able to reach or maintain budget positions with a sufficient safety margin to cope with cyclical fluctuations. However, a number of countries has not undertaken sufficient adjustment in the transition to the new regime. In these cases the 3% limit has been breached repeatedly in the downturn as structural balances and medium-term balances had not improved enough during the preceding period of higher growth (Issing, 2004). Clearly, *ex post* this can pose a dilemma, where in the short-run the requirements for stability and growth point in different directions. However, calls for relaxing the constraints just when they are starting to bite neglect longer-term costs for both stability and growth that could arise if the credibility of the overall framework is put into doubt.

In this vein, the decision by Finance Ministers on 25 November 2003 not to implement the sanctions procedure foreseen by the Stability and Growth Pact in the cases of France and Germany has underlined the political vulnerability of the enforcement of the rules and has prompted a discussion of possible reforms of the Pact. At the same time it is noteworthy that, notwithstanding the procedural dispute with the Commission, both countries concerned committed themselves to reduce their deficits below the three percent threshold within the timeframe envisaged in the Commission recommendations. In this way the Pact continues to exert influence, even in a situation where its legal application is in doubt. A simple set of fiscal rules is an indispensable safeguard for stability in the Monetary Union and preserving sound public finances also fundamentally remains in the longer-term interest of Member States. If anything this suggests a strengthening of implementation rather than an overhaul of the rules themselves.

4.3. Policy-mix and policy co-ordination

Both the monetary policy framework and the fiscal set of rules reflecting the "Maastricht consensus" have been criticised by proponents of a more activist management of the macroeconomy as excessively rigid. A further, more subtle, avenue to re-introduce scope for Keynesian demand management comes in the form of calls for closer co-ordination between the single monetary policy and fiscal policy actors for the euro area as a whole. In this way, it is argued, a better combination of stability and growth can be obtained via a more balanced macro-economic policy-mix or by promoting structural reforms (Sapir at al., 2003). If such co-ordination is to be understood as some form of *ex ante* joint agreement to undertake policy actions aimed at a particular combination of growth and stability it would clearly undermine the clear division of responsibilities under the Maastricht policy assignment. Moreover, either any such agreement would be redundant confirming if each policy continues to fully serve its respective objective, or, it would reflect compromises to the detriment of the credibility of both sides.

The notion of a balanced policy-mix rests on a Keynesian presumption that both fiscal and monetary policies should be jointly geared towards the management of aggregate demand in stabilising exogenous shocks (Dixit and Lambertini, 2001). This is subject to the limitations and reservations on fine-tuning interventionism mentioned in earlier sections. Such difficulties would be compounded by the sheer practical obstacles for organising effective agreement and implementation among a multitude of national and European actors. If co-ordination requires following policy courses that would not be regarded as optimal from the perspective of any individual policy actor, incentive and enforcement problems come on top of the need to share and agree on underlying information and assessment of the economic situation. Any attempts at co-ordination that extend beyond the regular informal exchange of views and information – i.e. explaining policy on the basis of the given respective mandates – risks confusing the allocation of responsibilities and thus reduce the transparency and accountability of the overall economic policy framework for the general public (Alesina et al., 2001).

Moreover, monetary policy and fiscal policies each operating within clear and transparent medium-term policy frameworks based on well-defined objectives can take existing interdependencies into account. Monetary policy geared to price stability will react to changes in fiscal policies to the extent that they affect the outlook for price stability and – as far as aggregate demand effects are involved – this will naturally imply a stabilising response for prices and output. Conversely, if national governments (and also social partners) take the single monetary policy's credible commitment to maintain price stability as given, when deciding upon their own actions, this will also have a stabilising influence on macroeconomic outcomes. In this way an appropriate underlying policy assignment together with systematic patterns of medium-term implementation can contribute to implicitly co-ordinated macroeconomic outcomes ex post. These are in general superior to any discretionary and explicit attempts at ad hoc co-ordination, in particular because they avoid introducing new uncertainties and credibility problems (Winkler, 1999).

One way to think about the implicit co-ordination properties of the Maastricht assignment of objectives is as a Stackelberg equilibrium in the context of strategic interaction between monetary and fiscal policy makers. If monetary authorities can credibly pre-commit to the maintenance of price stability, this commitment will then be taken as given by other policymakers. Such a set-up, supported by the constraints of the Stability and Growth Pact serves to limit policy conflicts and uncertainty, avoid "leadership battles" and ensures a favourable regime characterised by a combination of price stability and fiscal prudence (Canzoneri and Diba, 1998).

5. Concluding remarks

Five years into the operation of Monetary Union in Europe calls for a re-orientation of macroeconomic policies – both fiscal and monetary – towards growth rather than stability have become more widespread in the face of persistent economic weakness in the euro area over the last years. The very success in achieving price stability and considerable – if not always sufficient – improvements in public finances over the 1990s seems to have contributed to the appetite to re-direct priorities now in a different direction.

This paper has recalled the main rationales of the "Maastricht consensus" underlying the policy framework in place. Stable money and sound public finances are seen as a precondition for sustainable growth rather than as conflicting objectives. Objectives for stability and growth are clearly assigned to independent actors, policies are rules-oriented and pursued in a medium-term perspective. The basic consensus underpinning the Maastricht framework seems to be still in place, as testified by the reluctance of the European Convention to re-open any issue of substance regarding the monetary and the fiscal framework agreed in the early 1990s. However, this consensus remains fragile as shown by the debate on and (lack of) implementation of the Stability and Growth Pact.

Often the US approach to macroeconomic management is lauded as more pragmatic and flexible and as an example for Europe to follow. The performance of the US economy, especially over the latter half of the 1990s, indeed seems impressive compared to the euro area and the US also appears to rebound more quickly after adverse economic shocks. However, one should not forget that the US example also shows that sustained price stability and the successful consolidation of public finances over the 1990s were important pre-conditions for the economic success in that period. At the same time, the driving factors have to be seen in the innovative capacity and flexibility of the US economy in the context of favourable conditions for entrepreneurial activity, innovation and technological change. Greater flexibility in wage and price formation as well as deeper financial markets in the US also plays a role.

Against this background the key for improving Europe's growth performance lies with structural reforms as envisaged under the Lisbon Agenda. There are no easy shortcuts. A return to activist macroeconomic policies would likely prove a distraction. Higher inflation or higher deficits and debt cannot be part of a sustainable solution. Otherwise there is a risk that the lessons of the past will have to be learned all over again.

NOTES

[1] See Heipertz and Verdun (this volume) for an account of the historical constellation shaping the consensus behind the Stability and Growth Pact. Most recently, the failure by the ECOFIN Council on 25 November 2003 to implement, in the cases of France and Germany, the sanctions procedure foreseen in the Pact called the durability of this consensus into question.

[2] The term “macroeconomic governance” is used loosely to denote the formal and informal set of rules comprising the assignment of policy objectives and responsibilities as well as influencing the behaviour and interaction among various macroeconomic policy actors within a given allocation of tasks. The concept of governance thus includes softer forms of co-operation, social norms, conventions and enforcement beyond the official formal system (see Dixit, 2003, for a theoretical approach). The notion of “governance”, while not well-defined, has in recent times been widely used in the fields of development policies (e.g. in the publications of the World Bank), “corporate governance” in the wake of business accounting scandals and as “economic governance” been employed to capture the multi-faceted policy framework in the European Union (e.g. the “Working Group on Economic Governance” of the European Convention, the use of the term by the European Commission and the discussion in Torres, this volume).

[3] See the collection of papers discussed at the 2002 edition of the Jackson Hole Symposium (Federal Reserve Bank of Kansas City, 2002) for a good overview of the current mainstream consensus in the economics profession and in the central bank community, which continues to hold despite some signs of a revival of a more active role of stabilisation policies.

[4] Early seminal contributions came from Lucas (1972) and Sargent and Wallace (1973).

[5] See Orphanides (2002, 2003) and Ehrmann and Smets (2001) for research on the impact of data or parameter uncertainty.

[6] Alesina and Perotti (1995) and Roubini and Sachs (1989) were among the first to highlight political economy factors for fiscal policy.

[7] See Briotti (2004) for a recent overview, Hemming, Mahfouz and Schimmelpfennig (2002) and the early case studies in Giavazzi and Pagano (1990).

[8] The draft constitution submitted by the European Convention contains a reformulated, but similar list of Union objectives in Art. 3 in part I. However, in the draft the previous reference to “non-inflationary” growth has been replaced by “balanced growth”. The descriptions of the ECB’s mandate and independence remain unchanged in substance.

[9] See Artis and Winkler (1998) Buti and Sapir (1998) and Ongena and Winkler (2001) for more detailed discussions of the fiscal framework in EMU.

Chapter 9

The New Economy and Economic Policy in the Euro-Zone

By

Teodoro Dario Togati

Abstract: In an attempt to explain the present crisis in Economic and Monetary Union (EMU) macroeconomic policymaking, this paper identifies two key problems in the design of current policy guidelines. The first is that official EMU prescriptions lack 'internal consistency', and thus credibility, as they do not follow from any specific macroeconomic theory. The second problem is that EMU policy prescriptions lack 'external consistency' as they are not in tune with the New Economy (NE). Current EMU prescriptions would be adequate only if the NE consisted in solely a positive supply-side shock causing increased stability of the system. This chapter holds, instead, that the NE also has negative effects on the demand side and that these may give rise to endogenous instability and major deviation from satisfactory levels of income growth. These shortcomings explain why the actual policies implemented in the EMU are forced to depart from official policy rules and become more pragmatic. This chapter argues, however, that pragmatic policy moves are not enough. New policy guidelines reflecting the complexities of the NE are called for if the current crisis is to be overcome.

Keywords: New economy, euro-zone, new-classical macroeconomics, Keynesian model, internal and external consistency, policy guidelines

1. Introduction

The New Economy (NE) poses fresh challenges to policymakers in advanced countries. In March 2000, these challenges were taken up by the European Summit which set the following strategic goal for the Union over the next decade: 'to become the most competitive knowledge-based economy of the world, capable of sustaining economic growth with more and better jobs and greater social cohesion' (European Council 2000). In what follows, I suggest that current Economic and Monetary Union (EMU) macroeconomic policies are not adequate for such a task. As clearly testified by recent debates over the Stability and Growth Pact (SGP), the entire EMU project is facing a serious crisis.

The aim of this paper is to try and explain such a crisis. For this purpose, it is useful to make a distinction between the official policy prescriptions, which, together with the theoretical framework constitute the so-called ‘Brussels consensus’ (see e.g. Tamborini, 2004), and the actual policies implemented by governments and the ECB. In my view, two main problems undermine EMU policies. The first is that the official prescriptions are not credible because they lack ‘internal consistency’; in particular, they do not seem to follow from any specific macroeconomic theory. On close scrutiny, they appear to combine contrasting aspects of two alternative approaches to demand management in an uneasy coexistence. It can be noted, for example, that the SGP implies a tighter fiscal stance than the Maastricht Treaty (MT). Moreover, the ECB relies on a mixed strategy based on two different policy rules, (e.g. monetary and inflation targeting).

The second problem is that EMU policy prescriptions lack ‘external consistency’ in that they are not consonant with the NE. In particular, I suggest that when the Euro was launched, European policy-makers misinterpreted the nature of the NE. Current EMU prescriptions involving strict inflationary and budgetary rules would be appropriate only if the NE consisted in merely a positive supply side shock making the system more stable, as maintained by New Classical Macroeconomics (NCM). In line with a broad Keynesian view, I believe, instead, that the NE involves not only improvements in the supply-side but also negative effects on the demand side, and that these may give rise to endogenous instability an In this view, EMU prescriptions appear to be sorely lacking: their reliance on such strict rules within the context of the NE can only make the problem worse.

The Keynesian perspective seems to be justified by current European events today. The actual policies implemented in the EMU must necessarily depart from official policy rules to become more pragmatic. This can be seen in the failure of several countries to comply with the SGP as well as in their attenpt to seek inspiration from the US, which is certainly more highly aware of the fragile nature of the NE.

This chapter argues, however, that pragmatic moves alone cannot resolve the current crisis. While certainly useful, pragmatism is more of a short-run defensive strategy than an alternative approach. A successful solution will require the design of new policy guidelines that are better equipped to deal with the NE.

What follows is an analysis of these problems which I hope will shed new light on the issues at stake. In section 1, I propose a broad definition of the

NE. In sections 2 and 3, I focus on the two major interpretations of the NE, which can be used as benchmarks for the assessment of EMU policies. In section 4, I show that EMU policies do not follow clearly from existing theoretical frameworks and are not in tune with the NE. In section 5, I analyze the pragmatic moves adopted by European policy-makers to remedy these flaws. In sections 6 and 7, I argue that simple pragmatic solutions may be inadequate and suggest alternative policy strategies.

1. Key features of the NE

The NE is a complex phenomenon.[1] In my view it is not just Internet plus the old economy, it also includes many other features which have dual effects (positive and negative), on both the aggregate supply and demand sides of the economy.

One such feature is 'multiplicity', which refers to the large number of competitors, relations and opportunities for individuals and countries created by globalization.[2] The NE implies a strong acceleration of this relatively old phenomenon, resulting in some positive effects on the stability of the world economy. It brings about a higher degree of market unification greater integration among its key participants, leading to benefits for productivity and potential income in all countries. However, 'multiplicity' also leads to higher instability of the world economy: For example, it can generate greater fragmentation of society, promote growing inequality across regions and nations or increase the likelihood for mutual reinforcement of downturns and financial crises in different countries. Thus, for example, a demand shock in one country will have a wider international impact than in the past (The Economist, 28–9-2002: 31).

Another feature of the NE is 'rapidity', i.e. the increased speed of technological innovation with respect to the past, as can be seen in the exponential growth of the power and diffusion of Information and Communications Technologies (ICT). It is bound to have positive effects on stability because of its effects on the supply side. By allowing faster transmission of information and greater rapidity of decisions, ICT improves the efficiency of markets and the functioning of the price mechanism, induces a smoother production system and stimulates a more flexible use of labour. This, in turn reduces the natural rate of unemployment and inflation, raises real wages and grants swift adjustments of economies to external shocks.

However, 'rapidity' also makes the system more unstable, by increasing the vulnerability of aggregate demand. Insofar as 'rapidity' shortens agents' horizons (as a result of faster product cycles, for example), investment is less responsive to interest rate changes, and consumption tends to become more volatile and vulnerable to sophisticated marketing strategies and the 'state of confidence'. Moreover, consumption is negatively influenced by the greater income inequality stemming from changes in the job composition of jobs related to the diffusion of ICT.

Finally, a third characteristic of the NE is its 'lightness', i.e. 'weightless' factors, such as intangibles (knowledge and human capital, R&D and public infrastructure) and financial assets, play a greater role in the NE than in the past (see e.g. Stiroh 2000: 43). This feature, too, tends to have dual effects on stability. On the one hand, it implies the extension of the market logic to new sectors, such as culture or entertainment, and the expansion of old ones, such as financial markets. This has positive effects on employment, on the ability of consumers to smooth out their spending over time in the face of variations of income (Blanchard and Simon 2001: 163), on the financing of investment (see e.g. Baily 2001: 215, D'Avolio, Gildor and Shleifer 2001: 125, The Economist, 28-9-2002: 29, Woodford 2001: 297) and on sustainability (the reduction in use of raw materials).

On the other hand, like 'rapidity', 'lightness' also increases the fragility of aggregate demand. Intangibles are more difficult to price than standard physical goods and give rise to higher volatility in financial markets, with adverse effects on investment. Moreover, the new financial instruments increase the instability of the demand for money and induce agents to acquire too much debt during periods of boom (Godley and Izurieta (2002: 41). They also promote diminishing accounting standards and fraudulent practice (see e.g. Stiglitz 2002; Financial Times, 18-5-2002).

2. The New Classical Macroeconomics and the NE

a) General remarks on stability

Proponents of the New Classical Macroeconomics (NCM) maintain that the NE is more stable than the old economy. While this view is clearly based on assumptions about the intrinsic stability of a market economy, it is also supported by more specific analyses of the NE. In particular, NCM economists claim that NE markets are more efficient and that the system more closely approaches the perfect competition model because of the more efficient use of information made by agents (e.g. The Economist 1-4-2000).[4] Consequently, the various types of information imperfections (which for many Keynesians justify long adjustment lags for wages and prices) are drastically reduced in the NE so that the key assumption underlying NCM models –that of a continuous market clearing equilibrium— becomes much more plausible.

On these grounds, NCM theorists tend to focus only on the beneficial effects of the NE. Let us examine these in turn, starting from 'rapidity'. As emphasized by Real Business Cycle (RBC) theory, the NE provides a favourable technological shock which increases the current productivity of both labour and capital and thus leads to a production rise and to lower prices. Increased productivity also gives rise to wage increases which provide incentive for working more. A rise in productivity rises thus increases both production and employment in the same period, while lower prices increase consumers' welfare. This approach allows no room for the negative effects of 'rapidity' on aggregate demand. So long as markets work and prices are flexible, no aggregate demand problem can ever arise (Say's Law holds).

As for 'lightness', NCM naturally regards the new technologies as capable of improving the financial markets' ability to process information efficiently and of allowing further financial innovation which in turn helps agents make transactions in an intertemporal perspective. As for the negative implications of 'lightness', NMC does not completely rule out negative phenomena, such as firms going bust or recessions in general, but regards them as a natural part of the process. Structural adjustment induced by market forces is necessary for the selection of the 'winners' and for imbalances to be overcome. One could note, for example, that a fall in prices induced by technological innovation automatically rules out inefficient players.

Finally, NCM also stresses the beneficial effects of 'multiplicity', maintaining that the unifying effects of global competition fostered by ICT may pave the way to a single world market.

b) Policy implications

On the grounds that the NE is more stable than the old economy, the NCM grants even less scope to the role of active or discretionary demand policies in stabilizing the economy. Strictly speaking, for NCM granted very limited scope to such policies even before the advent of the NE. If the economy is always in equilibrium, as implied by NMC models, and actual income is always at its potential or natural level, no improvements can be obtained by implementing a systematic stabilization policy, and no short-run trade-off can be exploited. In principle, if agents' expectations are rational, only unanticipated changes in this policy would have any effects. However, the NMC predicts that even this limited effect may to some extent vanish in the NE, due to improvements in the agents' ability to anticipate the effects of policy changes. Not only do agents process information more efficiently, but they also operate in a context dominated by forward-looking financial markets which are increasingly concerned with the sustainability of stabilization policies. (Markets may react badly, for example, if these policies imply excessive deficits or debt – see e.g. Winkler, 2004, this volume).

More specific NCM policy conclusions can be derived by considering fluctuations in the natural levels of income induced by shocks. If the business cycle is induced by real shocks, as implied by RBC models, it can be argued that the best response is to let the market process carry out its purging role. Policies designed to stabilize the economy would be counterproductive, as they would induce inefficiencies. Indeed, as noted by Winkler (2004), any attempt to smooth the cycle could be detrimental to innovation and growth, as it could contribute to delays in the necessary structural adjustments or to the prolonging of structural macro imbalances. On the other hand, if the business cycle is induced by monetary shocks giving rise to inflation, efficiency gains could be possible through policies stabilizing the money supply. As Lucas puts is: 'Insofar as fluctuations are induced by gratuitous monetary instability, serving no social purpose, then increased monetary stability promises to reduce aggregate, real variability and increase welfare' (1981, p.234). In either case, the only kind of active policies the NCM recommends are structural or supply-side policies aimed at improving factor productivity, increasing competition in the markets for goods and labour or capital and lowering the natural rate of unemployment.

3. The New economy and the Keynesian model

a) General remarks on stability

The Keynesian interpretation gives rise to less clear-cut conclusions about the NE. While NCM rests on the assumption of stability and captures only the positive aspects of the NE, Keynesians in principle seek instead to account for both positive and negative aspects and make no assumptions about which will prevail. They do not deny, for example, that the NE may benefit the world economy by raising competitiveness, productivity, market flexibility and by easing investment financing. They point out, however, that this rosy scenario should not be taken for granted. In particular, there are reasons to believe that the NE brings with it potential new sources of instability, in the form of relatively major departures from potential income.

Two points are worth emphasizing. In the first place, the NE increases the frequency and intensity of external shocks that shift the economy away from potential equilibrium. Secondly, it makes the endogenous adjustment mechanism based on price flexibility much more costly and inefficient. The system is thus more likely to get stuck in a particular underemployment equilibrium state once it shifts out of potential equilibrium. In fact, this is bound to occur, because the NE affects not only potential income (i.e. the supply side of the economy) but also aggregate demand, which is the key autonomous factor capable of determining the equilibrium level of income both in the short and the long-run.

In particular, the NE affects both terms of the aggregate demand function, i.e. price flexibility and aggregate demand. On the one hand, the NE favours greater price flexibility. It has the potential for producing not just lower inflation but even falling prices, i.e. deflation, due to a variety of factors, such as greater competitiveness and productivity, less intensive use of raw materials and reduced wage pressure. It is important to note at this point that in the Keynesian perspective I am defending here,, deflation undermines stability. This is in net contrast with standard textbook analysis. Indeed, as clearly noted by Keynes himself, the flexibility of wages and prices does not guarantee market clearing; on the contrary, it could make matters even worse. For example, it can trigger pessimistic expectations and can increase the real burden of debt (Fisher's effect), which may outweigh the positive effects of price flexibility on consumption and investment (e.g. through Pigou's effect and Keynes' effect) and thus undermine aggregate demand. It can be argued that in the NE the aggregate demand function is more likely to react adversely to deflation. In particular, the negative effects of pessimistic expectations are amplified, while the positive effects of price flexibility tend to be reduced (for example, investments become less responsive to interest rate cuts). If a deflationary spiral fails to fully materialize - we now observe in fact a context of moderate inflation in most OECD countries – it is because the key factor of money wage rigidity keeps it in check. [7]

On the other hand, the NE increases the vulnerability of aggregate demand by affecting factors that shift the curve. It may cause rich countries to reduce exports due to increasing competition from developing countries, increase the likelihood of shocks in a context of highly integrated world markets, cause increased dependency of consumption and investment on the state of confidence and increase the fragility of agents' balance sheets.

b) Policy implications

For Keynesians, as opposed to NCM, the NE increases the scope for discretionary demand policy, as it increases endogenous instability and the likelihood of exogenous shocks. More specific policy conclusions follow from this general view. First, structural policies aimed at increasing factor productivity and flexibility in key markets do not provide a universal panacea. While not completely ineffectual, they may well fail to improve growth prospects in the absence of a sufficient rise in aggregate demand. They are not a substitute for but a complement of demand policies.

Second, monetary policy should not be unduly concerned with inflation. Keynes suggested that, within limits, inflation is not an evil. The NE provides further evidence in support of this view. In fact, inflation is not the most important danger in the NE, which generates deflationary tendencies instead, and whose other important weaknesses, such as the greater volatility of output, exchange rates and asset prices, should be more openly addressed by monetary policy.

Another recommendation for monetary policy in the NE deriving from the Keynesian model is that central banks should manipulate interest rates rather than seeking to control the money supply. The NE also implies greater instability in the demand for money and more uncertain causal links between money and inflation than stressed by Monetarists.

Ultimately, fiscal policy should be aimed at balancing budgets in indirect ways, i.e. by favouring growth rather than by seeking to cut public expenditure, which instead may prove to be a self-defeating tactic (e.g. such cuts imply lower growth, lower taxes and ever higher deficits). Several factors justify a more active use of fiscal policy. First, the NE calls for increasing public expenditure due to the greater heterogeneity of society, uneven income distribution and the need to support R&D. Second, the NE provides a wider scope for fiscal policy because of low inflation. Third, the NE increases the effectiveness of fiscal policy as agents have a shorter planning horizon. In contrast with the Ricardian equivalence view, consumers are more likely not to consider future tax hikes, and will react positively to tax cuts. Fourth, the increasing stock of financial assets in the NE makes a direct link between deficits and interest rates less plausible and thus crowding-out effects less likely. On these grounds, concerns about the sustainability of public deficit and debt seem to lose some of their relevance in the NE. There is no compelling reason for which public debt must be fixed at zero or at any other specific value.

4. The shortcomings of the EMU policy framework

In the light of the two benchmarks just described, we can now turn to an assessment of EMU policies, focussing on the two major problems of internal and external consistency which seem to impair them and to lie at the root of the current crisis. As already noted, the first problem is that these policies do not seem to follow from a specific macroeconomic theory. Moreover, they even seem to involve contrasting principles of demand management.

To make this point clear, let us start by considering the theoretical framework from which the policy recommendations and prescriptions for EMU member countries, such as the Maastricht Treaty (MT) and the Stability and Growth Pact (SGP), apparently follow. As noted by Tamborini (this volume) the theoretical framework and the policy prescriptions constitute the so-called 'Brussels Consensus' (BC). The theoretical background underlying the BC is similar to what has been called the 'new consensus' macro paradigm (see e.g. Arestis and Sawyer 2003:2-5) or 'core of modern macroeconomics' (e.g. Blanchard 2003) and can be summarised as follows:

> 1) output and employment fluctuate in response to unexpected shocks…2) fluctuations take place around a long-period value of …potential output'…3) The economic system responds to shocks with variations in quantities and not solely in prices because of imperfections in the organisation of markets, in the transmission of information or of disincentives by economic agents against price changes. 4) Neither fiscal nor monetary interventions on aggregate demand are able to alter the level of potential output … permanently, their only effect would be to raise the average level of inflation above 'core inflation'.
>
> (Tamborini , this volume)

It is now possible to focus on the relation between the BC and the two theoretical paradigms described in the previous sections.

a) The 'Brussels consensus' and NCM

There are many reasons to believe that the BC is in line with NCM (see e.g. Winkler 2004). First of all, one can note important links between the 'consensus macro' underlying the BC and the NCM, such as the following claims:

a) the market economy is stable;
b) the supply side plays a key role in the determination of employment and output (as shown by the concepts of natural rate of unemployment, neutrality of money property, absence of path-dependency and a vertical Phillips curve);
c) even low inflation entails significant costs;
c) macro policies may well destabilise the economy;
d) rules are preferable to ad hoc discretionary co-ordination of day-to day policy in the face of shocks;
e) there is a strong link between the money stock and inflation (quantity theory of money); monetary policy can thus be used to pursue low inflation;

Secondly, there is no doubting that some EMU policy prescriptions too are in tune with NCM. We can mention the following points:

a) the assignment problem: Europe relies on a rigid mix of tight demand policy and structural reforms to increase competitiveness and raise the level of potential income;
b) the role of the money stock as the first pillar of ECB's strategy;
c) the SGP does not allow discretionary demand policy even in the short-run as it implies a commitment to zero deficit and the reliance on automatic stabilizers to face asymmetric shocks (Heipertz and Verdun 2004, Tamborini 2004).

However, the BC is to some extent also openly in contrast with NCM. Here is a list of some of the main points where the 'consensus macro' departs from it:

1- emphasis on price rigidities and imperfections, which imply a sluggish adjustment of nominal and real variables;
2- in the short-run, changes in aggregate demand influence income;
3- in the short-run, production may not be at its natural level;
4- in the short-run, monetary policy may influence income and increases in the quantity of money may fail to increase inflation;
5- budget deficits boost economic activity in the short-run, but reduce capital accumulation and production in the long-run.

As for the policy prescriptions, the BC departs from NCM in other important ways:

a) in principle, the MT allows discretionary fiscal policy, as it only implies a maximum of 3% deficit over GDP and of 60% public debt over GDP;
b) the BC places strong emphasis on public deficit, debt and crowding out

effects. This implies the rejection of the Ricardian equivalence view held by NCM, according to which when the government's budget constraint is taken into account, neither deficit nor debt have effects on economic activity, and the method of government financing of public expenditure is neutral (deficits are equivalent to taxes because agents discount future taxes and save more in the current period). This means, for example, that deficit should not lead to interest rate increases nor harm capital accumulation;

c) the Maastricht regime is not designed along Monetarist lines. The ECB pursues a monetary strategy not unlike inflation targeting (IT) (see e.g. Blanchard 2003)[8] which for a number of reasons implies a departure from the Monetarist analysis of money and inflation, i.e. the quantity theory of money:

- IT implies that the quantity of money is no longer exogenous but endogenous, and is determined by the demand for money. Monetary injections thus play no causal role in the analysis of inflation. Rather, the quantity of money adjusts to the price level as determined by other factors. As shown by the second pillar of the ECB's strategy, for IT even information concerning cost factors, such as oil prices and wage settlements or productivity, matter in the assessment of inflationary tendencies. This means that IT is consistent with many explanations for inflation.
- IT allows discretion in reaction to changed economic conditions. In contrast with Friedman's k percent regime where the central bank has no hand in manipulating interest rates, according to IT, the ECB sets interest rates and may thus engage in the fine-tuning of aggregate demand (Bibow 2003: 6). Strictly speaking, IT is not entirely a rule, but nor does it provide for full discretion. The rule is to adopt an inflation target and to vary interest rates in pursuit of that target. However attaining a low inflation rate 'becomes the target and the goal at the same time. The absence of an intermediate target provides the central bank with the discretion to react to changed economic conditions without abandoning the commitment to reduce inflation.' (Arestis and Sawyer 2003: 3). This means that only degrees of discretion prevail with IT; this has been referred to as 'enlightened discretion'.

b) The 'Brussels consensus' and Keynes

Only a few significant links can be detected between the BC and Keynes. In particular, the 'consensus macro' underlying the BC emphasizes the role of aggregate demand and the possibility for the economy to depart from full employment equilibrium.

As for policy prescriptions, both the MT and the ECB' s official strategy inspired in part by IT allow a degree of discretion the ECB's strategy implies several Keynesian elements, such as the role of interest rate setting, the analysis of multiple factors of inflation and the view of the transmission mechanism as complex and uncertain.

On the other hand, there are also many non-Keynesian elements in the 'consensus macro', such as the assumption of long-term stability, the principle of effective demand as applying only in the short-run and the corresponding emphasis on supply side factors in the long-run. Among the most significant non-Keynesian policy prescriptions is the first pillar of the ECB's strategy and the SGP, which both rule out discretion.

c) The BC and the 'consensus macro'

The assessment of the BC does not end here. Problems of 'internal consistency' also arise within the BC itself. In particular, it is doubtful whether the EMU policy prescriptions actually follow from the 'consensus macro' they are supposed to be based upon. It should now be clear that while the 'consensus macro' allows for discretion, this several components of EMU policy, such as the SGP and the first pillar of the ECB's strategy deny such discretion. Apart from legitimate doubts about the validity of the 'consensus macro' itself, it is important to emphasize that widely varying policy conclusions could have been drawn based on the same theoretical premises underlying the BC. In particular, the MT could have given rise to a very different SGP, and the first pillar of monetary policy could have been dropped in favour of full-blown IT.

d) The BC and the NE

After examining the 'internal consistency' problem of EMU policies, we now turn to the 'external consistency' problem, i.e. their inadequacy to deal with the NE. One can note, for example, that the ECB's focus on price stability as the exclusive goal of monetary policy, coupled with the adoption of monetary targeting as the first pillar of its strategy, is not consistent with the NE for at least three reasons.

First, the NE spontaneously generates low inflation or even deflationary tendencies, even in the face of demand pressures. Therefore, inflation that is temporarily higher than expected should not be a matter of concern, as it could be the result of exceptional circumstances, such as oil shocks or exchange rate depreciation. A strategy such as the ECB's, which tries to curb all inflationary tendencies as such without making a distinction between the different causes of inflation, is a mistake, for it could trigger deflationary effects. Indeed as many economists suggest, the ECB runs this risk because it has too low an inflation target (see e.g. The Economist 28-9-2002: 11; Arestis and Sawyer 2003:21).

Second, choosing to target the money supply is a hopeless task in the NE. Indeed as noted by many (see e.g. Kuttner and Mosser 2002, Arestis and Sawyer 2002: 4-5), financial innovation in the NE has created a more unstable demand for money and has altered the channels through which monetary policy affects the economy.[9] This explains why most central banks have shifted from monetary to inflation targeting.

Third, focusing on inflation means neglecting the real danger in the NE, i.e. the greater volatility of real and financial variables due to more frequent shocks and endogenous instability. If low inflation is the exclusive goal of the central bank, even the discretionary approach implied by IT versus monetary targeting may not be enough to face real instability.

Similar remarks apply to the SGP, which is inadequate given that the cause of instability in the NE is not excessive public expenditure or deficit. On the contrary, the European experience clearly shows that governments tend to run deficits because of insufficient economic growth due to the combination of endogenous mechanisms and external shocks. In this context, insisting on the SGP implies a deflationary stance. As pointed out by many, the SGP is pro-cyclical, as it induces policies of cutting investment expenditure and increasing tax revenues even in times of stagnation, such as these (see e.g. Arestis and Sawyer 2003: 41; Blanchard 2003, Stiglitz 2003; and, in this volume, Talani, 2004, and Heipertz and Verdun 2004).

5. Actual EMU policies

In the light of such serious shortcomings of the BC, it is not surprising that European policymakers find it difficult to comply with official EMU policy prescriptions or that their actual policy practices often significantly diverge from them, in what can be considered a ‘pragmatic’ move.[10]

Let us start from monetary policy. As already noted, a certain degree of pragmatism is built into the design of the ECB’s two-pillar strategy. In principle, this mixed strategy can be justified in response to increased uncertainty concerning the transmission mechanism of monetary policy following the advent of the NE and the launch of the Euro (see e.g. Blanchard 2003; Arestis and

Sawyer 2003: 23). Moreover, some flexibility is implicit in the definition of the two pillars.[11] In the first pillar, the ECB defines a reference value for money growth. Unlike monetary targeting, this is not a binding target; there is no commitment to correction of deviations from the reference value. As for the second pillar, the ECB makes a broad evaluation of the prospects of price stability on the grounds of a large number of indicators (e.g. various measures of real economic activity, labour costs, exchange rates, financial asset prices, consumers' and firms' expectations based on interviews etc.). There is no doubting that this plethora of indicators requires a certain degree of discretionary assessment.

Now it can be argued that the ECB has used this discretionary power in actual policy-making in such a way as to violate its own official guidelines. Therefore, as noted by Blanchard (2003), analysis of the ECB's actual behaviour can be more revealing than analysis of its words. One could note, for example, that the ECB has engaged in some efforts towards output stabilisation, notwithstanding its official neglect of short-run output developments (see e.g. Blanchard 2003, Talani 2004). As shown by the experience of the last two years, when some other risks beyond inflation (i.e. various kinds of shocks, such as terrorism and war) have materialized and given rise to market instability, the ECB has not focused simply on inflation but has also taken growth into account. Indeed, the ECB has changed interest rates in response to risks of deflation and recession (see e.g. Arestis and Sawyer 2003:28; The Economist 28-9-02, Talani 2004). Moreover, it has done so even at the risk of missing the other official targets. In particular, it has failed to raise interest rates systematically when actual inflation was higher than target or actual M3 growth was higher than target.[12] It must be noted that this failure to act in line with official principles has led some economists (e.g. Blanchard 2003) to describe the ECB's strategy not simply as pragmatic but as consistent with quite a different policy rule, such as Taylor's rule, which holds that central banks determine interest rates in response to both output and inflation gaps.[13]

Also in the case of fiscal policy, the official EMU stance based on the SGP fails to correspond to the policy actually pursued by governments. This is not surprising, as experience generally shows that the attempt to balance the budget cannot be maintained as a permanent policy rule, especially in the face of shocks (Arestis and Sawyer 2003: 37). Faced with the greater variability of parameters and of the persistence of business cycles, many European governments have taken steps to relaxtheir official strict fiscal stances and adopt expansionary measures to support demand and output in the short-run.

A rather dramatic instance of this kind of pragmatism is revealed by the current debate concerning the SGP. In particular, as Heipertz and Verdun note, it has now become quite clear that ‘a number of countries no longer act as if the SGP budgetary ceilings are to be taken seriously’ (2003: 10).[14] Indeed such countries now realise that to compliance with the SGP would be very costly in terms of short-run output in a context characterised by basic uncertainty and sluggish growth. They thus seek to slacken the SGP restraint (e.g., to relax the 3% limit to permit borrowing for capital investment and/or allow more time to meet the balanced budget requirements) (Arestis and Sawyer 2003: 37).

6. The limits of pragmatism

Based on the preceding remarks, it would be nonetheless misleading to conclude that pragmatism is the best solution to the current crisis. The move towards pragmatism is indeed an indicator of the intrinsic limits of the BC, but it is more of a defense or survival strategy than an effective remedy. Overriding the main orientation and effects of official EMU policy prescriptions in order to gain some degrees of freedom within the existing policy rules it is not enough, as it does not force critical evaluation of the rules themselves. In particular, despite their pragmatic moves, European policy-makers still remain committed to the basic principle of rigour or stability as a prerequisite for growth on which the SPG and the ECB’s strict definition of price stability are based.

This principle itself is likely to reduce the positive impact of pragmatic policy moves in the NE. Thus, these moves continue to increase costs stemming from misguided official policy orientation Pragmatism may be an effective remedy when systemic failures are relatively rare; but it loses its efficacy when these failures occur more frequently, as in the NE. At least three types of problems undermine pragmatic moves in this context.

First, these moves may not be of the required scope. Due to the more frequent systemic failures it involves, the NE calls for relatively wide swings in the policy stance. These swings are quite difficult to carry out when policy is constrained by rigid rules. As pointed out by Arestis and Sawyer (2003: 30-31), for example, the relaxation of tight fiscal stance that has been recently implemented in Europe is too small to speedily lead to a real recovery.

Second, pragmatic moves may be too slow. In the NE where swift financial markets dominate slow production processes, pragmatism may fail simply because appropriate policy responses may take too long to materialize when policy-makers are constrained by policy rules which cannot be readily dismissed. Thus, for example, if policy rules focus on inflation, central banks may only realize that deflation is the real problem instead after a dangerous delay. Moreover, while the NE implies faster convergence to equilibrium, as Keynes pointed out equilibrium can be either good or bad. Slow policy-making may condemn a country or region to stagnation for a long period of time, as has recently been the case in Japan.

This problem is particularly serious in Europe, where pragmatic decisions have been made only following a long and painful period of dissatisfaction with the official policy and involving a lot of misjudgement. As emphasised for example by Arestis and Sawyer (2003: 18-20; 25), the ECB's response to evolving events has been remarkably slow. In particular, the ECB has been insisting for a long time that the existing level of interest rates was appropriate, despite the fact that several countries appeared to be on the brink of recession. Similarly, it may be some time before the ECB decides to cut interest rates in the face of a strong euro and much lower interest rates in the US. But this is also true for fiscal policy. Although strict application of the SGP has already been avoided in practice (e.g. Germany and France have both managed to avoid sanctions), European governments will probably only eventually agree to replace the SGP with more flexible prescriptions only after a long and harrowing decision-making process.

Third, pragmatic moves may lack credibility. In the NE where expectations and confidence are more influential than in the past and where policymakers must adopt a clear strategy to maintain credibility, pragmatism may fail because it creates a tension between two alternative views, and thus causes confusion in the markets. So, for example, while in the current official EMU 'stick-and-carrot' pedagogy [15] – for which the SGP is a condition for growth and thus even cutting spending in a downturn is necessary – continues to apply, pragmatism instead amounts to recognizing that the fiscal rules of the SGP are counterproductive especially during a slowdown and that cutting spending in this context would be destabilizing (see e.g. Stiglitz, 2003, and Arestis and Sawyer, 2003: 41).[16]

7. Some alternative policy suggestions

In the light of the impasse reached by EMU policies two major alternative solutions seem to arise. The first is to look to the US, where awareness of the fragile nature of the NE is more acute, as evinced by the following points.

First, unlike the EMU, the US seems to conceive of stability as the result, rather than a condition, of growth. In the US a virtuous circle has been triggered by the gearing of monetary policy towards GDP growth. Rising employment and a shrinking interest burden have delivered fiscal consolidation (see Bibow 2003: 6).

Second, the FED's strategy is formally much wider-reaching than the ECB's. It is intended to pursue not just monetary but also economic stability in terms of income and employment, exchange rate and financial stability. Although the ECB also takes growth into account, the FED certainly does so in more explicit terms. As emphasised by Arestis and Sawyer, 'while the FED kept lowering interest rates aggressively on a number of occasions (no less than thirteen times between January 3, 2001 and June 25, 2003), the ECB cut interest rates to a minor extent and with a delay causing sharp appreciation of the euro' (2003: 19).

Third, even in terms of inflation alone, the FED seems to prefer discretionary behaviour over ECB- style commitment to a precise definition of price stability. As noted by Blanchard (2003), the FED has neither an explicit inflation target nor an interest rate rule. Moreover, its actual behaviour suggests that it has an implicit inflation target of around 3%.

Fourth, the (current) absence in the US of a specific fiscal rule, analogous to the SGP, makes it is easier to adopt a flexible stance under adverse conditions, as can be seen by the rapid swings from surplus to deficit carried out in recent months. Indeed, while Europe is caught up in endless quarrels over the SGP, in the US tax cuts and military expenditure aimed at avoiding recession since the terrorist attacks of September 11 have rapidly transformed the budget from a surplus to a deficit with relatively little debate (see e.g. Godley and Izurieta 2002: 48-9).

Fifth, unlike Europe, the US has implemented the kind of policy which has greatly contributed to the rise of the NE: namely a shift towards quality, if not the absolute size, of expenditure. In particular, the US has allocated huge resources to military high tech and research in large institutions and universities that have positive externalities.[17]

Despite its positive aspects, the US policy stance is not without its limitations. In particular, it is still ruled by pragmatism. Although more effective than the EMU's policy, US pragmatism is flawed in two related issues. First, it seems far too dependent upon the intuition of individuals Informal comments to the media made by leaders such as Alan Greenspan often manage to persuade or reassure the markets that the FED will grant prosperity, for example by ensuring that financial markets remain liquid in the face of confidence crises.[18]

Second, it does not seem to rely on adequate theoretical foundations or on analysis of the NE. In particular, it appears vulnerable in its reliance on the 'consensus macro' that limits the validity of a full-blown discretionary policy approach to the short-run, and is too subject to sudden swings in public opinion about policy.

The other solution to the EMU impasse is to adopt a policy stance based on a theoretical framework capturing the essence of the NE, such as Keynes'. This does not imply rejecting pragmatism and discretionary behaviour in general but intends instead to place it on more solid ground. In particular, our Keynesian interpretation of the NE implies that discretion should be elevated to the status of a permanent policy option rather than a temporary remedy.

In order to acheive this goal, the drastic dichotomy between short and long-run on which many major policy guidelines are based, must be overcome as it leaves too little room for discretionary action. This dichotomy should be replaced with a 'threshold logic' which is more in tune with the NE.

To make this point clear, it is important to note that an alternative policy framework would first of all have to reject the stability/growth trade off set out in the standard literature. This gives rise to two key issues. First, the causality issue. As already noted, while standard theory suggests that stability (financial consolidation and very low inflation) is the precondition for growth, an alternative policy view based on Keynesian analysis should stress that, on the contrary, growth is a condition for stability (see e.g. Bibow 2002 and 2003).

Second, the definition of stability itself. In contrast with what is generally inferred from standard theory, stability does not necessarily imply a zero deficit and 2% inflation. Critics of the current EMU policy framework are not necessarily in favour of unlimited deficit and ever-increasing inflation. In line with the threshold logic, they could argue that within limits, perhaps 3 or 4 percent, both inflation and budget deficits are positive for the economy and can be sustained indefinitely; they become pathological phenomena only when these limits have been exceeded (see e.g. Arestis and Sawyer, 2003).[19]

8. Concluding remarks

Four main conclusions follow from the analysis developed in this paper. First, the interpretation given to the NE has very important practical implications due to its general impact on overall policy-orientation. Two major viewpoints have been distinguished. For the NCM, the NE is more stable than the old economy. The only risks for instability arise either from exogenous shocks or from state interference with markets. As a consequence, it is best to implement structural reforms and set a priori limitations on traditional demand policy. Instead, Keynesians hold that the NE generates greater potential instability. This implies that stability is not a spontaneous product of the market process but a possible outcome of careful discretionary policy-making.

Second, the current crisis within EMU policy-making indicates that the Keynesian interpretation is more plausible. EMU policy is loosely based on a rather eclectic combination of theoretical elements. Among these elements, the NCM's emphasis on a tight, non discretionary demand policy as a condition for growth plays a major role. This kind of policy is proving inadequate within the context of the NE. Indeed, pursuing it to accompany the launch of the euro has quite simply failed to grant growth.

Third, pragmatic moves made by EMU policymakers to remedy the shortcomings of the official stance have not proven sufficient to resolve the current impasse. While certainly preferable to dogmatic rule application, pragmatism is not an optimal solution. On the contrary, pragmatism in the NE is an increasingly costly policy option mainly because it lacks credibility and rapidity.

Finally, a few alternative policy solutions for the EMU (with different degrees of appeal) have been singled out. The first is to adhere more closely to the 'consensus macro' which at least allows for some kind of discretionary demand management. Indeed, if the official EMU policies were actually based on it, a rather different SGP could be devised. The second alternative is to look to the US policy stance, which proves to be a more effective form of pragmatism. The third, and in my view, the best, move forward is to define a new policy strategy based on a Keynesian theoretical framework. Among the key ingredients of such a strategy considered here are the views that discretion is a permanent policy option, growth is a condition for macro stability and threshold effects concerning inflation and budget deficits must be duly taken into account.

NOTES

[1] I discuss these issues in greater detail in my forthcoming book on the New Economy. See Togati (2004).

[2] The labels I employed here to summarise the features of the NE were first suggested by the Italian writer Italo Calvino to characterise the 20th century in general (see Calvino 1988).

[3] Indeed 'it is, of course, no accident that rational expectations have thrived in the age of information technology. The existence of powerful computers and software has enabled us to simulate models in which the agents are using information efficiently' (Minford 1997: 110).

[4] See e.g. Kydland and Prescott (1982); Winkler (2004).

[5] In contrast with the Neoclassical Synthesis or New Keynesian theory, I consider the principle of effective demand to be valid also in the long-run and thus reject the Neoclassical long-run equilibrium concept. For a similar view see e.g. Setterfield (2002). As a consequence, structural factors such as productivity and flexibility cannot be analysed separately from aggregate demand. A rise in productivity might not grant a rise in employment because firms demand labour and invest *only if* also aggregate demand increases adequately.

[6] That deflation is also a modern phenomenon rather than merely a relic of the past has been is confirmed by the Japanese experience of the 1990s. Moreover, after the stock crashes in 2001 there were fears that deflation could also spread to other countries, including Germany and the US.

[7] While standard theory considers money wage rigidity as a cause of unemployment, for Keynes instead it is a factor granting stability.

[8] In Blanchard's view, the ECB behaves as a *de facto* inflation targeter. The point is that although the ECB does not formally pursue an IT policy, it does pursue a monetary strategy with a clear commitment to price stability over the medium term (see also Arestis and Sawyer 2003: 7, 14).

[10] On the interpretation of the ECB's strategy as a pragmatic one, see e.g. Issing, Gaspar, Angeloni and Tristani (2001).

[11] As Talani (this volume) clearly emphasised, this flexibility is bought by the ECB at the expense of a certain (often-critisised) lack of transparency in decision making. For this reason it is possible to speak of a transparency/flexibility trade-off in the strategy of the ECB.

[12] Indeed as Talani (this volume) notes, while officially important, monetary targets are often neglected by ECB. In particular, M3 changes and interest rate changes tend to go in opposite direction. Moreover, another element of pragmatism is the loose definition of the period (the medium run) over which the ECB controls inflation (see e.g. Arestis and Sawyer (2003)).

[13] Taylor's rule coincides with neither monetary targeting (there is no money stock in the rule) nor inflation targeting (central banks care also about income).

[14] More in general, as Heipertz and Verdun emphasise in this volume, that 'consensus among policymakers about the importance of fiscal discipline is seemingly fading away'.

[15] See e.g. Tamborini (this volume).

[16] Similarly, many commentators (see e.g. Fitoussi and Creel 2002: 67; Talani this volume) have criticised the ECB's policy for being confusing especially to the financial markets. In particular, the M3 target has rarely been met, and yet this does not seem to have an impact on official strategy, the ECB often appears to downplay the importance of the money stock and yet it reaffirms its long-run importance.

[17] As noted for instance by Cohen, De Long, and Zysman (2000: 1), this kind of intervention has always been at the top of the US policy agenda since the World War II.

[18] It must be noted however that the FED's pragmatism is not always a matter of rational choice or 'formal' decisions, i.e. it is not a fully-conscious *ex-post* demand management. Sometimes it is due to simple errors. Stiglitz (2002), for example, talks about 'lucky' errors made by the FED in the late 1990s; its mistaken estimates of GDP growth and Nairu (the actual unemployment rate fell below 6% but inflation did not rise) and failure to raise interest rates actually favoured the boom.

[19] This view is justified by evidence provided by Ghosh and Philips (1998: 674) stressing two important nonlinearities in the inflation-growth relationship: at low inflation rates inflation and growth are positively correlated. Otherwise there is a negative correlation (see also Arestis and Sawyer 2003: 3).

Comment
BY
MARTIN RHODES

Both the chapter by Talani and the chapter by Heipertz and Verdun seek to penetrate behind the scenes and detect the underlying forces determining the form taken European Economic and Monetary Union (EMU) and its Stability and Growth Pact (SGP) and the conduct of European monetary policy under the European Central Bank (ECB). The Talani chapter develops a rather specific argument that the powers of export-oriented countries exerts influence over the policies of the supposedly politically independent ECB, promoting a position of ‘benign neglect’ regarding the depreciation of the European currency in its first two years of life. The methodology is explicitly intergovernmentalist. The Heipertz-Verdun paper is wider ranging, searching for an explanation of the recent crisis of the SGP in its origins in the 1990s, and seeks deeper insights than might otherwise be available, the authors argue, by combining an ideational with a ‘power-politics’ approach.

The Talani paper is based on a simple premise. If we wish to understand why the euro was allowed to depreciate vis-à-vis the US dollar in 2000-2001, then we need look no further than the influence of Europe’s major exporters to the US, namely Germany, Italy and France. Loosely employing Jeffry Frieden’s sectoral preference model, Talani argues that these country’s national politicians expressed the preferences of their powerful exporting industries that would naturally stand to benefit from a euro depreciation. Talani also appears to argue that it is such inter-governmental influence more generally (regardless of the absence of channels for the open expression of such preferences in the monetary policy making process) that explains the ECB’s pragmatism in giving less attention to prices and monetary targets that its rhetoric would suggest than to stabilising output.

This is a seductive argument, but there are serious problems in sustaining it. First, the author provides no evidence that in any of the countries concerned did their export sectors mobilise politically to achieve the goal of currency depreciation, or, indeed, that their national political representatives were receptive to such a message. It is not sufficient to quote businessmen and politicians views that a weak euro was a boon rather than a cause for concern to establish a connection between imputed country preferences and the ECB’s exchange rate position. Nor does the analysis allow the author to answer her own question “*Do considerations about single member states matter, or is it the outlook of the euro-zone as a whole that defines the Bank’s choices?*”. Given that 90 per cent of trade by EU countries is within the euro-zone itself (Germany, France and Italy are each other’s most important export markets), it may well be the case that the ECB’s policy ‘benign neglect’ – of both euro depreciation in the early 2000s *and* the strong appreciation against the dollar that quickly followed from 2002 - is due to the fact that intervention *would only serve* the special interests of particular export sectors, rather than being in the interest of producers and consumers, and growth, more generally. This point leads naturally to a third problem with Talani’s argument. Although the author mentions in passing the more recent appreciation of the euro against the dollar, there is no discussion of what this implies for the author’s sectoral preferences argument. If there were anything to that argument, one would expect the business communities of France, Germany and Italy to be up in arms about the strong euro, and their national representatives to be pushing the ECB in favour of intervention.

This requires some consideration to the difficulties of deriving preferences from objective economic positions, and real-world nature of business responses to exchange rate fluctuations. There has, it is true, been much criticism of US policy from EU central bankers, as well as guarded suggestions that the ECB would intervene if the euro rose much above $1.30-1.40. But whether strong pressure is coming from European business lobbies for such intervention is a moot point. In reality, most of Europe’s export sectors, and in particular those of Germany, have continued to perform well, despite the dollar’s strength, due to rising global demand. And although some exporters have been hurting (especially in the luxury goods markets dependent on US consumers), the most powerful potential lobbyists for ECB intervention, such as the large German carmakers, have suffered little, using financial derivatives for currency hedging, or moving more production to their US plants, in some instances exporting their cars back to Europe, thereby benefiting from the dollars decline. All of this suggests first, that within certain margins, the exchange rate is not the critical issue for these businesses that Talani assumes it to be; and second, that Frieden’s sectoral preference model would have to be rendered much more complex in its application to be of utility in this particular case.

Heipertz and Verdun have a more complex argument about the behaviour of policy makers and officials in the run up to EMU and the design of the SGP and their conclusions are much less controversial than those of Talani. If the growth of a “permissive consensus” amongst politicians and experts on the desirability of central bank independence and the need for a mechanism to enforce fiscal discipline among euro-zone members created the context for the SGP, the precise form taken by SGP rules and the sanctions mechanism was determined by ‘power politics: the ‘asymmetric bargaining power’ of the German government, domestic German pressure from the Bundesbank (which constituted an ‘informal veto’), and the influence of the financial markets which pushed governments forward by pushing up the DM against other currencies whenever deadlock threatened during the EMU stage 3 negotiations. Thus, ideas shaped the context, and power politics decided the detail. In presenting their arguments, the authors provide us with a complete analysis of the bargaining behind the SGP and of the influence of the respective actors. The authors also claim that understanding these origins of the SGP provide insights into its recent crisis, with France and Germany effectively abandoning the SGP by refusing to conform with its budget deficit limits. Thus, if ideas and power politics underpinned the creation of the SGP, shifts in both can also help explain its effective demise. As for bargaining power, Heipertz and Verdun argue that Germany is no longer the force it once was in insisting on a highly disciplinary SGP, and in any case it would be hypocritical for it to adopt such a position, given that it is itself in breach of SGP rules and is no longer an exemplary state. They also argue that the previous consensus on fiscal discipline is now fading away.

How convincing is this argument? Methodologically, the authors adopt an increasingly common combination of constructivist and rational approaches, the first to explain the emergence of a consensus around the idea of EMU and the price stability orientation of the new ECB’s monetary policy, the second to account for the SGP itself. This is quite acceptable. But the sceptic might well ask why the constructivist approach is needed at all to understand the shift in opinion in favour of a certain style form of central bank independence, when a power politics argument alone might serve that purpose just as well and provide a more parsimonious account. Of course, an ideational (though not fully constructivist) argument has a long pedigree in the work of Verdun, McNamara et al. But an alternative argument might suggest the following. Not only was German/Bundesbank power likely to lobby for a model for Europe very much along in line with its own preferences, but that in the 1980s, the fiscally-conservative Bundesbank model of central bank independence was the only game in town, given that most of Europe had long-pegged its currencies to the DM to secure an external constraint on domestically-generated inflation. The authors should also think a little more critically about how powerful the ideas they refer to were in practice once the ECB was up and running and pay some attention to one of the points made by Talani. As we know, the ECB has assigned its priorities between the twin 'policy pillars' of money supply growth and price stability, but in it effect disregarded strong money supply growth for a considerable period in the early days of the euro, without ever providing an adequate explanation. This degree of pragmatism in monetary policy practice makes one wonder exactly how powerful the monetarist ideas referred to by Heipertz and Verdun actually were.

Personally, I do think there is something in the ideational argument, especially when applied to the Monetary Committee which Heipertz and Verdun present as an 'epistemic community' wielding a particularly consistent expert view on the appropriate rules for monetary policy making under EMU. Nevertheless, in order to strengthen their point, the authors' ideational account should be backed up by a consideration of the rational alternatives and demonstrate why they are lacking in explanatory power.

The authors might also refine their analysis of the recent demise of the SGP and consideration of what will matter in its reconstitution. It may be that certain member states are less enamoured of the idea of fiscal discipline than they were in the past, but the ECB itself has certainly not changed its tune. But there is another issue here in the 'post-SGP' period that the authors do not refer to. Defections from the rules of the club do not seem to be provoking the non-institutional sanctions that might in different circumstances have backed up or substituted for formal sources of discipline. The issue of ECB credibility and the strength of the single currency in a 'non-optimal' currency area have been debated since well before the euro came into existence. Paradoxically, the fact that the ECB, for all its problems, now seems to have achieved credibility as a central bank, and that the euro has become a respectable currency for constituting reserves and attracting investment, the markets are no longer so concerned about the behaviour of governments within the euro-zone. The effective demise of the SGP did not provoke a reaction from the bond markets, for example, suggesting that one of the main reasons for having the hard SGP rules in the first place – guaranteeing the external credibility of the euro – no longer apply. But that of course provides a major challenge to the authority of the monetary authorities in the euro zone; and new ideas of how structural reforms are now to be encouraged in the larger member states are now certainly required.

COMMENT

BY

ELISABETTA CROCI ANGELINI

The long process which has led to Economic and Monetary Union (EMU) was an attempt to promote monetary and fiscal policy convergence across the European countries in order to better pursue the objective of low inflation and to restore the stable and high growth rates of the "golden age". The chapters by Bernhard Winkler and Roberto Tamborini give us the opportunity to compare two different views on the capacity of the present EMU institutional setting to keep the success of low inflation and deliver the missing objective of moving to a more sustained growth path. Let us start by giving a glance to the theoretical model by which both the functioning of the European Monetary System (EMS) and macroeconomic equilibrium under the EMU are studied.

Two analytical frameworks have been used in the literature to explain two decades of "high inflation" in Europe, the subsequent slow disinflation process, and the rationale for monetary and fiscal management under the EMU. The first draws on the Barro-Gordon "time inconsistency" model of monetary policy. The assumption is that the macroeconomic equilibrium depends on the fundamentals underlying the Phillips curve, on inflation expectations related to the monetary authorities' reputation, and on the inflation-unemployment trade-off pursued by national monetary authorities. The "new classical" interpretation is based on the a priori assumption that "high inflation" has to be traced back to the government authorities' tenet that the "natural" unemployment rate (Un) corresponding to the vertical long-term Phillips curve is stuck at too high a level due to a series of labour market distortions. Therefore, the government authorities are willing to bring the "natural" unemployment back to its previous lower level, as expressed by the following equation:

(1) $$U^* = (1 - \delta)\, Un$$

where U^* is the target for the unemployment rate and δ (where $0 < \delta < 1$) is the intensity of the desire of lower unemployment by manipulating the macroeconomy by means of monetary policy. More precisely, a value different from one of the parameter δ reflects the monetary authorities' expectation the "natural" unemployment rate has to be decreased to the level corresponding to the efficient resources' allocation by means of "active" policies. Let us now introduce a Phillips Curve:

(2) $$U = Un - \alpha (\pi - \pi^{e})$$

where parameter α represents the unemployment responsiveness to a divergence between actual and expected inflation. The parameter ? then expresses the incentive to make a "surprise inflation" in order to raise the output and employment levels above their "natural" levels. In the "staggered contracts" model, the "time inconsistency" problem applies because the central bank is assumed to act after wage contracts have been signed. The equation indicates that – following a "non-announced" monetary expansion - the higher is α, the flatter the curve and the wider the decrease in the unemployment rate.

Let us assume that a loss function in quadratic form has been chosen by the authorities:

(3) $$L = [\beta (\pi - \pi^{*})^2 + (U - U^{*})^2]$$

where π^* is the target for the inflation rate and β is the parameter indicating the "inflation aversion", on which the credibility of monetary policy depends. By substituting equations (1) and (2) in equation (3), and putting the target for the inflation rate equal to zero, the social loss function becomes:

(4) $$L = \beta \pi^{2} + [\delta U_n \alpha (\pi - \pi^{e})^{2}]$$

Under the constraint that agents have a perfect foresight of the inflation rate ($\pi = \pi^e$), the monetary authorities' minimisation of the social loss function (equation 4), after some rearrangements, yields the following rational expectation solution:

(5) $$\pi = \alpha (\delta U_n) / \beta$$

Therefore, the equilibrium inflation rate positively depends on both parameters α (the higher α, that is the unemployment reducing responsiveness to monetary expansions, the flatter the Phillips curve and the greater the incentive for a "surprise" inflation) and δ (the higher the divergence of the unemployment target from its "natural level", the higher the equilibrium inflation rate) and negatively depends on parameter β (the degree of "inflation aversion", fostering the decrease in the inflation rate).

The second analytical framework draws on the famous "unpleasant mathematics" put forward Sargent and Wallace, dealing with the incentive to "monetisation" stemming from a high level of public debt. Since the monetary financing of deficits is excluded due to the anti-inflationary commitment, the government budget constraint is as follows: $G - T + rB = dB / dt$, where $(G - T)$ is the "primary deficit" and rB the "secondary deficit" (the amount of the interest (r) payments times the stock of public debt (B)). The overall public deficit is then matched by bond-issuing (dB / dt). It can be easily shown that the accumulation of high public debts positively depends on the level of the public deficit and on the difference between the real interest rate and the growth rate of the economy, as a proportion of the public debt over the Gross Domestic Product (GDP). The stock of debt as a ratio of GDP is $b = B/Y$, where Y is the GDP. Given that $B' = b' Y + b Y'$ (denoting derivatives with the apostrophe), and with ε as the GDP growth rate, after some algebraic computations, we obtain:

(6) $$b' = (G/Y - T/Y) + (r - \varepsilon) b$$

If we focus only on the inflation component of the GDP growth rate, we can write:

(7) $$b' = G/Y - T/Y + (r - \pi) b$$

This equation is very telling. It says that, whenever the real interest rate exceeds the growth rate of the economy, in order to stabilize the public debt / GDP ratio the budget has to be in surplus ($G/Y < T/Y$) in the measure required by the value of b.

Let us now analyse the EMS rationale for achieving the public good of monetary stability in Europe as a fixed exchange rates accord between a low-inflation country, say Germany, and a high-inflation country, say Italy. Germany, the Central Bank of which deserves the highest reputation for being committed to low inflation ("high inflation aversion", that is "high" β), has values for parameters $\alpha_G = 0{,}6$, but $\delta_G = 1$. This last assumption means that there is no attempt to raise income above its natural level, so that no inflation bias is transmitted by the Bundesbank to the economy. Italy has instead a tradition of competitive devaluations ("low inflation aversion", that is "low" β_I) and values for parameters $\alpha_I = 0{,}5$ (in the past decades, the labour market in Italy has been even more rigid than in Germany) and $\delta_I = 1.4$, due to the tendency of the Bank of Italy to improve on the "high" Italian natural unemployment level by "monetary surprises".

Therefore, by substituting the above numerical values attributed to Germany and Italy in equation 5, from the two inflation rates:

(5*) $\pi_I = \alpha_1 (\delta_I U_n) / \beta_I$

(5**) $\pi_G = \alpha_G (\delta_G U_n) / \beta_G$

we obtain $\pi_I > \pi_G$

The simple exercise carried out above shows how the "time-inconsistency" model has been applied to the inflation differentials of Italy with respect to Germany and, more generally, as the rationale for the different inflation paths of Core and Peripehery countries during the EMS period. Despite the lowest employment responsiveness to monetary expansions in the Italian vis-à-vis the German labour market ($\alpha_I < \alpha_G$), the incentive for a surprise inflation was present not in Germany but in Italy ($\delta > 1$), due to the political pressure on the Bank of Italy to come to issue with the socially unbearable natural unemployment rate.

Let us now consider the impact of fiscal policy on macroeconomic stability. By substituting in equation 7 the Fisher equation: $r = \gamma + \pi^e$, where γ is the real interest rate, we have:

(8) $b' = G/Y – T/Y + (g + \pi^e - \pi) b$

The usual way to rationalize the fiscal authorities' task to abide by to the commitment to preserve the sustainability of public accounts is the strategy to keep under control public expenditures and follow the "tax smoothing" principle. Sticking to the Italian example, the low credibility of the Bank of Italy for running an anti-inflationary monetary policy was causing inflation expectations in financial markets higher than the ex post inflation rate was showing : $\pi^e – \pi > 0$. As a consequence, on the left side of equation 8 Italy has been experiencing during the 80s high values for b'. The more agents were expecting a surprise inflation, the more the Bank of Italy had to raise interest rates in order to accommodate the request by financial agents of both a devaluation and a default risk premium, thus fuelling a self-sustaining process of increasing public debt. Even when the public deficits turned to become public surpluses starting from 1991, the situation of public accounts in Italy kept being appalling due to large interest payments. The decrease in public deficit and debt ratios required by the Maastricht criteria was impeded at the numerator by the high debt service and at the denominator by the depressed GDP expansion after the low investment levels at least in part provoked by long period of high interest rates in Italy.

Differently from the advocates of the orthodox view, I believe that the rationale for macroeconomic instability across European countries stemming from the two analytical frameworks discussed above is no longer in place. The launch of the Euro has definitively eradicated the tendency to excessive monetary and fiscal stabilization which has been provoking macroeconomic instability across European countries. However, it is worth stressing that the EMU monetary and fiscal authorities are still dealing with the problem to choose the most appropriate monetary-fiscal policy mix. The main questions are the following: 1) There is no fear that the European Central Bank (ECB) might be tempted to engineer a "surprise inflation". On the contrary, the fear is that the "one size fits all" strategy pointing to the average EMU-wide inflation and output gap makes the ECB monetary stance deflationary for some countries; 2) The SGP is founded on the presumption that one country's expansionary fiscal policy conveys a deflationary effect on the other EMU countries (after the negative effect on aggregate demand due to the increase in the Euro interest rate larger than the positive trade effect) but no account appears to have been taken of possible under-stabilisation stemming from the overlapping of a "one size fits all" deflation and the SGP constraint on discretionary fiscal manouvres. In my opinion, these two open questions demonstrate that how the interplay between the "time inconsistency" model and the "unpleasant arithmetic" of the public debt does work inside the EMU has not been clearly set. Therefore, it can be doubted that monetary and fiscal authorities in Europe are really endowed with the right tool-box to implement stabilization policies. To this regard, what are the opinions of the two authors?

According to the Winkler paper, the "time inconsistency" and the "unpleasant arithmetics" models are a comprehensive guide to understand the threats to the EMU macroeconomic equilibrium and to fully agree on the EMU institutional setting. A merit of the paper is to assess very clearly the point of view of mainstream economics on the role of monetary and fiscal policy, both with respect to short run stabilisation and long run growth. The EMU institutional setting follows from the fact that the theoretical consensus reached on money neutrality in the long run, and sound fiscal policies as a necessary condition for low inflation expectations, was not thoroughly accepted by monetary and fiscal authorities during the EMS period. Once "monetary discipline" has been gained with the single currency and a single central bank inheriting the same

Bundesbank's high preference for monetary stability, the fear of "fiscal indiscipline" has pushed the implementation of the SGP towards enforcing "close to balance" public accounts. The motivation for sticking to the separate assignment of monetary policy to symmetric shocks and fiscal policy to asymmetric shocks under the SGP constraint, emerges exactly from the paper as the objective to avoid that the ECB monetary stances could be jeopardised by too expansionary stabilisation policies at the national level. Winkler endorses the orthodox view whereby the EMU countries should refrain from improving on the natural income level by monetary and fiscal expansions. Instead, the EMU governments should come to terms with the excessive rigidity of the labour markets. The insistence on labour market reforms, aimed at reducing job protection and decentralising wage contracts, is also the reason for the ECB tight monetary stance, which is formally based on the well-known "two pillars" but *de facto* pointing to a rigorous application of the monetary strategy advocated by the "inflation targeting" view.

In the light of the Tamborini's analysis, the EMU institutional setting is far from being the most appropriate for a sound macroeconomic management. A great merit of the paper is in the method. Tamborini is sympathetic with the Keynesian approach. Yet, in order to be able to carry out a rigorous evaluation of the EMU monetary-fiscal policy mix, he accepts the macroeconomic model of the mainstream approach to which the whole EMU construction is inspired. The bulk of the Tamborini paper is the critique of the complete overlapping - which Winkler instead applauds - between the theoretical tenets and policy prescriptions of the mainstream approach and the Brussels consensus. He convincingly argues that the presumption of optimality of the present EMU monetary-fiscal policy mix is flawed. It leads governments to underestimate costs and risks of insufficient stabilization stemming from the "monetary dominance" of the ECB acting as a Stackelberg leader, and national governments coping with asymmetric shocks by running "close to balance" budgets and just "letting automatic stabilisers work". I think that the main critiques put forward by Tamborini are worth to be carefully pondered.

Due to the loss of national monetary policy instrument, whatever the degree of correlation of asymmetric shocks, as for both demand and supply shocks, in the absence of a monetary intervention by the ECB, automatic stabilisers prove to be insufficient to optimally stabilise either output or inflation. Yet, apart from the case of perfectly symmetric shocks (which do not affect the EMU-wide output and inflation values), it is likely that symmetric but unevenly distributed symmetric shocks materialize. The ECB is then obliged to intervene, and spillovers across EMU countries in terms of output effects and financial effects - via the interest rate - ensue. While sticking to the functioning of the orthodox macroeconomic framework, Tamborini demonstrates that the joint operation of the ECB monetary policy and the national automatic stabilisers proves again to be insufficient. Moreover, the more asymmetric is the shock, the less the ECB is required to intervene. In view of possible reliance on discretionary fiscal impulses, Tamborini also argues that the counterfactual assessment of compliance with SGP by national fiscal authorities, conducted on the European data of past decades, does not show – contrary to the opinion of the economists at the European Commission - systematic pro-cyclical mismanagement of public budgets. I would also add that the evidence of non-Keynesian effects of fiscal policies - often mentioned in the literature which is sympathetic with the orthodox model - is scant and may in fact conceal reverse causation. It is very likely that the deflationary tendency of the macroeconomy has been causing automatic stabilisers to increase public deficits, not the other way round.

Two other Tamborini results are worth mentioning: i) Contrary to the SGP rationale (above mentioned in question 2), a possible increase in the EMU-wide interest rate as an effect of a national stabilisation policy, is likely to be overrunned – due to the high share of the intra-EMU exchange - by the positive spillovers spread over the other EMU countries' income level. In general, each government operating its optimal fiscal policy is a Nash equilibrium which trumps SGP policy prescriptions, thus putting in doubts the recourse to the SGP; ii) In case of negative supply shocks, the question has to be posed "whether the *aggregate outcome* of optimal discretionary fiscal policies is also optimal for the central monetary authority". First, contrary to the Dixit and Lambertini paper, the same relative weights for output and inflation in the loss function have to be considered by the ECB and the national fiscal authority. Second, even if the weights are different, in the long run no disturbing effect will affect the core inflation and potential output levels jointly decided by the ECB and national fiscal authorities, so that no distortion is caused by discretionary national fiscal polices. However, as far as the short run is concerned, in case of a possible disagreement between them about the relative variability of output and inflation an important warning is conveyed by the paper. The ECB might not be content with the fiscal stabilisation of expansionary public deficit and then react. Hence, the risk that conflicting interventions could jeopardize the EMU macroeconomic environment are severe. Yet, the solution is by no means the SGP, as a fiscal policy central authority appears to be the sensible choice.

In conclusion, the Tamborini's analysis of the present guidelines for EMU macroeconomic policy shows that the "Brussels consensus" is not such a solid and reliable construction. The reader gets the impression that the Winkler's satisfaction with the orthodox approach to the EMU macroeconomic management is beyond the point. Quite on the contrary, our attention is drawn to consider the possibility that - as an effect of both the ECB behavioural function and the SGP constraint on national fiscal policies - a deflationary bias is hampering in Europe the determinants of long-run growth.

Comment
by
Annette Bongardt

Dario Togati's paper shares with other contributions to this volume (Winkler and Tamborini) a common theme, the discussion of Economic and Monetary Union (EMU) and of the Stability and Growth Pact (SGP) from an economic perspective, but adds a different perspective: the New Economy (NE). The author's focus and contribution resides in his analysis as to whether and to what extent the advent of the NE has changed economic and thus policy conditions and whether the existing macroeconomic policy prescriptions in the eurozone can be considered adequate in the light of the objective to transform the EU in the world's most competitive knowledge-based economy (Lisbon strategy).

His paper explores two lines of thought. First, and more generally, he defends that EMU policy prescriptions following from the Maastricht Treaty, the SGP and the Brussels Consensus, lack "internal consistency" or credibility, meaning that they do not follow from any specific macroeconomic theory – new classical or Keynesian. Secondly, he argues that EMU prescriptions lack "external consistency" on the grounds that they are out of tune with the NE that increases demand instability. Lastly, he makes the case for new Keynesian policy guidelines featuring more flexibility within thresholds, claiming that the present ones with too tight fiscal and monetary policies, albeit with a pragmatic enforcement, lack credibility and have contributed to the present economic difficulties.

The first and the last issue – an evaluation of the existing macroeconomic toolbox in the light of symmetric (dealt with by ECB monetary policy) and asymmetric (dealt with by national fiscal policies in the absence of EU fiscal federalism) shocks, or indeed of permanent or temporary ones - shall not be focused here. They are also addressed in this volume by Winkler and by Tamborini and by Croce Angelini in her comment on the two authors.

The second issue begs an analysis as to what is so new about the NE as to require new economic policies. To start with, it might be useful to define what exactly is meant by the NE, given that this term might be interpreted differently, and distinguish it from another frequently used term, information economy. Drawing on Bryson (2003), the NE is generally considered to comprise the following elements:

- A productivity revival (verified in the US in the second half of the 1990s, after the slow-down noted from the 1973 oil crisis onwards)
- Elevation of knowledge to a quasi-production factor and information and communications technologies (ICT) raising the productivity of third sectors;
- The need for multi-dimensional changes – e.g. firm organisation, institutions, competition patterns;
- The belief in the end of the business cycle, with recessions overcome and stock prices representing the actual present value of firms.

Evidence (i.e. the 2001-2003 recession and the end of the bubble in the US, the pioneer in the NE) has in the meantime dismissed the proposition that the NE would spell the end of the business cycle. The first three items now tend to be referred to as information economy. It should be noted that they are microeconomic in nature, highlighting not only knowledge and ICT but as well changes, for instance in firms, institutions and governance, necessary to realise their full benefits, notably in terms of efficiency gains.

In this context it might be useful to recall that the productivity slow-down in Europe and in the US has its roots in the exhaustion of the old mass production paradigm in terms of base technology, working practices / skill profiles inspired by Taylorism and organisation; a fact to which management science has long called attention. The acceleration of technological advance and the advent of new, more flexible production technologies with the then available ICT highlighted flexibility at the firm level (i.e. production equipment, working practices, less hierarchical organization, inter-firm cooperation) and the market-driven faster and more flexible reaction to clients' needs. This production paradigm shift for which ICT created the preconditions, referred to as lean production or flexible mass production, pioneered by the Japanese firm Toyota (and also denominated as Toyotism), is centred on different organisation and is market- rather than production-technology driven. It was implementing flexible mass production with different firm and work organization in its industrial organization settings that European and US firms regained competitiveness. At the European level, the European Community addressed the "productivity paradox" to overcome "Eurosclerosis" in the first half of the 1980s by putting in practice the four freedoms and liberalizing internally (Single European Act and the Single Market) and externally (Uruguay Round).

Focusing on the information economy of which the United States are the pioneer, with the proliferation of ICT and the US productivity revival in the second half of the 1990s, it is noteworthy that the very existence of a productivity gap between Europe and the US is not uncontested (I should like to thank Paul de Grauwe for having reminded me that productivity per hour is not much different between Europe and the US, considering factors such as differences in terms of longer working hours and lifetime work in the US). Another issue is whether firm structures, governance and institutions are adequate for realising the full benefits from knowledge and ICT in a knowledge-based economy. Could the fact that Europe fails to deliver growth in the information economy not rather be related to the fact that Europe has not managed to create a favourable environment for the information economy to work and produce growth? The European Council recognised in 2003 that the potential of the Lisbon strategy rests on global and coordinated reforms, notably in terms of structural reforms, employment policies and social protection, apart from macroeconomic coordination.

The possible linkages between the microeconomic sphere and macroeconomic stability were brought back to general attention by the reality of the persistence of business cycles. It is generally held that the information economy enhances the functioning of markets and supply-side conditions (corroborated by the information economy literature reviewed in Bryson (2003)). Togati argues that the NE does not resume to a mere positive supply shock in line with the New Classical Macroeconomics view, but that it also increases endogenous demand instability. On the basis of the fact that the information economy augments speed and functions within a context of market liberalisation / globalisation as well in sectors long closed to competition (notably financial services), the question is whether many of the problems in the microeconomic sphere that allegedly enhance demand instability would really be best addressed by macroeconomic demand management.

Rather, it might be useful to take a step back and give some thought to the micro foundations of the information economy and how to avoid some of the potential sources of demand shocks in the first place. This would include for instance better accounting standards (e.g. avoiding another Emron case) and banking regulation to prevent crises of consumer and investor confidence such in Japan (where demand stimulation did not prove successful for many years), employment formation and re-qualification policies as a response to structural change and to prevent structural unemployment, or regional policies to improve regional competitiveness and social policies of various kinds, or reinforcing consumer information and protection.

THE EURO AS A WORLD CURRENCY AND AS A EUROPEAN ANCHOR

Chapter 10

Ever Challenging the Buck? The Euro and the Question of Power in International Monetary Governance

By
Hubert Zimmermann

Abstract: Monetary Power matters – this has been the firm conviction of many proponents of European monetary integration which saw the Euro as a political project to liberate Europe from its dependence on the American dollar. This article discusses how the trajectory towards a common currency was affected by this idea, whether it is embedded in the actual form of Economic and Monetary Union (EMU), and how it is reflected in current debates about the external management of the common currency. It argues that the current institutional set-up of the Euro-zone is not conducive to an active monetary policy. This lack of acting capability might become a serious problem as the Euro moves towards an increasingly important role in the international monetary system.

Keywords: Bretton Woods, monetary power, Germany, France, United States, Maastricht, ECB

This chapter deals with the past and future of an idea which sparked the imagination of many European politicians and analysts (and does so still): the idea of creating a so-called European monetary personality and in the process a currency which is able to rival the dollar on world monetary markets. Behind that idea lays the assumption that monetary power matters. This fundamentally political interpretation of the necessity of European monetary integration played an important role in the debate about Economic and Monetary Union (EMU) since the 1960s. I will discuss how this idea affected the trajectory towards a common currency, whether it is embedded in the actual form of EMU, and how it is reflected in the debates about the external management of the common currency. Finally, the progress and prospects for an enhanced international role of the euro and the implications of such a development for global economic governance will be assessed.

1. Some Recent Developments

Over the last two years, the euro has appreciated to an extent which surprised many observers (see also Pompeo della Posta's chapter in this volume). Even the end of the war in Iraq has not resulted in a reversal of this trend, contrary to past military conflicts with United States (US) participation which, on termination, led to a strong upward movement of the American currency. Of course, the unstable situation in Iraq suggests that the US will be engaged there for the foreseeable future and that there will be no quick easing of the military burden, let alone a peace dividend in the form of petroleum exports leading to lower energy prices. Analysts and markets, however, seem less worried about the direct cost of the war; they rather point to the huge budgetary deficits resulting from the economic policy of the Bush administration and to the traditionally high American current account deficit (Calleo 2003). These are no results of the Iraq war. The International Herald Tribune warned already in December 2002 that America's "current account deficit is running at record levels, requiring as much as $2bn. a day in inflows from foreign investors to finance it" (Pfanner 2002). Whereas in the second half of the 20th century the persistent deficits of the United States were offset by massive capital inflows mostly from European and Asian countries, it appears now as if the situation has changed. The Economist Intelligence Unit noted in its country report on the US that it is "increasingly difficult to attract these funds – a key reason why the dollar fell during 2002. Foreign governments and central banks are now providing a significant minority of all capital flows into the US, suggesting that the private sector's appetite for US dollar assets has waned."[1] In late 2003, this trend was continuing. It eroded increasingly the major privilege associated with the dollar's role as the world's leading currency; the ability to react with benign neglect to persistent current account deficits. The Financial Times reported in December 2003 that the American deficit required a net inflow into dollar assets of about $46bn a month, but the actual amount had fallen in September 2003 to $4.2bn (Hughes/Swann 2003). To attract investors, the US will in the long run have to raise interest rates or find other means to get foreigners to invest in dollar assets.

However, these potential investors appear to have found an alternative: the euro. Reports in the international press have multiplied, indicating that more and more countries plan to diversify some of their reserves in euro. In March 2003, Russia "imported" for the first time more euros ($1.6bn) than dollars ($1.2bn). That is a more than three-fold increase compared to the year before (Neue Zuericher Zeitung, 2003). Reportedly, the share of euro-based deposits quadrupled in some Moscow banks in this year, suggesting that the gigantic estimated $50bn in dollars which are hoarded by Russians might be converted increasingly to euros (Wines 2003). The Russian central bank has lowered the share of dollars in its reserves from 90% to 75%, augmented its holdings of euros. This trend might continue since almost half of Russia's imports come from Europe.

At the 2002 ASEM (Asia-Europe Meeting) summit, China, Japan and eight other Asian countries stated their intention to use the euro as reserve currency along with the dollar (Süddeutsche Zeitung 2002). After 9/11, reports circulated that Arab countries were withdrawing massive amounts of capital from American accounts because of preoccupations that these funds might eventually get vested in the campaign against the financial sources of terrorism. The German finance Minister Hans Eichel reported after a trip to Latin America, "Everybody is interested in a strong euro, since they do not want to depend on the dollar" (Herz 2002). In November 2003, the International Monetary Fund (IMF) published figures which showed that the Euro's share in world monetary reserves had unexpectedly risen from 14.6 to 18.7% (IMF 2003).

The old dream of enthusiasts of European cooperation appears as if it might come true: a common currency as a cornerstone of Europe's rise to equality with the US on a global scale. Such visions, however, have regularly received sobering comments from the guardians of the euro. In its last report on the international role of the euro, the European Central Bank (ECB) has stated that it "does not pursue the internationalisation of the euro as an independent policy goal, which implies that it neither fosters nor hinders this process" (ECB 2002). This statement is similar to the position the Bundesbank took in the 1960s and 1970s when the Deutschmark (DM) became a safe haven for funds moving away from dollars. It is a deeply engrained conviction of most European central bankers that a more assertive role of the eurozone in the international monetary system would have to be based on far-reaching internal market reforms, in particular labour market liberalization, so as to gradually reduce the competitive advantage of the US as optimum currency area. For the bankers, the economic fundamentals determine the international use of a currency. Probably even more important is that the ECB and the European System of Central Banks (ESCB) want to be free to target monetary policy to the internal objective of price stability.[2]

However, the ECB is not the only institution shaping the international monetary policy of EMU. The member states and the euro-12 are responsible for exchange rate management and the external representation of the eurozone.

Different traditions have shaped their perspective on the international role of the euro, as will be shown in this chapter. The disjunction between the massive amount of speculation about the international role of the euro and the relative silence of European authorities is conspicuous. Assessments as regards future developments on monetary markets are notoriously difficult. A glimpse back into history and an analysis of the question whether a European currency was also perceived as a potential rival to the dollar may help to clarify long-lasting political trends. These trends might shed light on a question which, especially given current transatlantic discords will certainly attract enormous attention in the coming years. What does the possession of a hegemonic international currency mean in terms of monetary power and is it desirable that European monetary authorities pursue an active policy in this in this respect? This question is notoriously hard to grasp since research has not yet managed to agree on precise definitions of the effects of monetary power.

A historical overview can provide some evidence in this respect. It will be shown that the idea of an active European monetary policy vis-à-vis the US was a driving force in decisive moments of the history of European monetary integration. However, in the blueprint for the eurozone this consideration played hardly any role. Similarly to the situation in the US after World War II, the eurozone has no specific institutional structure and policy to deal with the consequences of a development which seems to become increasingly a reality: the rise of the euro to the status of an international currency comparable to the dollar. This could result in the incapacity on part of the eurozone to formulate a coherent response to major monetary crises, for example in the event of massive changes in the value of the dollar.

2. Dollar Hegemony and Monetary Power[3]

It had not been foreseen after 1945 (particularly not by the British) that the pound would soon lose its role as the world's major international currency to the dollar. At the Bretton Woods conference in 1944, the US and the United Kingdom had envisioned a world in which several currencies played a leading role. In the end, however, the features of the monetary system as it emerged after 1945 differed in important aspects from what had been planned. Soon, all major industrial countries linked the value of their currencies to the dollar. The dollar's value was expressed in a fixed ratio to gold ($35 an ounce), and guaranteed by an American promise to exchange at this rate dollars to gold from the abundant reserves at Fort Knox. This gold exchange guarantee provided the dollar as reserve currency with credibility. The strength of the US economy seemed beyond doubt; however, the main condition on which the stability of the whole system rested was that the US managed its domestic economy and the effects of its external commitments in ways that were not detrimental to dollar stability.

Monetary relations in the Western World became part of an overall strategy which was to shield Western democracies through economic stability and growth from the perceived threat from abroad and from within, especially in countries with strong Communist parties such as France and Italy. The United States became economically (and militarily) much more entangled in Europe and Asia than it had planned. This caused an unprecedented outflow of dollars and would have not been possible if the US had not been the centre of the world economy and, at the same time, the linchpin of the Western security system. Thus, it had not to worry about the balance of payments deficits resulting from its enormous political and economic commitments as long the bills were not presented at the US treasury for gold all at once. The role of the dollar as the linchpin of the system spared the US also the need to pursue potentially costly adjustment policies, which is one of the main benefits of monetary power (Kirshner 2003: 22). As lender of last resort, it also cast the decisive vote in the emerging post-war monetary governance structure. And finally, it also reaped the benefits of seigniorage and profited from the fact trade in currencies and major international commodities was done in dollars.[4] Domestic autonomy, external leverage and economic benefits are core attributes of monetary power and they certainly contributed to the lasting super-power status of the US (though research at present is unable to give and estimate of the exact weight of those different elements).

Against simplistic zero-sum game arguments of power, however, this did not mean that the Europeans did not profit from the post-war monetary system. An informal bargain emerged. The US had the privileges of monetary hegemony, and the Europeans profited from US capital outflows for investments. Furthermore, they acquired security against the East through the American military commitment. Political and economic aspects were very closely intertwined in this construction: the transatlantic monetary order was not only a set of economic arrangements. It was a highly political enterprise, based on a common outlook and language in economic *and* political affairs. As long as the larger political and economic objectives of Europe and the US were in accordance, the Europeans would be content to allow the US call the tune in international monetary relations. However, as important and welcome the support of the United States for the reconstruction and integration of European economies was, a certain uneasiness always existed, even outside leftist and nationalist circles, regarding the dependence of Europe on American economic and military support.[5]

Despite this uneasiness, alternative conceptions of monetary order were rather marginalized in Europe. The European Payments Union, which could have been the core of a distinctly European monetary order, was dissolved without discussion in 1959 when it had fulfilled its immediate task of regulating intra-European payments balances. Although this was regretted by many participants, there was no sustained advocacy for an initiative which would deepen and institutionalize European monetary cooperation. Early proposals for a European currency policy, such as a resolution by the European parliament in 1959, were not taken serious by the transatlantic elite managing international monetary policy (Tsoukalis, 1977: 53-4).

However, as early as the late 1950s, cracks in the Bretton Woods system appeared. Robert Triffin formulated the famous dilemma of the dollar-gold standard: the growing world economy necessitated a continuing supply of the reserve currency. However, as soon as the dollars accumulating in the system approached the value of the American gold reserves, doubts in the dollar-gold exchange pledge inevitably arose (Triffin 1960). Curbing the dollar outflow would result in a shortage of liquidity. To continue pumping dollars abroad, however, would cause increasing exchanges of dollars to gold, thereby undermining the base of the dollar even more. The American government felt particularly threatened by the possibility of a run on its gold reserves in case nervous holders began to cash in their dollars. In fact, from 1958 to 1961, the American gold stock declined from $20.6bn to $16.9bn. However, a devaluation of the dollar against gold was ruled out, partly for prestige reasons, partly because it would have made US investments and commitments abroad vastly more expensive. When President Kennedy asked his Secretary of Treasury to educate him on the actual advantages of a reserve currency, Douglas Dillon answered: "To date, foreign countries and their nationals have acquired nearly $20 billion in dollar accounts. This, in effect, is a demand loan to us of $20 billion which has allowed us to pursue policies over the years that would have been utterly impossible had not the dollar been a key currency[6]".

Fearing the unknown consequences of a radical policy change, the US took a strong lead in forging a reaffirmation of the transatlantic bargain. Eisenhower and Kennedy called on the Europeans to help shore up the system.

In the following years the leading industrial states devised an elaborate system of new rules and regimes which were to stabilize the monetary order (Goldpool, General Agreements to Borrow, Roosa-Bonds, etc.). Germany (later joined by other countries such as Italy and Japan) agreed to transfer back the dollars it acquired from the huge American military machinery on its territory by buying American weapons – a clear sign for the close link between security and monetary system (Zimmermann 1999). Although the dollar gold link turned out to be a potential constraint on the US, it had enough leverage to get other countries to play by the rules and actively support the dollar. The American-led effort to stabilize the system glaringly exposed its political background. The European willingness to go along rested upon the US promise to put their balance of payments in order and even more on the still intact common outlook regarding the political and economic bases of the transatlantic system.

Despite the re-enforcement of international cooperation, the American deficits did not disappear during the 1960s. It was clear that the monetary system was in need of reform. Voices calling for a radical reform of the system became more influential among academic economists. Even more ominous was that alternative political conceptions of monetary order became increasingly popular. The core figure in this context is the French President Charles de Gaulle. As soon as he assumed his post in 1958, he embarked on a mission of regaining national autonomy for France in what he considered one of essential domains of state power: autonomy in the pursuit of monetary policies. To the Gaullists, the Bretton Woods system symbolized a "Yalta monetaire fait à deux[7]", paralleling in importance the famous wartime conference of 1945 during which the Big Three allegedly had divided up Europe without regard to the concerns of smaller countries. The Gaullist critique of the dollar centred on two points: that an overvalued dollar (with respect to gold) helped the US to buy up European industries with cheap money, and that the key currency role of the dollar allowed the Americans to finance their expansive foreign policies by printing money (Bordo/Simard/White 1995). In February 1965, the French President threw down the gauntlet. He announced that France from now on would exchange every dollar it earned immediately for gold in order to force the US to a radical change of the monetary system. However, the Gaullist idea of national monetary autonomy was not uncontested in France. Many officials in French monetary institutions remained transatlantic in their outlook. Another solution was represented by Finance Minister, Giscard d'Estaing, and pronounced by his deputy, Andrè de Lattre, in January 1965: the idea of a European currency.[8] The major intention behind this step "was the creation of a currency to rival the

US dollar and the pound sterling" (Dyson/Featherstone 1999: 100-1).

Giscard's supranational initiative was greeted with silence in the European Economic Community (EEC) countries. De Gaulle did not like the ideas of his minister either, and in January 1966 Giscard d'Estaing left the government. De Gaulle's intention of bringing down the transatlantic system failed too, however, although the US gold reserves in Fort Knox shrank considerably. No other monetary power supported France. Germany immediately declared its solidarity with the US. To be sure, it shared with the rest of Europe some of the critique de Gaulle uttered against lax American monetary policies. The Germans complained that the system forced them to import inflation and thus undermined the domestic priority of price stability (Emminger 1976). But the primacy of transatlantic cooperation in solving the monetary distortions remained dominant, not only in the Federal Republic but also in countries such as Britain, Italy or the Netherlands (as mentioned earlier, an important factor was the security partnership linking these states to the US).

However, within a few years, this allegiance was shattered sufficiently to lead to a major rethinking among America's allies. The most important reason was the Vietnam War. It resulted in a much more assertive and confrontational American policy towards its allies, and it provoked grave apprehensions in Europe whether the US would honour its side of the bargain and keep the dollar stable while preserving its security commitments in Europe. The war also led to fundamental doubts in the general thrust of American policies and thus undermined the political rationales for supporting the dollar. Many critics suspected that Europe was financing the Vietnam War by holding dollars. Increasingly, American pressure to induce European countries to hold dollars (and thus extend credit to policies they would underwrite no more) was deeply resented.[9]

The US also moved away from the transatlantic bargain. Those in the US which since the early 1960s had seen the international role of the dollar rather as a burden became increasingly vocal (Nau 1990: 152). When Richard Nixon became president in 1969, the de-legitimization of the transatlantic order in the US accelerated. Nixon had no attachment to the institutionalized cooperation established by the Bretton Woods framework – particularly since the public debate suggested that its effects were damaging to American national interests. The Nixon administration was not willing to agree to European demands for a domestic economic policy which would stabilize the external value of the dollar. It saw its domestic autonomy threatened by these demands which were interpreted as European attempt to free-ride on a monetary system resting on America's already over-burdened shoulders. In economic issues, Europe was increasingly seen as rival not as partner. Nixon's Secretary of Treasury, John Connally, wrote, "I believe we must realize there is a strong element of thinking within Europe that would take advantage of weakness or clumsiness on our part to promote the Common Market not as a partner but as a rival economic bloc, competing vigorously with the dollar and reducing or shutting out, as best as it can, US economic influence from a considerable portion of the world.[10]"

For these reasons, the new government took no initiative to do anything about the monetary turmoil as long as it did not see its domestic priorities endangered by the "market". The rise of neo-liberal thought in those years had the welcome function of legitimizing this policy. As a result of the policy of 'benign neglect', however, American balance of payments deficits rose out of all proportion. When dollar-holders desperately tried to cash in their reserves, Nixon acted and in August 1971 closed the gold window. As there was no alternative to the dollar, the world was set on a virtual dollar standard. Thus, the burden of adjustment was shifted abroad, and America's autonomy regarding its domestic policies and the size of its external commitments was preserved. The Europeans, however, were left with two unpleasant options concerning the resulting dollar glut: either to revalue their currencies against the dollar or to try and neutralize the capital inflow by restrictive measures on the domestic market. The idea of "liberating" Europe from that ties that bound it to an erratic American monetary policy received a strong push by these events.

3. Dollar 'Decline' and European Monetary Integration in the 1970s

The decisive change in this respect occurred in Germany. Unprecedented speculative funds streaming to the Federal Republic became a regular feature, undermining the domestic autonomy granted until then by the Bretton Woods system. The 1968 Bonn monetary conference, during which Germany resisted the urgent calls by the US, the UK and France to revalue the DM, was a sign that the disillusionment of German politicians in currency matters was prevailing over its continued allegiance of the financial elite to the transatlantic system. The time was ripe for alternative conceptions and in early 1969 there was already one on the desks in European capitals: EC Commissioner Raymond Barre's report on European monetary integration (Memorandum der Kommission 1969). The Barre report was a reaction to the Bonn conference and it reflected the deep concern of the Commission regarding the effects of monetary disunity on the project of European integration. The reaction of the member countries during prior consultations ranged from mildly positive to indifferent.[11] Italy and the Netherlands still had reservations and warned of a duplication of transatlantic mechanisms by European structures.

The French finance minister, however, welcomed the plan. His name was Giscard d'Estaing who had reassumed his post after de Gaulle was replaced by Georges Pompidou in April 1969. Giscard wasted no time to communicate to the German government that he still considered a European solution the best way to confront the monetary crisis, despite the silence which had greeted his earlier proposals.[12] The huge speculative movements from franc to DM in 1969 convinced the non-Gaullist and non-Communist part of the French establishment that a strategy of national autonomy was illusory and that a European solution was the only possibility to avoid that the franc, if ever free from dependence on the dollar, was subjugated to German monetary policy. To the long-term concern of avoiding monetary dependence on Germany came the urgent short-term business of saving the CAP which was thrown into havoc when France and the Federal Republic finally realigned their currencies (in August and October 1969 respectively).[13] Thus, the de-legitimization of Gaullist ideology and a mix of short- and long-term concerns opened the path for the French government's embracement of a European solution. However, this opening was fragile: Pompidou, for example, was not convinced that a European solution was preferable to the Gaullist conception (Dyson/Featherstone 1999: 290-1).

Giscard's hints and the Commission proposals surprisingly struck a receptive chord in Germany, the country which had been the core supporter of the transatlantic system on the European side. The major reason is that the previous consensus in Germany on the priority of pursuing international monetary policy in a transatlantic framework was rapidly dissolving. Although important actors, such as the Bundesbank, remained wedded to the Bretton Woods system, and although some politicians flirted with a Gaullist conception of national autonomy, based on the success of Germany's anti-inflationary policies, it was the European option which ultimately prevailed at the EC Hague summit of December 1969. The central role in this decision fell to Willy Brandt who was elected Chancellor in September 1969. Brandt was acutely aware of the problem that his new *Ostpolitik* might provoke apprehensions from countries wary of greater German independence. Additionally, he was sympathetic to the critique levelled towards US policies by the European left and thus not particularly disposed to make a strong effort in order to save the transatlantic bargain.

During the heads of government meeting in The Hague, Brandt surprised the assembled group by endorsing the idea of a European reserve fund and calling for the accomplishment of an economic and monetary union in stages (based on a plan from the Economics Ministry). Like the agreement between Mitterrand and Kohl prior to the Intergovernmental Conference in Maastricht, Brandt's decision to table a plan for monetary union was taken in an extremely volatile international situation and in very short-term and unpremeditated way. Retrospectively, Brandt wrote that he intended to give Europe renewed impetus with the reserve fund idea (Brandt 1976: 322). At a time when the security relationship to the United States weakened, suggesting less dependence, the German government also took a step towards liberating itself from the straightjacket of the dollar. The parallels to Maastricht are striking. The EMU proposal was supported by the smaller countries; even Italy now emphasized the necessity of a European counterbalance to the US (Tsoukalis 1977: 89). A working group, chaired by Luxemburg's Prime Minister, Pierre Werner, was charged with presenting a plan in respect of Economic and Monetary Union.

However, although after 1969 the final objective of European monetary policy had become consensus and slowly replaced the old transatlantic outlook, there was no agreement on the way to achieve it. The Werner plan was never implemented, and the early 1970s became a period of ideological ferment with many different conceptions competing in Europe. The US, perceiving itself in a defensive position, agreed only to a limited extent of international cooperation, abandoning even this whenever opportune. In February 1973, US Secretary of Treasury, George Shultz, remarked that "American policy for interest rates and domestic liquidity will only be determined in accordance with the needs of the United States economy, excluding other international concerns (quoted in: Tsoukalis, 1977: 127). The ups and downs of the dollar during the 1970s were major factors in repeated European attempts at closer cooperation despite strong cleavages in monetary philosophy among EC members. European governments and central banks became less and less willing to make any sacrifices for the sake of transatlantic cooperation - in contrast with an increasing willingness to coordinate their monetary policies in the European context (Loedel 1999). The dollar problem was seen as the main source of intra-European currency instability, forcing Germany, and, consequently, other European countries to incessant adjustment measures (Kaelberer 2001: 130-1). This provided ample opportunities for French proponents of a European monetary identity. When

Giscard d'Estaing, in 1978, called for a "new Bretton Woods for Europe", he found a receptive listener in Germany's chancellor Helmut Schmidt. In his writings, Schmidt emphasizes his disillusionment with American monetary policies (terming them repeatedly 'ruthless') and his conviction that monetary union in Europe was the only way to solve this problem (Schmidt 1990: 221, 231). Dutch Prime Minister Wim Kok called the EMU "the foundation for Europe's increased power in the world." (Quoted in Rodman 2003: 74). The idea of a European currency as means to enhance European bargaining power became a constant element of statements on this issue.

4. Maastricht and the External Role of the euro

The theme of EMU as an instrument of independence, of course, remained a staple of French monetary policy. Mitterrand's belief in the EC as means to enhance European autonomy, for example, underpinned his attitude to EMU (Dyson/Featherstone 1999: 126). This argument, in combination with the fear of German monetary dominance, kept monetary union alive in France despite the formidable heritage of Gaullism. It was clearly visible in the Dumas memorandum of June 1984 which called for a European currency as medium of defence against the dollar and as possible second reserve currency (ibid: 153). A cultural conception of monetary union as building block for a European unity pervaded also the ideas of lower rank officials, such as Jean-Claude Trichet (ibid.: 177).

In the run-up to the Maastricht conference, however, this goal was subjugated to other objectives, above all the binding of a reunited Germany which had become a major preoccupation of Mitterrand (Baun 1996). This strong interest gave the Germans the bargaining power to push through their own vision of a future institutional framework for EMU (Kaelberer 2001: 171). An emphasis on the external role of the European currency was not part of their ideas at this time, particularly given the vital role of the United States in the process of German reunification. Thus, monetary union was created above all with a view to the internal goals of price stability and central bank independence, not the external objective which had so strongly inspired it throughout its history. The French, careful not to stir up more domestic opposition in Germany as already existed, gave up their idea of a strong "gouvernement economique". The question of the external representation of the euro remained unresolved in Maastricht. The conspicuous silence of

European authorities regarding the much-debated rise of the euro to a rival of the dollar might be due to the interest in avoiding internal conflicts which had been covered up in the Maastricht compromise.

One major result is that the present EMU faces a series of institutional limitations for a more assertive and coherent international role. Predictions that the US would have to "confront a larger, more cohesive, and more self-confident and powerful partner" (Henning 1997: 94) have not yet come true. The dollar remains the global vehicle currency and, despite recent trends cited above, the euro's share in international foreign exchange reserves does not yet come close to suggest a displcement of the dollar (ECB 2002: 10-11). In a recent analysis, Benjamin Cohen sums up the reasons for the failure of the euro to surpass the dollar: 1) inertia. Looking back at the history of the decline of the pound it is clear that major changes in the composition of the world's most important currencies take many years. 2) The higher cost of transactions in euros; 3) the anti-growth bias built into the eurozone; and 4) EMU's ambiguous governance structure (Cohen 2003: 56). He might have added the fact that with the UK the country with the most important European financial centre is not part of the eurozone.

The fourth point cited by Cohen seems particularly relevant for the future of international monetary governance. The representation of EMU in international fora, such as the IMF or G-7, is as yet unclear. McNamara and Meunier have argued that as long as there will be no single voice for the euro, there is no way the euro will achieve a role comparable to the dollar (2003: 850). An unresolved tension exists between the euro-12 and the ECB on this issue with the latter claiming that the external value of the euro should be solely a result of the ECB's monetary policy. Former ECB President Duisenberg stated: "Generally speaking, the commitment of the ECB to successfully fulfilling the mandate of the Treaty, that is, to maintain price stability in the euro area, will also shape the ECB's international role. This is, without doubt, the best contribution the ECB can make to a stable monetary system".[14] However, it might be expected that in high-level diplomacy the finance ministers will keep the last word, potentially undermining positions taken the ECB. What is therefore needed is a "clear system of political representation in the area of monetary and financial governance in the EU that allows for effective partnership with the other major economic powers in the international system" (McNamara/ Meunier 2003: 858). One solution for this problem might be the installation of a "Mr EMU", modelled after the successful experiment with Javier Solana in the realm of external foreign policy.

Despite this uncertainty regarding the euro's external representation, the signs for its continuing rise are very apparent and have been mentioned at the beginning of this chapter. The euro is thus the first international currency which is not backed by a centralized political authority. What does this mean in terms of European monetary power? The well-known distinction between structural and relational power introduced by the late Susan Strange might be useful to answer this question. Undoubtedly, the eurozone alone by virtue of its size has enormous structural power, that is, the power to shape the environment in which others have to operate (Strange 1988: 26). However, when it comes to the use of relational power (getting others to do what you want), which is needed in case global monetary governance structures are re-negotiated, it might lack the necessary institutional clout. This scenario is not far-fetched.

The still growing interdependence between Europe and the United States suggests that the common interest in stabilizing mutual economic relations will exert immense pressure for a concertation of monetary policies. Conflicts will inevitably arise. The history of Bretton Woods shows that so-called economic rationality is usually subjugated to political imperatives. Whereas in the United States pressure by the Congress might lead to an uncooperative monetary policy, the EU has still to deal with member states which are autonomous in much of their domestic economic policy. Diverging priorities in domestic markets and the resulting pressure on political leaders might easily lead to a situation which intensifies rather than prevents international monetary crises. The intentional institutional distance of European monetary decision makers from the vagaries of domestic political battles can diminish quite rapidly. Thus, in the US as well as in Europe domestic developments can quickly undermine the present loose governance structure in the internaional monetary system. It is in particular the scenario of major turmoil resulting from US current account deficits and indebtedness which might lead to major monetary conflicts. The eurozone is also not immune against external shocks. In this case, rapid transatlantic consultation might be necessary and an international bargaining process will determine which actor would have to bear the costs of adjustment. Currently the eurozone is ill-equipped for such a negotiating process. The key issue for the international role of the euro in the next years will be therefore whether the structural power of the eurozone can be transformed in relational power required to bargain with other monetary actors.

If that happens, a co-leadership will emerge in the international monetary system which is divided between two currency areas. There are hardly any analogies for such a situation, apart from the interwar period in the 1920s and

1930s when the dollar and the pound were the leading currencies. Historians and political scientists might take a closer look at this period for lessons regarding the future of governance in the international monetary system.

NOTES

[1] Economist Intelligence Unit, Country Report U.S., April 2003.

[2] Thanks to F. Torres for alerting me to this point.

[3] The following sections draw heavily on: Zimmermann (2001).

[4] Seigniorage entailed 1) the holding of non-interest bearing dollar currency by other countries (in 1998, this was estimated to amount to 50-60% of the total U.S. money stock; 2) financing external deficits by borrowing its own currency with the benefit of a liquidity discount equivalent to $5-10 bn annually. See: Portes/Rey 1998: 309-10.

[5] See the articles in: Trachtenberg (ed.) 2003.

[6] Foreign Relations of the United States (thereafter: FRUS) 1961-63, IX, Memo Dillon to JFK, 11 Feb. 1963, p. 164.

[7] Testimony of Jean-Yves Haberer, Chef du Cabinet of French Foreign Minister M. Debré, in: Institut de Gaulle (ed), De Gaulle en son Siècle III, Paris 1992, 55-6.

[8] Political Archive – Auswärtiges Amt (PA-AA), Dept. III A1, vol. 176, Botschaft Paris to AA, 19 Jan 1965.

[9] The only country which, after massive political pressure, would sign formally such a commitment was Germany in the form of the famous Blessing letter in 1967 (Text of the letter in: Hearings before the Combined Subcommittee of Foreign Relations and Armed Services Committees on the Subject of US Forces in Europe, US Senate, 90th Congress, 1st sess., 3 May 1967, Washington 1967, p. 81ff.). This commitment was part of the acrimonious negotiations taking place in 1967 between the US, Britain, and Germany about the cost of Allied troops in Germany and the possibilities of Germany to offseting this cost. The negotiations showed how strained the bargain had become. See: Zimmermann 2002.

[10] Declassified Documents Reference System (thereafter:DDRS) 1999, Doc. 385, Connally to President Nixon, 8 June 1971.

[11] PA-AA, Dept.I A 2, vol. 1519, Telegram from the German EC-embassy to Auswärtiges Amt, 6 Dec. 1968.

[12] PA-AA, Dept. III A 1, 612, Paris Embassy to Auswärtiges Amt: Future French Monetary Policy, 24 July 1969.

[13] The fixed agricultural prices in Europe were based on units of account equivalent to the dollar. The devaluation of the French franc therefore led to a situation in which French producers got more money in francs for the same product (which was bought by the EC at the fixed price in units of account). Such a situation threatened to lead to overproduction and dumping in other EC countries. The reverse happened to German farmers.

[14] http://www.ecb.int/ (Key speeches: The euro: The new European currency. Speech at the Council of Foreign Relations on 1 February 1999 in Chicago).

CHAPTER 11

THE DOLLAR/EURO EXCHANGE RATE AND EMU ECONOMIC INSTITUTIONS *

BY
POMPEO DELLA POSTA

Abstract: The predictions made by economists of the value of the euro prior to its introduction were essentially based on the expected portfolio adjustment resulting from the role that it might play as an international currency. As a result, most analysts agreed that the euro would be a strong currency, appreciating against the US dollar. The first years of life of the 'virtual' euro contradicted such a forecast. Economists therefore abandoned predictions based on the euro as a 'global' money and directed their focus almost exclusively towards traditional, 'fundamentals-based' explanations. Among these explanations, several authors mentioned the unsatisfactory structural and institutional set up of Economic and Monetary Union (EMU). Nevertheless, later on, when the euro started appreciating, a different set of fundamentals had to be isolated in order to account for such behaviour. It is possible to argue, then, that the EMU economic structure and institutions are, or at least are currently perceived as, capable of supporting a strong euro, which plays the role of international money. 'Framing' of expectations, however, still keeps driving the behaviour of the exchange rate, so that the same structural and institutional set up may be subject to different evaluations, depending on the particular state of expectations of the international currency markets. Finally, since the available evidence suggests that the euro is starting to play an international role, I argue that the 'international money' and the 'framing' of expectations approaches explain the behaviour of the dollar/euro exchange rate better than the 'fundamentals' one.

Keywords: Euro, dollar, fundamentals, international currency, portfolio adjustment

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1. Introduction

"An economist is an expert who will know tomorrow why the things he predicted yesterday didn't happen today" (Laurence J. Peter)[1]. In the case of the recent behaviour of the euro, this famous aphorism would seem to be apt. As a matter of fact, before the introduction of the euro most analysts agreed that it would be a strong currency, appreciating against the US dollar. The first years of life of the 'virtual' euro contradicted such a forecast. Economists therefore abandoned predictions based on the euro as a 'global' money and directed their focus almost exclusively towards traditional, 'fundamentals-based' explanations. Among these explanations, several authors mentioned the unsatisfactory structural and institutional set up of the Economic and Monetary Union (EMU). Nevertheless, later on when the euro started appreciating, a different set of fundamentals had to be isolated in order to account for such behaviour. It is possible to argue, then, that the EMU economic structure and institutions are, or at least are currently perceived as, capable of supporting a strong euro, which plays the role of international money. 'Framing' of expectations, however, still keeps driving the behaviour of the exchange rate, so that the same structural and institutional set up may be subject to different evaluations, depending on the particular state of expectations of the international currency markets. Finally, since the available evidence suggests that the euro is starting to play an international role, I argue that the 'international money' and the 'framing' of expectations approaches explain the behaviour of the dollar/euro exchange rate better than the 'fundamentals' one.

The paper is structured as follows. Section 2 briefly describes the recent behaviour of the dollar/euro exchange rate and defines the three possible categories that explain it. Sections 3.1 and 3.2 summarise the reasons why economists expected respectively a strong and a weak euro. In section 4, I survey the explanations provided in the literature for the initial weakness of the euro, while in section 5, I consider the arguments advanced to account for its current strength, thereby implicitly evaluating the robustness of the explanations previously provided for its weakness. When considering both the predictions and the *ex-post* analyses, I stress in particular the role of the EMU institutional set up, so as to evaluate the role that it plays in determining the behaviour of the dollar/euro exchange rate. Section 6 concludes.

2. What determines the behaviour of the dollar/euro exchange rate? Fundamentals, portfolio adjustments and 'framing' of expectations

The international use of a currency assures several benefits to the country issuing it, in particular seigniorage, lower interest rates and a significant economic and political role on the international arena.[2] After World War II, the US have benefited of such a position, but the advent of the euro might challenge the role of the dollar. As a matter of fact, Mundell (1998) and Salvatore (2002), among others, suggest that the US and the European Union might be involved in a struggle for supremacy.[3] Feldstein (2000) takes a stronger position, by arguing that the US might become "a politically convenient adversary" capable of unifying the otherwise divergent European countries. Portes and Rey (1998) even quantified in a reduction in growth of up to half percentage point the loss for the US resulting from the introduction of the new currency.

Other authors, however, express a different opinion. According to Bergsten (2002) and Johnson (1994), quoted in Kaikati (1999), the international role of the dollar would not be challenged by the euro, as long as the former assures price stability in the US. Mussa (2000) maintains that while the success of the euro might reduce the role of the dollar, higher European growth would certainly benefit also the US, so as to create an overall positive balance. As a matter of fact, according to Krugman (1998), the euro would imply at most a loss of 0.1 percentage points in the US rate of growth. Reflecting the declarations made by the former US President Bill Clinton (and also the reassuring voices coming from Europe), Larry Summers, former Deputy Secretary of the US Treasury, did not foresee in the advent of the euro any threat to the leadership of the dollar, so as to rule out any struggle for supremacy. The same cautious approach, probably determined by political reasons, seems to be followed by the Maastricht Treaty in designing the international role of the euro. Zimmermann, in this book, analyses in detail the evolution of the European approach towards the euro as an international currency.

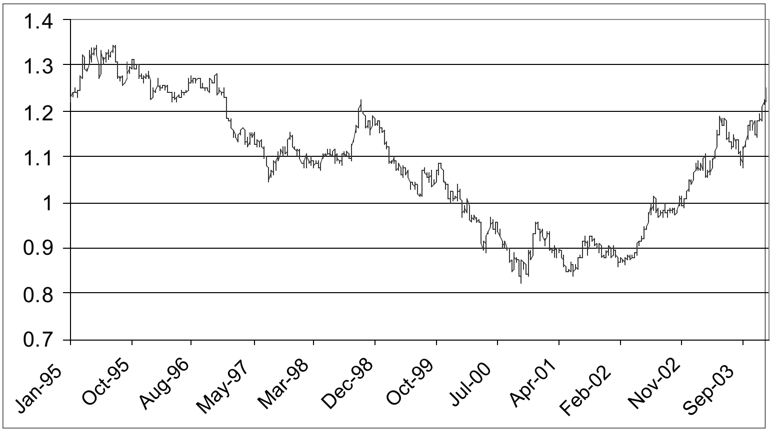
Having defined the scenario within which the conduct of the dollar/euro exchange rate can be analysed, let us describe the different phases that have characterised its recent behaviour.

Before the creation of EMU, the ECU started depreciating against the US dollar in 1995: from a value of 1.3456 on 28 July 1995, it fell to a value of 1.0785 by 6 April 1998. Only after the formal admission of participating countries to EMU, the dollar/European Currency Unit (ECU) exchange rate started increasing and reached the value of 1.2262 on 6 October 1998.

During the first two and half years of its 'virtual' life, however, contrary to most predictions, the euro followed the previous depreciation of the ECU against the US dollar and reached its lowest value of 0.8422 on 5 July 2001.

Finally, at the beginning of 2002, in coincidence with its physical introduction the euro started appreciating against the US dollar and it reached the value of 1.2615 on 31 December 2003, the last date that I consider in this article (see figure 16).

Figure 16: The dollar/euro exchange rate



Source: 1995 -1998, FED (US$/ECU);

1999 - 2003, ECB, Monthly Bulletin (various issues)

Many economists and commentators have provided various explanations for the different phases described above. Those explanations refer to three separate categories, a) fundamentals, b) portfolio adjustments and c) 'framing' of expectations, as I illustrate below.

a) Both the neo-classical synthesis and the monetary approach to the determination of exchange rates agree that the strength or weakness of a currency depends on the 'fundamental' variables of its underlying economy (Gross Domestic Product (GDP) growth, money growth, interest rates, the inflation rate, the balance of payments, the public deficit, the public debt). Several authors interpret extensively such 'fundamental' variables and include among them, as I will do, also the economic structure and institutions.
b) In predicting the value of the euro prior to its introduction, however, most economists followed a different approach: by referring implicitly to the potential struggle for supremacy between the euro and the US dollar

mentioned above, they recognised that the expected ability of the European currency to fulfil at the international level the functions of means of payment, unit of account and store of value would have caused a high demand for it, so as to induce its appreciation.[4]

This observation suggests that 'fundamentals-based' models might well represent the working of a relatively 'small' currency, but they might be unsuitable for the analysis of the behaviour of a 'large', potentially international currency like the euro, calling instead also for a portfolio approach to the exchange rate determination.

c) As I will argue more extensively below, however, the behaviour of a currency can also be affected by 'framing' of expectations and by unstable perceptions. In this paper I will try to verify which of these exchange rate driving forces is better capable to account for the behaviour of the dollar/euro exchange rate during the first five years of life of the euro. As I will show in section 5, the explanations based on fundamentals are inconsistent over time (sections 5.1 and 5.1.1), so as to lead to the conclusion that portfolio adjustments (section 5.2) and 'framing' of expectations (section 5.3) prove more satisfactory in explaining the strength of the European currency with respect to the US dollar.

3. The predictions of the future value of the euro before the launch of the EMU

Let us report, in the next two paragraphs, the reasons why economists expected the euro to become respectively a strong and a weak currency. In doing so I will distinguish between explanations based on expected portfolio adjustments and explanations based on the expected state of fundamentals.

3.1. The reasons why economists expected the euro to be a strong currency

3.1.1. Expected portfolio adjustments in favour of the euro

The predictions made by economists of the euro's future value were based essentially on the expected portfolio adjustment resulting from its role as an international currency. As a result, the majority of them anticipated that the European currency would appreciate over time (Bergsten, 1997, Portes and Rey, 1998, Mundell, 1998, Kaikati, 1999, Frenkel and Sondengard, 1998). In particular, Bergsten (1997), among others, believed that the euro would satisfy the pre-conditions, identified by Kenen (1983) and listed below, for a currency to be used, by both the private and the official sector, as an international means of payment, unit of account and store of value:

a) a large sized economy, with substantial global trade;
b) a relatively closed geographical area;
c) lack of exchange controls;
d) broad, deep and liquid capital markets;
e) sound macroeconomic policies.

This analysis was substantially correct although, as we will see in section 4.2, it ignored the role played by history and inertia.

3.1.2 Expected good state of European fundamentals and expected bad state of US ones

Given the focus on portfolio adjustments, traditional 'fundamental' variables received little attention. Nevertheless, some authors concurred that the rather persistent current account deficit experienced by the United States, coupled with the European surpluses, suggested a weakening dollar (Alogoskoufis and Portes, 1997, Bergsten, 1997 and Kaikati, 1999).

An additional reason for predicting a strong euro derived from the expected EMU sound economic institutions. In particular, Bergsten (1997) argued that the ECB would guarantee internal stability, by establishing early on its anti-inflationary credibility. He believed that the European Central Bank (ECB) would act in a tougher way than the Bundesbank, precisely in order to show its commitment to price stability at the earliest opportunity. He also anticipated the possibility that fiscal authorities would 'fudge' the Maastricht criteria. However, contrary to the arguments of some commentators later on, he posited that such a weakening of the fiscal position would not affect negatively the euro, since the ECB would respond in an even tougher way.

His prediction of a strong euro, therefore, was based on the opinion that: "markets prize stability more than growth, as indicated by the continued dominance of the dollar through extended periods of sluggish US economic performance. Hence the euro should qualify on these grounds as well." (Bergsten, 1997, p. 91).

As we will see respectively in sections 4.1 and 5.1, while these 'fundamentals-based' arguments had to be overlooked during the initial period of life of EMU, characterised by a weak euro, some of them (in particular the US external deficit) have been readily resurrected in order to account for the current strength of the European currency.

3.2 The reasons why economists expected the euro to be a weak currency

3.2.1 Expected lack of portfolio adjustments in favour of the euro

In considering the possibility for the euro to act as an 'international money', Fratianni et al. (1998) performed a lucid analyses and reached opposing conclusions by considering the following aspects: inertia of the dollar in keeping its international monetary leadership; European financial market segmentation; possibility of an excess of euro denominated bond supply; and loss of the reserve status for European currencies (Masson and Turtelboom, 1997 also made this point). As I will argue in section 4.2, these reasons proved correct in explaining the initial weakness of the euro.

3.2.2. Expected bad state of European fundamentals

In considering instead the 'fundamental' variables pointing towards a depreciated euro, some authors stressed what they believed to be serious European structural and institutional weaknesses. Since the ECB was a new institution, for example, it might have lacked credibility with regard to its commitment to price stability, thereby affecting negatively the euro. Moreover, structural rigidities (high social security payments, stringent employment protection and restrictions on working and opening hours), institutional weakness (to be described in more detail below in section 4.1.1), and the fact that the euro zone was not believed to represent an optimum currency area, were the basis on which Feldstein (1997a, 2000) grounded his prediction of a weak euro.

Since Europe is a relatively closed economy, the exchange rate does not affect its economy in a significant way, so that some observers expected the ECB to conduct a policy of 'benign neglect' towards the dollar (Eichengreen, 1997), a strategy that might have ended up producing a weak euro.[6]

While these arguments found many supporters during the period of euro weakness (see section 4.1.1), they proved incorrect in the light of the current phase of the euro strength (see section 5.1.1).

4. 1999-2001: The weakness of the 'virtual' euro. Expost explanations

After having presented the reasons why economists expected the euro to be respectively a strong and a weak currency, let us consider the explanations provided expost in order to account for its weakness during the period 1999-2001.

4.1 'Fundamental' weaknesses of the euro area

In Buiter's view, (1999) the initial weakness of the euro reflected closely the state of fundamentals.[7]

Eichengreen (2000) and, with different accents, Bibow (2002a), Salvatore (2002) and Begg (2002b), argue that the weakness of the euro was a mere adjustment to the rise that characterised the final months of 1998, when the final stage of the monetary unification process drove the exchange rate to too high a level.

The role of the actual growth differential between the US and Europe is underlined by Buiter (1999), Neaime and Paschakis (2002), Eichengreen (2000), Corsetti (2000), and even Bergsten (2002). According to this last author, the weakness of the euro was due to the fact that although Europe had achieved price stability, it needed to improve its performance on the growth side. It should be noted that such a statement contradicts his previous position, reported at the end of section 3.1.2, in which he stressed the role of stability as opposed to growth.[8]

Corsetti (2002) focuses instead on the role played by the *expected* rate of growth differential[9] and shows that the series produced by the "Consensus Forecast" follow closely the behaviour of the dollar/euro exchange rate.

Neaime and Paschakis (2002), Sylos Labini (2000) and Vlaar (2002) point out the role played by the strong rise in oil prices from the Summer of 1999, implying a higher transfer of euro currency to oil exporting countries.

In section 5.1, when considering the 'fundamental' reasons advanced in order to account for the current strength of the euro, I will go back to these explanations and I will show their inconsistency.

4.1.1 European structural and institutional weaknesses

Among the 'fundamental' explanations for the low value of the euro, particular attention has been reserved to the European structural and institutional weaknesses.

In agreement with Feldstein (1997a and 2000) and Eichengreen (2000), Arestis et al. (2002a) point out that the euro area is not an optimal currency area and that the presence of asymmetries and divergences, first of all relative to the unemployment rate, creates the potential for political and economic conflicts among the euro area countries, thereby depreciating the euro. They also underline the presence of labour market rigidities.[10]

According to Salvatore (2002) and to Alphandéry (2002), the fact that Europe lacks political unity might have been interpreted as a sign of weakness.[11]

Uncertainties may have arisen also because of some institutional conflicts between politicians (in particular, the former German finance minister, Mr. Oskar Lafontaine) and the ECB and because of some actions undertaken by the German government to support with public funds some private firms under financial difficulties (Eichengreen, 2000).

Arestis et al. (2002a) believe that the accounting tricks that have accompanied the adhesion of some European countries to EMU reduced the credibility of the Eurosystem. At the same time the safeguards contained in the Stability and Growth Pact have proved unnecessary and above all non credible, as the example of Ireland flouting them, shows.

Buiter (1999) stresses, among others, the lack of clarity in exchange rate orientation, resulting from the fact that the Maastricht Treaty (art. 109) assigns to Finance Ministers the right to determine the exchange rate policy.

In line with this criticism, Mundell (1998) argues that in order to show coherence between internal and external objectives of monetary policy, the ECB should target exchange rates explicitly.

Buiter (1999) also mentions the lack of accountability, openness and transparency of the ECB as a problem to be solved. Uncertainty arises not only from the lack of clarity as to the transmission mechanism of monetary policy, but also from the inconsistent behaviour shown by the ECB Board members with regard to the exchange rate.

According to Talani (in this book), the initial weakness of the euro and the apparent lack of concern of the ECB with regard to the external value of its currency, would suggest that the European monetary authority followed a 'benign neglect' policy towards the exchange rate. In her view, such a strategy might find a rationale in the economic interests of the large European exporting countries (Germany, Italy and France).

ECB communication problems are identified, among others, by Feldstein (2000), Arestis et al. (2002a), Bibow (2002a) and Organisation for Economic Cooperation and Development (OECD) (2001). The first three contributions find that the 'two pillars' strategy generated confusion in the markets. First of all, money growth (the 'first pillar'), overshot systematically the reference value that the ECB had established.[13] Second, it was not clear what was the role of the exchange rate in determining the union's monetary policy. Furthermore, the initial moves of the ECB seemed to show a dependence on the Fed, something that proved that the euro was still dominated by the US dollar.[14]

In Bibow's view, the contractionary policy followed systematically by the ECB ("price-stability above all else") is harmful to the exchange rate since it suggests that growth will be penalised. By acting in an excessively restrictive way, then, in his view the ECB would have caused a weak euro (given the assumed link between the rate of growth and the exchange rate).[15]

Other authors judge the behaviour of the ECB in rather different terms, but still they find it responsible for the weakness of the euro. Favero et al. (2000b), for example, believe that the ECB has followed a rather expansionary stance, especially if compared to the policy that would have been followed by the Bundesbank or by the Fed. In particular, in their view the ECB has followed closely the needs of large countries like Germany or Italy, rather than of the whole union, thereby losing credibility with the private sector and causing the weakness of the euro.[16]

Hartmann and Issing (2002) find this explanation unconvincing, and I agree with them. After all, the ECB has proved successful in guaranteeing a stable environment: during the initial period of life of the euro, the US inflation rate has been systematically higher than the European one. It is not clear, then, why (unless we accept Altavilla and Marani, 2000 or Bibow's, 2002 explanation), the ECB would have proved successful in guaranteeing internal stability, while it should be blamed for the external instability.[17] Recent monetary theory has stressed the role of expectations in determining inflation, so that the latter results from the central bank's lack of credibility and the absence of an anti-inflationary reputation. If expectations have been such as to guarantee low inflation in the euro area, it is difficult then to understand how the same set of expectations may be held responsible for a depreciated exchange rate.

An overall positive interpretation of the behaviour of the ECB is provided by only a few authors. Begg (2002) argues that "the ECB has not only operated by consensus rather than majority voting, but also shown no evidence of dissent" and that "this is not a suprising outcome given that central bankers tend to have a common outlook" (Begg, 2002, p. 27). He points out the success in the launch of the euro, which would be due to the fact that the ECB has been following a rather transparent approach (contrary to the position expressed among others, by Bibow, 2002 or Buiter, 1999).

Hartmann and Issing (2002), stress the fact that the European Central Bank is neutral on the euro's role in the international markets, so that the dollar/euro exchange rate is mainly determined by developments in financial markets. In their view, the reason why the ECB does not target explicitly the exchange rate has to do with the recognition that currency markets are extremely volatile and might therefore undermine internal stability.[18]

Kenen (2002) also criticises the ECB for its behaviour: "I do not want it [the ECB] to practice the art perfected by Chairman Greenspan - saying nothing at lenght. There is, however, a danger in saying too much too often" (Kenen, 2002, p. 354).[19] Contrary to many analysts, however, he does not find it responsible for the depreciation of the euro since, in his view, such a weakness was due to the inertia of the dollar in playing its global role, as I will explain in the next section.

Given that the institutional and structural set up of the euro area has not changed over the last five years, it is easy to conclude, as I will argue in section 5.1.1, that even this 'fundamental' variable cannot account for the current phase of euro appreciation. As a result, it cannot be a reliable explanation for its previous weakness either.

4.2. Lack of success of the euro as an international currency

A different set of explanations for the weakness of the euro focuses on its lack of success as an international means of payment, unit of account and store of value, as Fratianni et al. (1998) had predicted correctly (see section 3.2.1).

Kenen (2002), Frisch (2003), McKinnon (2002), Bergsten (2002), Eichengreen (2000) and Neaime and Paschakis (2002) underline the role played by inertia, so that once a particular currency has taken on the role of global money, "it cannot be readily dislodged, even if another currency could do just as well" (Kenen, 2002, p. 348).

Pollard (2001), Alphandery (2002) and Hartmann and Issing (2002) stress instead the negative effect of the high European financial markets segmentation on the use of the euro as a medium of exchange and as a store of value.

McKinnon (2002), De Grauwe (2002a) and Meredith (2001) find that the excess of euro-denominated bonds issued by Extra-European borrowers brought about massive capital outflows, ultimately responsible for the depreciation of the euro.

The most important factor, however, according to Sinn and Westermann (2001a and b), has been the behaviour of criminals and tax evaders, who feared that the conversion to euros of their liquid holdings would have been subject to rigid rules and scrutiny that might have threatened their secrecy. As a result, they decided to move out of the currencies that they held (especially German marks) and to buy US dollars, so as to convert them to euros later on, in the absence of any stringent regulation. Bergsten (2002) gives credit to this explanation.

Contrary to the explanations for the euro weakness based on fundamentals, those based on its lack of success as an international currency are perfectly consistent, as I will discuss in section 5.2, with the explanations for the euro strength based on portfolio adjustments.

4.3. 'Framing' of expectations, pessimism and misperceptions about European fundamentals

The initial weakness of the euro can also be attributed to erratic behaviour, pessimism and misperceptions regarding European fundamentals. This view implies that markets on the one hand were excessively optimistic about the US economy, and on the other hand overemphasised European structural weaknesses (for example the need for fiscal, social security and labour market reforms).

Referring to some theoretical contributions by, among others, Tverski and Kahneman (1981) and Kahneman and Tverski (1984), De Grauwe (2000a) argues that since markets are uncertain about the 'fundamental' value of the exchange rate, they refer to the value taken by the exchange rate in order to infer the specific fundamentals on which to focus. As he points out, then, the order of causation gets reversed: it is not the fundamental that affects the exchange rate but rather the latter that indicates what are the fundamentals to be considered in order to justify its value.

De Grauwe's position is further justified by observing that some well-behaving European fundamentals, like the current account or the inflation rate differential, did not receive any attention during the period in which the euro was depreciating. As a matter of fact, Goldberg and Frydman (2001), quoted in Frisch (2003) show that different sets of fundamentals explain the exchange rate behaviour in different time periods.[20]

The role of *confidence* and of *market sentiment* is stressed by Altavilla and Marani (2000) too. They show that the dollar/euro exchange rate follows closely some measures of *market sentiment* rather than the usual fundamentals. In particular, the weakness of the euro would result from the negative effects on *market sentiment* produced by the excessively tight monetary stance followed by the ECB. As a matter of fact, too high interest rates would make clear to the private sector that the ECB, rather than following a counter-cyclical Taylor's rule, takes price stability as its first and exclusive objective. Such a lack of attention towards the economic conditions of the euro area, would be responsible for the depreciation of the currency.[21]

Salvatore (2002), while providing a whole set of possible explanations based on fundamentals for the weakness of the euro, subscribes to the hypothesis according to which the exchange rate has no connections with fundamentals, but only follows a random walk, "There is no shortage of explanations for the current strength of the dollar and, as some older explanations are contradicted by emerging facts and evidence, new ones are confidently introduced. Of course, should the dollar begin to depreciate heavily with respect to the euro, all sorts of reasons will be advanced for that. In short, no economic model or theory can consistently and accurately predict exchange rate movements in the short run because fundamental forces at work are easily and frequently overwhelmed by transitory ones and 'news'. (Salvatore, 2002, p. 133).

I find the above arguments particularly convincing. I also believe that 'framing' of expectations explains satisfactorily both the initial weakness of the euro, and the current behaviour of the dollar/euro exchange rate, as I will discuss in section 5.3.

5. 2002-2003: the strength of the 'tangible' euro: were the *expost* explanations for the weakness of the euro correct?

By mid 2001 the euro stopped depreciating against the US dollar and from the beginning of 2002 it has been appreciating against it. This turnaround of the European currency offers a nice opportunity to check the robustness of the explanations listed above, and in particular to verify whether the asserted European structural and institutional weaknesses could really be blamed for its previous low value.

Since several analyses found the euro undervalued during its first years of life (thereby recognising implicitly that the exchange rate had lost connection with the fundamentals of the economy), it would be possible to argue that the current value of the euro is finally in line with economic fundamentals.

Such an interpretation, however, conflicts with the fact that other analyses, as we have seen, found that some of the fundamentals of the European economy could well account for the weakness of the euro. If this was true, its current appreciation should be accompanied by an opposite change of those variables. Since this has not always occurred, as I will show in the next section, it can certainly be said that most of the 'fundamentals-based' arguments advanced to explain the weakness of the euro proved inappropriate when the latter started strengthening.

5.1 'Fundamental' strength of the euro area (and weakness of the US)

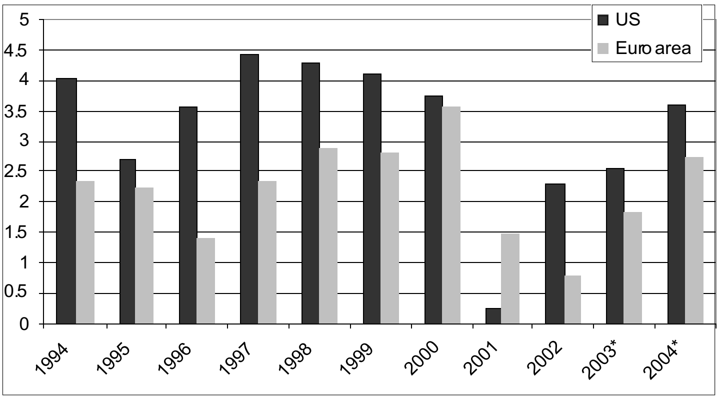
Let us go back now to the 'fundamental' variables considered in section 4.1 in order to account for the weakness of the euro. In doing so, it will be easy to verify that those variables are not capable to explain its current strength.

Since there is still a positive rate of growth differential between the US and the euro area, such a variable cannot any longer explain the behaviour of the dollar/euro exchange rate (see figure 17).

As for the expected rate of growth differential, the European Commission (2003), updating the 'Consensus Forecast' series utilised by Corsetti (2002) to explain the appreciation of the dollar vis à vis the euro, shows clearly that the effect of the expected rate of growth differential on the dollar/euro exchange rate has vanished. This contradicts previous findings and interpretations provided by Corsetti (2002).

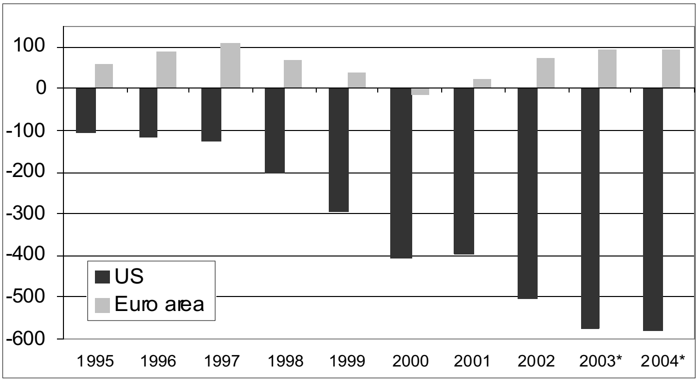
Even if the expected growth differential is still in favour of the US, markets seem to point their attention toward the uncertainties surrounding the huge current account deficit (encountered already in section 3.1.2 when listing the 'fundamental' reasons for expecting a strong euro) and the growing external indebtedness of the US (European Central Bank, 2003a, European Commission, 2003, and Monacelli, 2003) (see figure 18). *The Economist* also underlines such a switch of attention: "Over the years, currency theories move in and out of fashion. Growth differentials are, it seems, no longer relevant; currencies are being driven instead by trade imbalances and differences in interest rates. Investors have become less willing to finance America's huge current account deficit and are taking advantage of higher European interest rates." (*The Economist*, 10 May 2003).

Figure 17: Real GDP growth (percentage change from previous period)



Source: OECD, 2003

Figure 18: US and Euro area current account ($ billions)

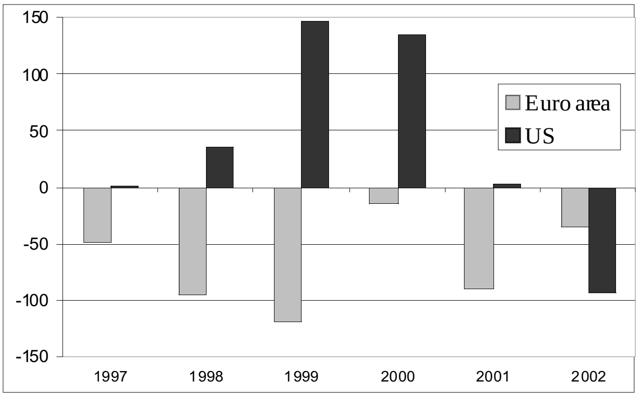


Source: IMF, Annual Report, 2002

*Forecast

The current depreciation of the dollar is accompanied not only by a worsening in the current account but also by a worsening in the financial account of the balance of payments. More precisely, it turns out that while net portfolio flows are still positive, foreign direct investment has turned negative in 2002 (see figure 19), reflecting the doubts and uncertainties surrounding US growth, but also, and more importantly in my view, signalling an end of a process of mergers and acquisitions that began at the end of last century and continued for just a few years (European Commission, 2003).

Figure 19: US and Euro area direct investment ($ billions, net flows)

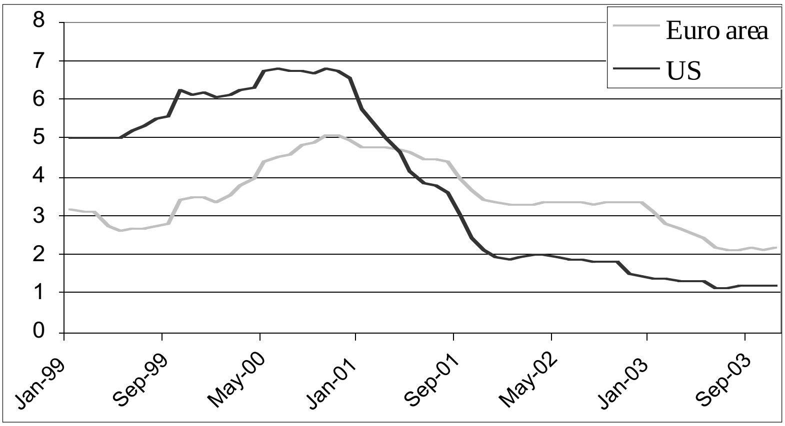


Source: ECB, Monthly Bulletin (various issues) and IMF, International Financial Statistics (various issues)

After a short period during which the dollar kept appreciating even if European interest rates were higher than US ones, the euro area-US interest rate differential seems to have restored its prominent role in explaining exchange rate behaviour (European Commission, 2003) (see figure 20). Such an interpretation, however, should be taken cautiously, since uncovered interest rate parity suggests that a positive interest rate differential can only attract foreign capital if markets do not expect any significant depreciation of the domestic currency.

Contrary to previous findings by Neaime and Paschakis (2000), Sylos Labini (2002) and Vlaar (2002) (see section 4.1), the recent appreciation of the euro has been accompanied by rising oil prices, leading to the conclusion that there is no longer negative correlation among the two variables (see figure 21).

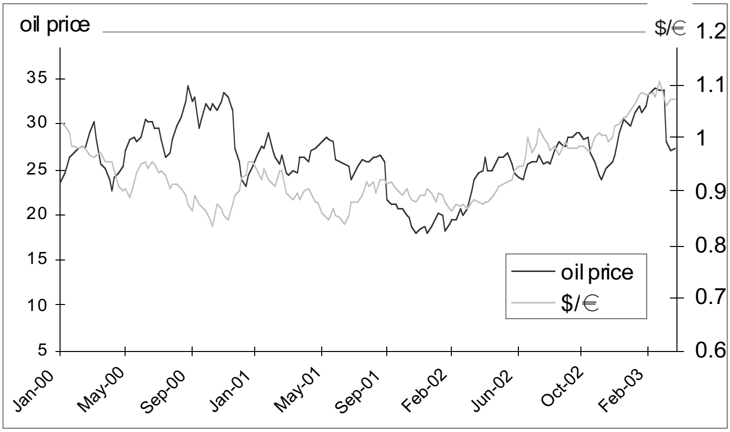
Figure 20: Euro area - US 3-month interest rates
(Percentage per annum, monthly data, period averages)



Source: ECB, Monthly Bulletin (various issues)

Having concluded that the ‘fundamental’ variables considered in section 4.1 cannot explain the current strength of the euro, let us verify in the next section whether the European structure and institutions, blamed by some authors for being responsible for its previous weakness, can do that.

Figure 21: Crude oil spot price (dollars per barrel) and $/€ exchange rate



Source: IMF, World Economic Outlook, 2003

5.1.1. How about the European structural and institutional weaknesses?

As we have seen in section 4.1.1, among the different explanations for the weakness of the euro, several authors referred particularly to the fragility of the structural and institutional aspects of the EMU (Arestis et al., 2002a, Feldstein, 1997a and 2000, and Favero et al., 2000b, among others). If that explanation was correct, the current strengthening of the European currency should result from the solution of at least some of the structural and institutional problems characterising the euro zone. The environment described by the authors mentioned above, however, has not changed in a significant way (although the initial success of the EMU might have led those who feared its failure to revise their point of view). As CER (2002) reports, for example, the ECB has not stopped targeting the needs of a core Europe (notably Germany and France) rather than of the whole monetary union. Such an observation, then, contradicts the conclusion, reached by Favero et al. (2000b) (see section 4.1.1), that the weakness of the euro was caused by a lack of credibility of the ECB.

Also the effects of the recent violation of the Excessive Deficit procedure defined in the Stability and Growth Pact seems to confirm my conclusion: the day after the European Council of Finance Ministers (Ecofin) expressed its unwillingness to proceed against Germany and France (contrary to the recommendation of the European Commission), surprisingly the dollar/euro exchange rate reached the value of 1.2017, above the psychological threshold of 1.20.

5.2 Portfolio adjustments resulting from the international role of the euro

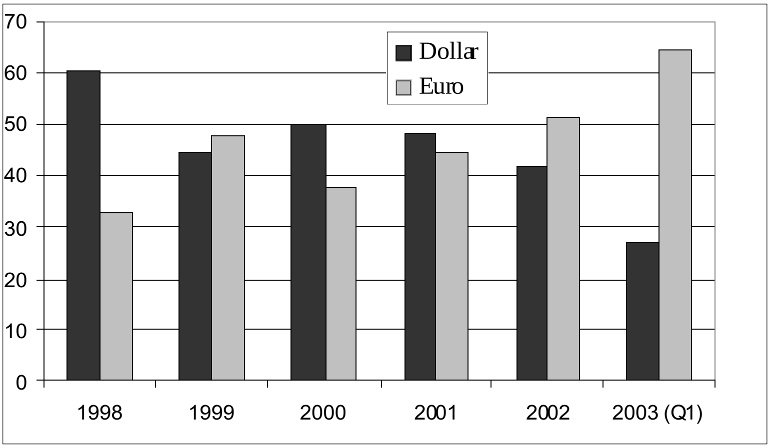
Having observed that the current appreciation of the euro is not explained by significant changes in the fundamentals of the economy, in this section I argue that it might be due to the growing role of the euro as an international currency.

In particular, I believe that the inertia characterising the first years of life of the euro is gradually giving way to portfolio diversification. As a matter of fact, the European Central Bank (2003d) shows some evidence of the growing role of the euro as an international currency.

Two other facts however, point to this direction: the composition of Chinese foreign reserves has been re-balanced by increasing the weight assigned to the euro as opposed to the US dollar; and Russia, the second world oil exporter, has declared recently that oil will also be quoted in euros. The euro, then, is increasing its international role both as a reserve currency and as a unit of account. Inevitably, this will also imply a higher role for it as a medium of exchange.

As we have seen in section 4.2, one of the explanations for the weakness of the euro was based on the excess of supply of bonds, so that the current phase of appreciation should be accompanied by a significant slow down in their issuance. Since this does not seem to be the case (see figure 22), the current strength of the euro can only be justified by the fact that both the domestic and the international demand for euro-denominated bonds has increased, so as to match or even exceed the supply.

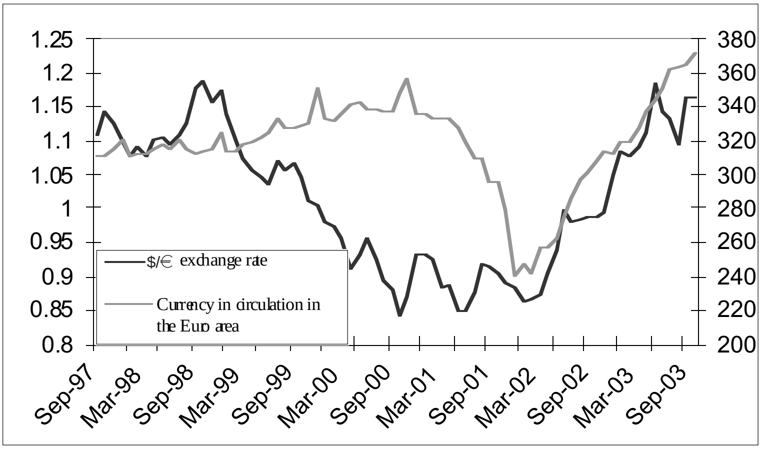
Figure 22: Net issuance of international debt securities by currency (percentage)



Source: BIS Quarterly Review, June 2003 and Kenen (2002)

Furthermore, the currency in circulation, after the fall occurred between November 2000 and January 2002 (and ended exactly after the physical introduction of the euro), is now above its initial level. The fact that the phase of euro depreciation was accompanied by a drop of the currency in circulation, as pointed out by Sinn and Westermann (2001a and 2001b) (see section 4.2), while its current appreciation is associated with a rise of the latter (see figure 23), lends further credit to the hypothesis that the weakness of the euro was due to a low demand for euros, while its current appreciation is driven by a high demand for them, most likely caused by portfolio adjustments.

Figure 23: Currency in circulation in the Euro area (€ billions, ECU billions until 12/1998) and $/€ exchange rate



Source: ECB, Monthly Bulletin (various issues)

5.3. 'Framing' of expectations, optimism and overvaluation of European fundamentals

The worsening of the US balance of payments described in section 5.1, together with some official declarations calling for "more exchange rate flexibility", like the G7 Statement issued on September 20, 2003 in Dubai, might have determined the market expectation of a weak dollar, an event favoured by the American government. As a matter of fact, the economic relationship among the US dollar, the euro, the Chinese Yuan and the Japanese Yen, suggests that the value of the dollar is a "hot political issue" (*The Economist*, 27 September 2003).

Nevertheless, I also believe that since portfolio adjustments have started to occur as a result of the growing international role of the euro, attention might have directed towards both the fundamentals and the pre-conditions validating this fact, as predicted by De Grauwe (2000a).

Whatever rational explanation we embrace (either the one based on fundamentals or the one based on portfolio adjustments), then, it is difficult to deny the role of (not necessarily rational) expectations and of elements of short run unpredictability in the behaviour of the exchange rate.

The fact that the same institutional set-up or the same level of financial markets segmentation has seen both a weak and a strong euro, suggests that even the institutional aspects might be subject to 'framing' of expectations: the same institution may receive a different evaluation, depending on the mood of the markets. In making forecasts of the strength or weakness of the euro and above all of the timing of such evolution, for example, nobody seemed to consider the distinction between the 'virtual' and the 'tangible' new currency, although the current appreciation might well result from its physical introduction:[22] only the presence of actual euro coins and bills would have removed the doubts and uncertainties surrounding the new currency and might have really spurred the adjustment process envisaged by economists before the creation of the EMU.

6. Concluding remarks

Prior to its introduction, the predictions made by economists as to the future value of the euro were based essentially on the portfolio adjustment resulting from the role that it might play as an international currency. As a result, most analysts agreed that the euro would be a strong currency, appreciating against the dollar. The first three years of life of the 'virtual' euro contradicted such a forecast. Economists, which with a few exceptions had ignored since then the role played by inertia in the use of an international currency, therefore abandoned the 'international currency' view and directed their focus towards traditional, 'fundamentals-based' explanations, on which most exchange rate models concentrate. The initial weakness of the euro *vis à vis* the US dollar, then, was explained mainly by considering the actual and expected positive rate of growth differential between the US and the euro area, and by considering as unsatisfactory and inadequate the European structural and institutional set up. Later on, when the dollar started weakening, though, different 'fundamental' variables, like for example the euro area - US interest rate differential and the US current account deficit, had to be identified as responsible for the exchange rate behaviour.

While the explanations based on fundamentals prove inconsistent, then, in my view the available evidence suggests that during the initial period of the euro, portfolio adjustments might have affected the dollar/euro exchange rate more than is generally believed (although in the opposite than expected direction), and that they have now started to operate in the expected direction, leading to an appreciated euro. Such a conclusion is reached by considering, in particular, the still high emission of euro-denominated bonds, the close relationship between the euro currency in circulation and the dollar/euro exchange rate, and various pieces of evidence suggesting a higher presence of the euro in both private and public portfolios, pointing towards an overall growing international role for it.

If the euro is really starting to play an international role, then, it is possible to conclude that the markets are not interpreting (at least currently) the approach of 'benign neglect' followed by the European institutions with regard to the external value of its currency, as a sign of 'fundamental' weakness and that they also believe that the European institutions are assuring the satisfaction of the pre-condition of sound macroeconomic policies required for playing such an international role.

It should be kept in mind, however, that institutional arrangements are subject to market evaluation: 'framing' of expectations keeps affecting the behaviour of the exchange rate, and might play a crucial role in the current phase of euro appreciation.

NOTES

[1] From JokEc, *Jokes about economists and economics* available at the internet address: http://www.etla.fi/pkm/JokEc.html.

[2] The benefits, however, will have to be weighted against the costs incurred by a country issuing a reserve currency, especially the risk of losing control of money supply (Demertzis and Hughes Hallet, 1999). Alphandéry (2002) also warns against the fact that holdings of euros by non residents may be subject to sudden reversals that might cause treasury problems. In his view, this is the reason why both Japan and Germany avoided playing a more central role in the international arena.

[3] The title of the special issue of the *Journal of Policy Modeling*, vol. 24, 2002, gives a clear demonstration of such a possibility: "The euro versus the dollar: will there be a struggle for dominance?"

[4] De Grauwe (2002) argues instead that the strength or weakness of a currency does not depend on its international role, as the experience of the dollar would suggest. While in a well established situation a currency playing a global role may appreciate or depreciate for various reasons, I believe instead that when such an international position is in the process of formation, the resulting demand for the currency will certainly cause its appreciation.

[5] Fratianni et al. (1998) acknowledge that this position was first taken by McCauley (1997) and by Bank for International Settlements (1997). This point is also made by European Commission (1997).

[6] It should be noted, however, that such a feature characterises the US dollar too, so that it is not clear why a 'benign neglect' policy of the Fed should produce a strong dollar, while the opposite should occur in the case of the ECB. According to the European Commission (1997), however, the ECB does not follow a 'benign neglect' policy, since it wants to avoid both the risk of excessive fluctuations and misalignments and the negative effects that an over depreciated euro would have on price stability.

[7] But, according to Corsetti (2000): "To be honest, it is hard to provide a convincing interpretation of the recent evolution of the euro" (p. 2). The same position is taken by Sartore and Esposito (2002) and McKinnon (2002).

[8] Alquist and Chinn (2001) and Vlaar (2002) quoted in Frisch (2003) consider a longer time period, respectively 1985-2001 the former and 1973-2001 the latter, and also find a positive correlation between respectively the difference in productivity and in growth and the dollar/euro exchange rate. Corsetti et al. (2003), obtain similar conclusions by estimating a structural VAR model over the period 1970-2001. In particular, they show that a permanent positive shock to US labour productivity in manufacturing causes both an increase in output and consumption and a real exchange rate appreciation.

[9] If the expected rather than actual growth differential is considered, an explanation can be found for the appreciation of the yen against the euro in the second half of 1999 (Eichengreen, 2000).

[10] As observed also by De Grauwe (2000), however, they argue that those rigidities have characterised Europe for quite long time. It would not be clear, then, why the euro, the ECU, or an artificial measure of it, in some instances appreciates and in others depreciates.

[11] Corsetti (2000) also indicates several uncertainties about the evolution of the European institutional and political setting. However, he finds this conclusion incompatible with the observation that the market in euro-denominated bonds has experienced a massive growth.

[12] In his view, however, the weakness of the euro is a 'non-issue' since the euro area is relatively closed.

[13] Arestis et al. (2002a) observe that M3 has been growing at rates higher than 4.5 percent, while inflation has been higher than 2 percent, the reference values indicated by the ECB respectively for money growth and inflation rate.

[14] See Hartmann and Issing (2002) for an alternative definition of international money, based on the leadership role played in the conduct of monetary and exchange rate policy.

[15] As we will see, Altavilla and Marani (2000) also underline the possible negative effect of a restrictive monetary policy on exchange rates.

[16] Bergsten (1997), Portes and Rey (1998) and Neaime and Paschakis (2002) also agree that the strength or weakness of the euro depends on the reputation of the ECB.

[17] With internal (external) stability I refer to the ability of a currency to preserve its purchasing power with respect to internally (externally) produced goods and services. Internal stability is a necessary but by no means sufficient condition for external stability, as demonstrated by the first years of life of the euro. Alphandéry (2002) observes that while the ECB concentrates exclusively on the objective of internal stability – price stability – paradoxically the media (and therefore the broad public) focus on its external value.

[18] It should be noted that such a proposition implies the belief that exchange rates are driven by 'news' and (not necessarily rational) expectations rather than by fundamentals.

[19] As a matter of fact, Mr Duisenberg, the former President of the ECB, has often been blamed for his untimely declarations as to the external value of the euro. The credibility of the ECB might also have suffered from the substantial violation of the prescriptions of the Maastricht Treaty relative to the period of appointment of its President: at the time of his election, Mr. Duisenberg agreed to resign after only four years of mandate rather than the eight years indicated in the Maastricht Treaty. As of 1 November 2003, Mr Trichet is the new President of the ECB.

[20] Some of the current analyses on the temporary failure of the euro to play an international role implicitly support this position: "the gradual depreciation of the euro during the first two years was of course not

fostering its international use for investment purposes" (Hartmann and Issing, 2002, p. 324). In other words, financial markets looked at the actual behaviour of the euro, rather than at fundamentals (including the creation of a monetary entity that might rival with the dollar), in order to decide the appropriate portfolio composition.

[21] Bibow (2002a), as we have seen above, makes the same point.

[22] Only after the passage from the virtual to the real euro, Neaime and Paschakis (2002) recognised that credibility might have been negatively affected by the absence of tangible euros, and Bergsten (2002) wondered what the effects of its physical introduction would have been.

Chapter 12

Ceart Go Leor – Ireland, the UK, the Sterling Area and EMU*

By
Maurice FitzGerald

Abstract. Although they acceded simultaneously, Ireland and the United Kingdom have often reached very different decisions when it comes to European Union policies that lend themselves towards deeper integration. This has never been more evident than with Economic and Monetary Union: one state has fully signed up to this process, while the other has elected to see how it develops. After entering the 20th century in a monetary union – i.e. sterling – they left it, having determined that their futures lay in different directions. Ireland has swapped economic dependence on its neighbour, and membership of the sterling area, for interdependence with all member states, and has willingly joined the euro zone; at the same time, the United Kingdom has decided upon a strategy of waiting in the wings on the single currency, which is entirely consistent with its general attitude regarding European integration. The former has become increasingly integrated, usually seeing the benefits of membership, while the latter invariably remains detached, typically counting the costs. This chapter argues that before, during and after the accession negotiations of the early 1970s, one country sought to maximise its return from Europe, while the other appears to be more concerned with wishing its membership away.

Keywords: Ireland, United Kingdom, punt, sterling, euro, economic and monetary union, European integration, enlargement

Introduction

To the more dispassionate observer, the reluctance shown by the United Kingdom (UK) towards the European single currency is as predictable as it is questionable. Just weeks before its launch, UK prime minister Tony Blair declared: “we said that it wouldn’t happen. Then we said it wouldn’t work.

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* I wish to thank the editors for their kind invitation to contribute, their helpful comments thereafter and, most importantly, their patience. I would also like to thank the other conference participants for their feedback, especially the contributions from my co-panelists, and in particular the insightful views of our discussant. This contribution was completed with the financial assistance of the Nuffield Foundation.

Then we said we didn't need it. But it did happen. And Britain was left behind" (Blair, 2001). His words would not seem so prescient, nor would they resonate so loudly, but for the fact that he was referring in this speech to the views of successive UK governments regarding the European Economic Community (EEC) back in the 1950s, and not to the prospect of his country joining the euro at the beginning of the 21st century. There are, of course, none so blind as those who will not see.

History has a nasty habit of repeating itself, especially when the lessons of the past are forgotten or ignored, and certainly when they are not applied to the present or, in truth, when they are not sufficiently factored into planning for the future. This chapter argues that, even during their negotiations across the 1960s and early 1970s for entry into the then European Communities (EC) – subsequently the European Union (EU) – Ireland and the UK demonstrated rather different attitudes towards European integration, its implications and opportunities, the price that would have to be paid, and the impact that membership would have upon them. It surveys the century and a half of Anglo-Irish monetary integration, concentrating on Ireland's development as a sovereign state, and shows how this may help to explain their different paths.

This is not to say that either country has been unstinting in its approach and support for or worries regarding the project. For the UK, the endeavours of Edward Heath as prime minister at the beginning of the 1970s were proof positive that the British do not necessarily have to be classed as reluctant Europeans, as some sort of eternally awkward partner; many of Blair's earlier efforts might be seen in the same light, even if subsequently overtaken by hesitation and a lack of vision. In Ireland's case, ratification of the Treaty of Nice, and especially poor handling of the first referendum by the *taoiseach* (Irish prime minister), Bertie Ahern, is enough evidence of a possibly exceptional event that proves the general rule; the Irish are – relatively – good Europeans, both in the sense that they are fairly committed to the project but also because they are strategically astute in negotiating the best terms available.

Within the context of Anglo-Irish relations, this chapter investigates advances in their bilateral ties and their respective decisions regarding Economic and Monetary Union (EMU). It is divided into three main parts: ranging in time from Ireland's participation as an independent state in the sterling area – thus with a focus across the second and third quarters of the 20th century – and then making specific reference to the EU accession negotiations of 1970-72, before concluding with a brief examination of subsequent economic and monetary developments, specifically Irish membership of the European Monetary System (EMS) and, in turn, EMU.

Once EU entry was achieved, the next question requiring an answer as the 1970s progressed was simple, even if T.K.Whitaker, then Central Bank of Ireland governor, posed it in Gaelic: "*an ceangal le sterling – ar cheart é a bhriseadh?*", he asked (Whitaker, 1976, p.82). Translatable as 'Ireland's link with sterling, is it right to break it?', this was the major economic and monetary issue that Dublin then faced. At least initially, the conclusion reached was to wait a little longer (Kelly, 2003, p.96). But, when it finally came to making a decision regarding the future of its currency, the Irish government gave a resonant *ceart go leor* – declaring 'fair enough' – to EC proposals on the table. At long last the time had arrived to move from being a supplicant to being an equal. With the decade coming to a conclusion, and in the express context of European developments, the Irish pound's links with sterling ultimately needed to be broken, and the punt thus became a currency that helped to make up the European Currency Unit (ECU).

The *Saorstát* pound's ties to the sterling area

It has been argued that, in order to "understand events and trends in Ireland, one must keep in mind what was going on at the same time in the world outside, particularly, of course, in Britain" (Whitaker, 1976, p.91). This is as true today as it was for yesteryear. Ireland entered the 20th century as an integral, if troublesome, component of the UK. An Act of Union between the two countries in 1800 led, in part, to the amalgamation of their currencies in 1826; indeed, their economies became increasingly integrated as the century, especially the second half, progressed. In many ways, particularly in economic terms, and despite gaining independence in the early 1920s, the newly established *Saorstát Éireann* (Irish Free State) remained firmly within the UK's ambit. It had established itself as a sovereign state, yet was very slow to develop an independent monetary policy.

In fact, a conscious decision was taken in 1927 for the Irish pound to remain inside the sterling area, though this policy would be run by an Irish Currency Commission. This was a practical choice, with 98% of exports (mostly agricultural) going to the UK in 1924 and 80% of imports originating there (Kelly, 2003, p.90). Any link with a different currency – such as the dollar – was only ever a theoretical alternative (Whitaker, 1976, pp.94-5). Sterling appeared to offer stability, which is what a new state emerging from a civil war required above all else. Indeed, notwithstanding the various calamities which befell Ireland, the UK and sterling across the next two decades – for instance, the currency crisis of 1931, an economic battle which raged between them from 1932 to 1938, the Second World War, the declaration of an Irish republic in 1948, or indeed a further currency crisis in 1949 – the Irish pound stayed firmly put. It is therefore worth examining some of these events in detail in order to demonstrate why the break with sterling – and in particular the decision regarding EC entry and an acceptance of all that membership entailed – was such a significant move when it eventually came.

The Irish Free State actually issued its own currency after 1927, but the *Saorstát* pound was in effect operating at parity with sterling whilst maintaining "100 per cent backing in gold, sterling, or British securities" (Connolly, 1998, p.526). However, just four years after the Irish decided that their future remained within the sterling area, the UK government suspended the gold standard – some six years after restoring it – because of the global, and in turn domestic, pressures facing their economy. The Irish had serious doubts regarding the UK's preparedness to consider economic circumstances beyond their own. It has been argued that (Moynihan, 1975, p.167):

> For some time there had been reason to view the position of sterling with disquiet, and in the Saorstát there were ample reasons for special interest and concern – the statutory link between the two currencies, the very large Irish holdings of sterling assets and the preponderance of transactions with the United Kingdom in the Saorstát's external trade and payments.

This sterling crisis was not a singular event, there was another soon after the war. In the meantime, a serious Anglo-Irish dispute broke out in 1932 – involving intense trade disagreements, a major constitutional realignment, and protracted negotiations – it was only resolved in 1938. Euphemistically termed the Emergency by the Irish, the Second World War quickly followed, and unsurprisingly impacted seriously upon relations, mainly because of Ireland's neutral status. But, even in the face of major global, bilateral and national developments, it still remained within the sterling area. Indeed, the Irish pound had become "fully acceptable in Northern Ireland by the late 1930s" – thereby lessening the import of the island's partitioning, at least to a minor extent – and "British coins continued to circulate" in Ireland (Connolly, 1998, p.367). In essence, these two countries were operating a lop-sided monetary union, the UK deciding and Ireland following. And throughout the 1930s and 1940s, the small – if open – Irish economy that existed up to 1932 was supplanted by a more insular economic vision which saw the "accumulated capital" it had previously held being expended with little to show in return (Girvin, 2002, p.202). Even a Central Bank Act, 1942, which renamed the Currency Commission as the Central Bank of Ireland, only meant relatively superficial change and, despite Ireland having the possibility of operating an independent monetary policy, it chose not to do so.

Not even the surprise decision taken in 1948 for the *Saorstát* to become a republic shattered these ties. Ireland "had beyond all question ceased to be either a colony or a dominion", but it was also readily apparent that the pertaining monetary situation suited both countries: "neither Government was desirous of change in the currency arrangements or in Ireland's position as a member of the sterling area" (Moynihan, 1975, p.349). Unsurprisingly, the matter of Ireland's new status as a republic raged in *Dáil Éireann* (Irish lower parliamentary house), and an obvious question was put forward (Moynihan, 1975, pp.349-50):

> … whether it was proposed to make any alteration or adjustment in the existing relation between Irish currency and sterling or in the existing Irish financial arrangements and whether there had been any negotiations on such matters with other States … On 2nd December [1948] the Taoiseach replied … that no such change was contemplated and that there had been no negotiations of the kind …

This was the position taken in London too. Indeed, according to one UK government minister, "there was no reason to expect any change in the existing arrangements" regarding sterling, as it remained "very convenient, especially in Northern Ireland. It was in the interests of both countries that the arrangements should be maintained, and there was no reason why the entry into force of the Republic of Ireland Act should affect this position in any way" (Moynihan, 1975, p.350). Thus, when sterling devalued against the dollar the following year, the Irish pound quickly followed suit. In the lead-up to this decision, the Irish were kept completely in the dark regarding UK intentions (Fanning, 1978, p.445). This was to be a familiar story during their participation in the sterling area, but a price that they were prepared to pay.

When the currency crisis had occurred two decades earlier, it was felt both in Irish banking and government circles that (Moynihan, 1975, p.354):

> … the reasons which were accepted in 1927 as justifying the link with sterling still remained valid … In the Central Bank and the Department of Finance the view prevailed in 1949, as in 1931, that the parity between Irish currency and sterling should be maintained.

Of course, it is very unlikely that the then Dublin government (a five-party coalition) was totally united on this issue. After all, this latest monetary crisis offered a distinct opportunity "to loosen, if not to break, the link between Irish currency and sterling"; even still, Irish finance minister Patrick McGilligan announced on 19 September 1949 that to follow sterling in devaluing was "the course of least disadvantage" (Moynihan, 1975, pp.355 & 358). A cabinet colleague, Irish foreign minister Seán MacBride, had campaigned for office on a republican ticket, but even he stated that his "[economic] policy would not … necessarily involve a break with the sterling area or a change in the existing parity with sterling" (Moynihan, 1975, p.361). This particular devaluation – sterling would face further crises during the early 1950s (Fanning, 1978, pp.473-82) and again in 1967 (Kelly, 2003, p.94) – increased costs, as Irish imports were being sourced more widely, but they did not see corresponding increases in export returns because the UK market remained dominant (Whitaker, 1976, p.97). What chance was there that a situation which by this point had existed for nearly a quarter of a century would ever change?

When the occasion did arise to take an active role in their economic future, the Irish, following some initial hesitation, had made as much use as possible of the post-war Marshall Plan. However, when the Bretton Woods system instituted during the war led to the creation of the International Monetary Fund and the International Bank for Reconstruction and Development soon afterwards, Ireland demonstrated its usual laggard approach. Despite a recommendation in 1947 by the then Irish finance minister Frank Aiken that it should join, a decade would pass before it did so. As one historian has written: "the matter appears to have been left in abeyance"; in truth, "it was not until 1957 … that the necessary legislation was passed and Ireland became a member of the two institutions" (Moynihan, 1975, pp.18 & 332). Any estimation of Ireland's monetary autonomy and how it pertained to national decision-making would have led to serious questions being asked regarding the propensity and desire for independent action. It has been argued that "despite its sovereign status, Ireland appeared to have lost the ability to direct its own future" (Girvin, 2002, p.202). This was unmistakably the case in monetary affairs.

Major evidence of a transformation in the economic direction pursued by the Irish government would only come in the late 1950s, with the publication of *Economic Development* by Whitaker, then the Irish finance ministry's most senior civil servant. Its promulgation and espousal through the Programme for Economic Expansion was led by Seán Lemass, *taoiseach* from 1959 to 1966, a process continued by his successor, Jack Lynch, from 1966 to 1973 and *taoiseach* again from 1977 to 1979. Recurring applications – to the EEC in 1961 and the EC in 1967 and again in 1970 – were proof positive of the economy's radical reorientation, even if this liberalisation would not necessarily be matched as rapidly by social change. The far-sightedness and innovation shown by Whitaker was matched by the flexibility and pragmatism of Lemass. But this was only the beginning of a process of economic change, a course of action to a large extent spurred by decisions taken in London regarding European integration, at the same time as being financed by foreign direct investment. In the interim between applying for membership of, and entering, the EC, the Irish were fully prepared to become even more economically dependent on the UK through the Anglo-Irish Free Trade Area (AIFTA) agreement of the mid-1960s, going one step backwards in order to go two forward. But, as the 1960s came to a conclusion, there was some good news: the value of Ireland's exported manufactured goods belatedly surpassed that of agricultural products. Indeed, by that stage less than 70% of Irish exports were going to the UK, with 50% of imports originating there. The economy was finally maturing (FitzGerald, 2001).

This chapter is not necessarily the place to examine in detail the efforts made during the 1960s by Ireland and the UK to adhere to the EC, but this section gives a very strong indication of the monetary ties that existed between them, and an awareness that EC membership had increasingly become a foreign economic policy priority. The next section therefore examines what one analyst sees as the two strategic decisions which have "been made by the Irish authorities since the foundation of the State. The shift in the late 1950s and early '60s from protection to free trade, culminating in EEC membership … [and] entry to the EMS and the consequential break in the link with sterling" (McCormack, 1979, p.111).

EC entry and the origins of EMU

The archival evidence regarding the Irish 1970-72 entry negotiations – certainly from the material available in Ireland and the United States – shows that, as far as Dublin was concerned, plans for Economic and Monetary Union (EMU) hardly featured; it was not really a problematic issue, just very low down a long list of other priorities. Clearly, EMU was an "important [consideration] ... bearing on the future development and strengthening of the [European] Communities" (Maher, 1986, p.278). But, a small semi-peripheral and economically retarded – if newly dynamic and vibrant – country had more pertinent concerns than the possibly long-term prospects for economic, monetary and/or even political union. At the beginning of the 1970s, the Irish government was, for instance, more concerned about protecting the economic benefits of the AIFTA than it was in shedding membership of the sterling area; it was certainly not planning years ahead for something that might not necessarily happen, that is when the negotiations for access to Common Agricultural Policy (CAP) funds and the creation of a Common Fisheries Policy (CFP) were still being concluded.

The policy of Irish neutrality is a decent parallel experience to EMU, and in fact the former remains negotiable to this day. For over forty years, Dublin governments have held a consistent line on this issue and remain prepared to face and shape the consequences of any agreements made, that is once a concrete alternative to their original policy path becomes both self-evident and, just as importantly, sustainable. In the meantime, that is in the period between an issue being raised and subsequent negotiations being concluded, the ability to compromise and discuss will always allow for a reasonably acceptable alternative to the optimal position. Problems arise when each issue becomes so singular, and each position becomes so entrenched, that a decision – a stark yes or no – appears to be the only choice left available. Strategically, such a situation demonstrates ineptitude and a lack of understanding. Unfortunately for the UK – in terms of its appreciation of the thinking behind, and possibilities inherent in, the European project – it is often as diametrically opposed to the common EU position as it is possible to be. At other times, it allows the Irish, and other member states, the opportunity to hide behind its intractability.

Ireland was a part of the sterling area mainly because of its colonial history, but also as a result of the lack of alternatives. Remaining there for most of the 20th century reflected the economic realities it faced. In truth, Ireland was dependent upon the UK in many areas, none more so than in terms of trade patterns. This is why its decision in July 1961 to apply for EEC membership was not only evidence of this unhealthy economic relationship – Ireland applied because it knew the UK was about to do the same – it also marked one of the first steps it took in seeking relationships beyond the British Isles and the Anglophone world. Along with its western European neighbours – once the UK also joined – a new set of relations and opportunities saw it exchange an inflexible economic and monetary policy, as well as a minor and unappreciated voice, for a seat at the larger table. As the 1960s progressed, the logic of the Irish position stiffened in favour of even deeper integration, partly as an escape-route from isolation – and dependence – to choosing a common purpose – and interdependence. The rewards would be extraordinary with, for example, the CAP "removing pressure from [farmers on] the government and transferring the subsidisation of agriculture from the Irish state to Brussels" (Girvin, 2002, p.209).

Twice unsuccessful in even reaching the negotiating table, in 1961-63 and 1967, it was a matter of third time lucky during the 1970-72 talks. At the first full ministerial meeting held in Brussels on 21 September 1970, Ireland's list of priorities – detailed in Table 2: the Dublin government's view of the issues necessitating negotiation (D/T-S18523B) – were rather transparent; they read as follows:

Table 2: The Dublin government's view of the issues necessitating negotiation

Transitional period

- Customs Union
- Common Agricultural Policy
- Ireland's trading arrangements with the UK during the transitional period
- safeguard measures for Irish industry
- dumping
- industrial incentives
- rights of establishment in agricultural land
- Common Commercial Policy
- association agreements
- non-applicant European Free Trade Association countries
- free movement of workers
- free movement of capital
- tax provisions
- general aspect of the approximation of laws
- equal pay
- European Coal and Steel Community
- European Atomic Energy Community
- financing of the Communities
- institutions
- other matters

Striking for a number of reasons, not least the preponderance of economic subjects, it is possible to infer much about Ireland's attitude to EMU from this negotiations agenda. It was, simply put, not a major consideration. When Jean Rey, as European Commission president, helped to open the substantive negotiations at this autumn meeting, he specifically made reference to "the creation in stages of the economic and monetary union" (Maher, 1986, pp.268-9). Irish foreign minister Patrick Hillery did not demur from this line of argument, unequivocally declaring that "the Irish Government accept the Treaties of Rome and Paris, their political objectives and the decisions taken in their implementation", before adding that it was "also willing to participate in the further development and strengthening of the Communities" (D/T-S18523B). It was making all the right noises.

Ireland and the other accession countries already knew from 30 June 1970, with the formal opening of negotiations – and indeed from The Hague summit the year before (Verdun, 2003a, p.316) – that proposals had been tabled for an EMU to be achieved through a multi-stage strategy. The Werner report that came out in October 1970, and its suggested three part plan for implementation by the end of the decade, meant that the Irish had to confront the issue during their accession negotiations. In all, there would be ten meetings at ministerial level – detailed in figure 2: Ireland's negotiations timetable, June 1970 to January 1972 (EEC6IRE10/1/70) – as well as nearly twice as many meetings again at deputy level. The problems which would be created for a semi-peripheral and relatively underdeveloped economy led the Irish to request that EMU be put on the agenda for the second ministerial meeting set to be held on 15 December 1970. The Irish were refused on the grounds that the Six did not themselves have a fixed position, and indeed they were still arguing amongst themselves, but it was clear that the matter would return within months. Indeed, it played a relatively prominent role in the early part of Ireland's negotiations timetable; the progress made can be summarised as follows:

Table 3: Ireland's negotiations timetable, June 1970 to January 1972

Date of Meeting	Form of Meeting	Focus of Meeting
30 June 1970	*formal opening meeting*	
21 September 1970	1st ministerial meeting	general airing of views
15 December 1970	2nd ministerial meeting	transitional periods
2 March 1971	3rd ministerial meeting	quotas; fisheries
7 June 1971	4th ministerial meeting	fisheries; dumping
12 July 1971	5th ministerial meeting	regional policy; cars
19 October 1971	6th ministerial meeting	fisheries; tax reliefs and incentives; animal and plant health
9 November 1971	7th ministerial meeting	fisheries; animal health
29-30 November 1971	8th ministerial meeting	fisheries; animal health
11-12 December 1971	9th ministerial meeting	fisheries; animal health
10-11 January 1972	10th ministerial meeting	sugar
22 January 1972	*accession treaty signing*	

EMU was quickly linked by the Irish to regional policy, but other issues overtook the former consideration, and it never really emerged as a crucial negotiating question beyond the initial attention it received. Despite not being on the formal agenda for the ministerial meeting of 15 December 1971, the issue was however raised: "Hillery said that Ireland ... [was] particularly interested in plans for economic and monetary union, and in regional policy", that Ireland would provide more information on both subjects at subsequent meetings (EEC6IRE10/1/70).

The Irish decided upon a twin-pronged approach, firstly pushing for progress on a regional policy to take account of outlying and backward regions, while secondly pushing for a protocol to be annexed to any accession treaty along the lines of that accorded to Italy when it helped to inaugurate the EEC. Such a protocol would seek to protect Irish development efforts within the context of membership. The EMU issue made it on to subsequent ministerial meetings in the form of an agenda item termed internal developments. Nonetheless, no matter how important this issue appeared, especially in the medium-term, and even with the adoption of a definitive position by the Six in the spring of 1971, the Irish government was more interested in defining concrete negotiating positions and outcomes that it could sign up to rather than putting any store in dreaming up arrangements for an EMU timetable. Thus, at the third ministerial meeting at which they participated, held on 2 March 1971, the Irish foreign minister showed that it was possible to agree a position favouring future developments in exchange for the institution of a regional policy. In fact, when Hillery referred to successful efforts by the Six to reach agreement on EMU at this meeting, he then affirmed Ireland's readiness to co-operate fully when it became a member too, before consciously linking the whole issue to "an aspect of particular interest to Ireland: namely, regional policy" (EEC6IRE10/1/70). Hand in hand with efforts to create this policy at the European level, the Irish negotiating team emphasised at further meetings, such as the one held on 7 June 1971, that part of its economic strategy was "to retain its present system of fiscal incentives to industry (such as tax relief on export profits) after it joins the Community" (EEC6IRE10/1/70). This tactic paid off when, at the ministerial meeting on 12 July 1971, "the two sides [Ireland and the EC] settled two of the main issues in the EC-Irish negotiations: regional policy and motor vehicle assembly" (EEC6IRE10/1/70).

Within a year of EMU being raised in earnest, and following a series of ministerial meetings that concentrated on more intractable issues that troubled the Irish – such as agreeing to a CFP, veterinarian concerns, and questions regarding the free movement of workers, issues which would remain open almost to the last minute – they signed their Accession Treaty on 22 January 1972. In truth, the Irish had cleared most of their major negotiating questions by the autumn of 1971, and were waiting on the UK to conclude negotiations long after they had dealt with most of their remaining concerns. At the end of the negotiation process, the Irish had even gotten their special protocol "noting the aims of Irish development policies and pledging community support of these aims" (OECD, 1972). They had also secured an embryonic EC regional policy as their price for economic and monetary union.

From the *punt Éireannach* to the euro

It was as a candidate, though not one waiting in the wings but directly participating in determining the future of Ten, that the Irish took part in the meeting of Economic and Finance Ministers (ECOFIN) of March 1972. This meeting was meant to determine the approach to EMU. Because of fixed parity existing between the punt and sterling, the Irish participated briefly and indirectly in the new monetary system from May 1972 when the latter joined. The Irish were meant to join formally in July 1972, but by then the UK had already exited the system. The 'snake in the tunnel' continued to exist without its membership and, in truth, never suggested that it was the solution to the reestablishment of stable exchange rates following the breakdown of Bretton Woods. The difficulties that the Ten had in setting up a stable monetary policy meant that EMU was one of the main items up for discussion when the Paris heads of state/government summit took place in October 1972. Given this forum, Lynch used the occasion, not surprisingly, to reinforce his country's European credentials. In pressing for the summit to come up with "concrete decisions ... [and] not merely general declarations of goodwill", he gave his backing to measures that would ensure economic and social progress, especially in relation to living and working conditions, and any measures which would promote a more equitable regional policy (D/T-S18523B). But there was nothing here that went beyond reaffirming Ireland's desire to find a resolution to the impasse that had stalled economic and monetary union, while making quite sure that regional policy was implemented, a position that the Irish remained committed to after accession. The Irish had clearly determined that EMU would have serious implications if an EC regional policy was not available to counterbalance adverse effects (Maher, 1986, pp.287-8).

There were other monetary developments. Both Ireland and the UK had already taken steps to modernise their currencies as the 1960s came to a close, with the former following the latter when decimalisation was introduced on 15 February 1971. But even this rejuvenation was not seen as the opportunity to break a link freely forged decades before. The Central Bank Act, 1971, specified that the "practice of referring, in the English language, to the currency of Ireland as 'the Irish pound' … 'an punt Éireannach' in the Irish language" would continue (Central Bank of Ireland, 1979, pp.41-2). And, of course, the punt remained firmly attached to sterling.

Nevertheless, official entry into the EC on 1 January 1973 meant that Ireland would take part in the establishment of EMU as soon as circumstances – both internal and external to the Nine – allowed. As a member state, Ireland would be in a position to ensure that an EC regional policy would counteract any negative effects of EMU. Thus, when the question to break with sterling was posed in earnest from the mid-1970s, the decision to say yes – or even fair enough – was not fundamentally doctrinaire. It was certainly time for an independent and fully functioning economy to have a currency which traded as an equal and not as an adjunct. There was no sense that it would allow the symbolism inherent in developing its own monetary policy, that is away from the shackles of sterling, to stop it from changing course again in the future if needs must. In truth, the break with sterling would not hinder it from participating in any eventual solution at the European level, in fact the latter proved to be the means employed. Although it could not be said that the Dublin government was particularly active in promoting a European solution to the broader economic and monetary problems that the EC faced, they were prepared to come on board any viable project when the opportunity presented itself. But, in terms of policy contribution, it should be added that (McAleese, 2000, p.103):

> Ireland appears to have made little original contribution to strategic policy formulation in Europe. Our forte has been in the management and adaptation of policy. One major thrust among Irish efforts was the Community's regional policy. This may have been to some extent self-serving …

So why did the break with sterling come when it finally did? The answer is partly for political reasons: it was hard to justify or sustain any argument that the punt should stay attached to it for ever, particularly as sterling was performing so poorly on international exchanges. It was economic too: the sterling link was being blamed for imported inflationary pressures on the Irish economy, even if these pressures were also being created domestically (Whitaker, 1976, p.101). To be frank, it was also psychological: because in assuming control, Ireland was severing one of its last colonial ties with the UK, though it would also have the effect of reinforcing partition with Northern Ireland. Therefore, it was very important that there was a sound basis for this revolution in monetary policy. Another basis had emerged, as the EC was developing its own proposals, with France and Germany at the heart of the initiative taken at the European Council meetings of March 1978 in Copenhagen and July 1978 in Bremen (Central Bank & Financial Services Authority of Ireland, 2004, p.19). A new monetary anchor was in the offing (McAleese, 2000, p.98), but it was a decision which would clearly have profound implications

On 15 December 1978, the *taoiseach* announced that Ireland would participate in the EMS, while continuing to sustain parity with sterling for as long as possible. It was recognised in Dublin that this move – tying Ireland's fortunes to those of the other EMS members – would probably necessitate breaking with sterling at some future point as the UK had indicated that it would not be participating fully, at least not initially. According to the Irish government, the EMS created "a zone of monetary stability [which] would … facilitate the attainment of the Government's aims of faster economic growth, lower inflation and full employment … failure to participate in the new system, which was a step in the direction of monetary union in Europe, could lead to the creation of divisions within the Community"; it thus began operating on 13 March 1979 (Central Bank of Ireland, 1979, p.40). By the end of the month, with the UK ultimately deciding not to participate, and sterling appreciating in value due in part to rising oil prices, the punt's break with the past was unavoidable: "Just over fifty years after its formal adoption, the link between the Irish pound and sterling was broken" (Kelly, 2003, p.98). On 30 March 1979, parity between the punt and sterling ceased in order for Ireland to comply with its EMS obligations (Central Bank of Ireland, 1979, p.41). The value of the Irish pound against sterling subsequently fell.

As the 1980s progressed, with the punt – and the ECU – struggling against sterling, the Irish had real fears regarding the creation of the Single Market, partly due to the sense that a geographically peripheral country might not be able to take advantage of the larger – core – marketplace (McGowan, 2002, pp.59-60). Ireland also had, what might generously be termed, an erratic experience while operating as an independent currency within the EMS, with devaluations of 8% in August 1986 and, in many ways more significantly, 10% in January 1993 (McGowan, 2002, pp.60-1). In addition, it has been pointed out that, while this system operated (Honohan, 2001):

> … the Irish pound fluctuated widely against sterling … going below 74 pence (February 1981) and as high as 110 pence (November 1992). Nor was it stable

> against EMS partner currencies. Realignments in the EMS were fairly frequent, averaging about one a year in the 1980s, and the Irish pound depreciated steadily against the Deutsche mark (DM), anchor of the system, reaching a cumulative depreciation of 34 per cent by its low point in 1993.

It has though also been argued that, on the whole, the credibility of the Irish pound as a member of the Exchange Rate Mechanism (ERM) was maintained (Ledesma-Rodríguez, 2000, p.170). The punt was clearly weak, but it was not alone in suffering the vagaries of the policies pursued by other countries or by currency speculators. “Lacking a home-grown currency is nothing new for Ireland” (Honohan, 2001) but, if nothing else, EMS allowed Ireland to contemplate monetary life beyond sterling. Thus, when the opportunity to participate in a fully functioning EMU began to emerge during the early 1990s – and the vagaries of autonomous action and subsequent devaluations by states were put into perspective by shared experiences, especially in the economic backlash following German reunification – it was decided in Dublin that there was safety in numbers. Therefore, it should have come as no real surprise to any seasoned observer that Ireland would choose to participate fully in the implementation of EMU, particularly in the light of its strong economic performance as the decade progressed. Indeed, it adopted the euro at its launch on 1 January 1999, and saw notes and coins being transacted three years later, because that is where the “balance of advantage” now lay (Kelly, 2003, p.90).

In contrast, as a shadow from 1988 and as a member from 1990, the UK briefly flirted with the ERM, in retrospect seeing its entry as occurring too late, at the wrong rate, and not for the right reasons. Its departure from the ERM on 16 September 1992 was both costly and embarrassing. Even signing up to the Treaty of European Union (TEU or Maastricht Treaty) in 1991 meant negotiating an opt-out from the latter stages of EMU; what is perhaps forgotten is that the UK also missed the opportunity to argue that London should be the site for the European Central Bank (ECB) and, of course, how the Maastricht convergence criteria should be interpreted. The UK’s difficulties with the Social Charter was further evidence of its fundamental problem with deeper European integration.

It was different for Ireland. It managed to negotiate substantial structural funds in return for facilitating the negotiation of TEU. A decade later, the introduction of the euro still allowed some individuality, though less manoeuvrability, with the Irish facing rebuke for not reigning in control over the economy at the height of the Celtic tiger years. At the same time as being one of the first countries to be castigated for breaking the Growth and Stability Pact rules, EMU has offered discipline and has allowed Ireland the comfort of being part of a larger whole, while casting sideward glances at its neighbour. By 2002, Irish exports to the UK accounted for 24% of its total, while 36% of its imports originate there; the rest of the EU accounts for 40% of Irish exports and 23% of imports (Central Statistics Office, 2004). Since it achieved membership, the EU has increased exponentially in value as an export destination (McGowan, 2002, p.58). It is readily apparent where its interests now lie. Having decided that the country's future was in supporting, rather than hindering, European integration in general – and policies such as EMU in particular – a certain logic, perhaps even maturity and perspective, has been demonstrated by successive Irish governments. Staying outside these developments only shows that lessons remain unlearned as far as London is concerned – delaying decisions or shirking them does not exhibit the leadership required, or expected, from a larger member state.

Conclusions

Under Blair, the UK appears to be no nearer joining the euro than when the single currency was first proposed; this maintains the British approach: "with, but not really of, Europe" (Carter, 2003, pp.1 & 9). In contrast to this reticence, the UK's nearest neighbour – Ireland – is one of the original members of the euro. As this chapter has argued, taking this position was fairly predictable enough, anything to be different, certainly to the country with which it shares a border. But, as a monetary policy, was its adoption questionable? As far as Dublin was concerned, not really. Always assert your individuality from a safe position, this time from within the euro zone pack, and argue your corner at ECOFIN and European Council meetings while being prepared to seek and reach consensus.

In some respects, it suits Ireland to be within while the UK remains without. Irish adherence was certainly expected, and readily accepted by the other prospective euro zone countries, once the EMU project actually reached the stage of issuing a single currency. It must also be said that the absence of a strictly Irish exchange rate removes some of the economy's flexibility and vulnerability, but instead brings more monetary certainty. What is of particular interest in the context of this chapter is that the constituent parts of the British Isles had of course entered the 20th century with a single currency – sterling.

But, at its conclusion and the beginning of a new century, one country stands alone, wallowing in the past while forlornly wishing that the future will not happen; meanwhile, the other has swapped the pound for the punt for the euro, dependence for interdependence, with hardly a glance back at yesteryear.

In truth, Ireland and the UK had signalled their intentions back in the early 1960s. But these issues were faced squarely during the 1970-72 EU accession negotiations – the main hinge of this chapter – and in choices that both countries made as they tried to enter the European economic mainstream at the third time of asking. In fact, it is back in this period that the motivations – the fears and the attractions – behind subsequent policy can be seen; decisions were reached at that time which impact increasingly into the present day and beyond. This chapter has used those entry negotiations as one way of examining the current situation, particularly where the pound has everything to do with emotion and national identity, and little to do with economics or the merits of Europeanisation, while the punt was recognised some time ago as the means to an end and, even if its consignment to history did not necessarily go unremarked, there were few regrets (McAleese, 2000, p.98). The punt finally disappeared on 9 February 2002, with one commentator noting: “Here, a banknote is a banknote, what it buys is what’s important to people in Ireland” (Williams, 2002). Such subtleties appear lost on London, and prove that it still does not completely understand or fully appreciate the pliable or progressive nature of the European integration project.

Culturally, an interesting point worth reemphasising was that UK currency flowed fairly freely in Ireland throughout the 20th century, even beyond 1979 when coins of different shapes and sizes began circulating (Connolly, 1998, p.367). Bearing the head of Victoria, and subsequently Edward VII and George V – and in fact George VI and Elizabeth II – UK coins did turn up and were used in Ireland, but for the most part were far outnumbered by Brian Boru’s harp. To the latter symbol has now been added representations of Juan Carlos, Beatrix and John Paul II, and sterling is a much less common sight in Ireland as a result. This has not stopped the euro from entering the UK, in some respects by stealth and in others by design; euro cash machines operate in Belfast and the currency is welcome across Northern Ireland – thus contributing, even in this rather minor way, to the normalisation of relations between the two parts of the island – while Irish race-goers continue to turn up in their droves at Cheltenham with their new currency as equally acceptable as their punts were previously.

In truth, the adoption of the euro is an extension of a conscious decision taken over four decades ago by Irish politicians to see their future in Europe. In an increasingly globalised world, those asserting sovereignty and independence are being forced to recognise that, now more than ever, absolute control over monetary policy is an aspiration that cannot be fulfilled. Most EU countries recognised these realities some considerable time ago, and indeed are well acquainted with the benefits – as well as the costs – which are inherent in pooling sovereignty; meanwhile, other states have yet to learn this important lesson and have apparently decided, once again, not to be more directly involved in the shaping of their own futures.

CHAPTER 13

CURRENCIES IN THE WESTERN BALKANS ON THEIR WAY TOWARDS EMU

BY

RENZO DAVIDDI AND MILICA UVALIC *

Abstract: The paper discusses present exchange rate regimes in the Western Balkan countries (WB) - Albania, Bosnia and Herzegovina, Croatia, FYROM, Serbia and Montenegro - to which in mid-1999 the EU has offered concrete prospects of EU membership. Yet membership will also depend on macroeconomic stabilisation, where the exchange rate plays a crucial role. The large variety of currency regimes in the WB is analysed in order to evaluate their contribution to macroeconomic stabilisation in recent years, as well as the key longer-term issues linked to the requirements of joining Economic and Monetary Union (EMU).

Keywords: Exchange rate policies, currency regimes, macroeconomic stabilisation, Western Balkans, transition economies

1. Introduction

The Western Balkans (WB) - Albania, Bosnia and Herzegovina (B&H), Croatia, FYR Macedonia (FYROM), Serbia and Montenegro (until February 4, 2003, FR Yugoslavia) - is a region of growing interest for the European Union (EU). Due to continuous political instability during the 1990s, the EU has intensified its relations with these countries only after the war in Kosovo. The launch of the Stabilisation and Association Process in mid-1999 specifically for these five countries has opened concrete prospects of EU membership. Yet, such prospects will depend crucially on the achievement and maintenance of macroeconomic stability, and accelerated progress in implementing structural economic reforms (in addition to political criteria).

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During the 1990s, all countries in the region have gone through various episodes of major monetary instability, even hyperinflations among the highest recorded in economic history. Most countries have also experienced reversals in macroeconomic stabilisation, due to major economic/political crises or other reasons. Despite variable results, the exchange rate has in all cases played a fundamental role in stabilisation efforts. Presently, the WB countries are characterised by a large variety of exchange rate regimes.

The paper presents a comparative analysis of these various exchange rate regimes, in order to evaluate their contribution, in recent years, to macroeconomic stabilisation. After a cursory description of the different currency regimes (section 2), the main achievements and failures of macroeconomic stabilisation programmes are briefly discussed (section 3). The role of the various currency regimes in transition economies, particularly in the WB, is then considered (section 4), as well as the key longer-term issues related to the option of joining Economic and Monetary Union (EMU) (section 5). Some final remarks summarise the main conclusions.

2. Exchange rate regimes in the Western Balkans

Presently, the WB countries are characterised by a large variety of exchange rate regimes, even within countries (see table below).

Table 4: Exchange rate regimes in the Western Balkans

Country	*Exchange Arrangement*	*Date of Adoption*	*Currency*
Albania	Pegged Independently floating	1990-91 Aug. 1992	Lek, linked to the US$ Lek
Bosnia and Herzegovina	No unique regime BiH dinar pegged	1992-96 Aug. 1994	BiH dinar, new BiH dinar, Croatian dinar (later kuna), RS dinar, YU dinar
	Currency board Arrangement	1997	Convertible marka linked to the euro
Croatia	Pegged Managed float	1992 Oct. 1993	Croatian dinar, in 1993 replaced by the kuna
FYROM	Pegged	1992	Coupons, later replaced by the Macedonian denar
	Conventional peg	1995	
FR Yugoslavia	Pegged	1992	Yugoslav dinar
-Serbia	Pegged Managed float	1992 Dec. 2000	Yugoslav dinar
-Montenegro	Euroisation (euro *De jure* legal tender)[1]	1998	Euro
-Kosovo	Euroisation (euro *De facto* legal tender)	Mid-1999	Euro

Montenegro and Kosovo have recently adopted the euro, though under very different legal backgrounds. FYROM has opted for a conventional peg, with the Macedonian denar linked to the Deutschmark (DM) (today the euro). B&H has a currency board arrangement (CBA, or 'irrevocable peg') with the Convertible marka pegged to the euro. The remaining three countries/entities - Albania, Croatia, and Serbia - today have some form of a flexible regime, but with different degrees of flexibility, though in the past all three had also pegged their national currencies - to the DM (Serbia and Croatia), or the United States dollar (US$) (Albania). These variegated choices seem to correspond to the general trend observed world-wide: the WB seem to conform to the 'new orthodoxy' of the 1990s, characterised by the move away from fixed rates towards either floating or 'hyper-fixed' rates (Nuti, 2001, p. 3).[2]

These different currency regimes will now be examined in greater detail, together with the principal results regarding macroeconomic stabilisation.

(1) Albania

Albania in 1991 adopted a fixed exchange rate regime with the lek pegged to the US$. A flexible exchange rate was introduced in August 1992, as part of an International Monetary Fund (IMF)-supported stabilisation program. This choice found support in the literature, in the context of a small open economy in transition, when the level of international reserves is below a minimum threshold (Muço et al., 1999, p. 536). Today, the country has an independent float: the exchange rate is formed on the basis of supply and demand for foreign currency. The Bank of Albania calculates and announces the daily exchange rates for the US$ and other currencies. Since exchange rate stability has been a primary goal of the central bank, effectively the lek has been informally pegged to the US$, despite the EU being its most important trading partner. Until recently, 60% of foreign reserves and domestic deposits in foreign currency were held in US$, but the euro has quickly been replacing the US$ after 2002.

Regarding macroeconomic stabilisation, inflation decreased to a one-digit figure only after 1995.[3] In 1996-97 there was a major economic crisis, following the collapse of a number of fraudulent pyramid schemes. This led to a dramatic depreciation of the lek in early 1997, but by mid-1997 the exchange rate returned to relative stability of around 150 lek per US$ (Muço et al., 1999, p. 541). Since then, inflation has been maintained low (usually well below 5%), though the public deficit remains the highest in the region (8% of Gross Domestic Product (GDP) in 2002).

(2) B&H

Bosnian independence in mid-1992 was followed by the creation of a national bank and introduction of the Bosnian dinar as legal tender, but the four-year war postponed effective monetary reforms until much later. A new Bosnian dinar was introduced in mid-1994 pegged to the DM, but it was not accepted in the whole country. During this period, various currencies were in use - the new Bosnian dinar; the Republika Srpska dinar and the Yugoslav dinar; the Croatian dinar/kuna - in the areas populated by the Bosniacs, Serbs, and Croats respectively. In mid-1997, a CBA was introduced which pegged the new currency, the Convertible marka (KM) to the DM (KM1=DM1) and from January 2002, to the Euro (KM1 = € 0.51129). An independent Central Bank was established in August 1997, under the guidance of an internationally appointed governor.

The 1997 currency reform provided a strong nominal anchor and successfully drove down average inflation to one of the lowest rates in the region - by 2002, to 2% in the Federation and 5% in the Republika Srpska. Foreign currency reserves have continuously increased, from KM 144 million (end 1997) to over KM 2.2 billion (July 2003). Achievements in fiscal policies have been much less remarkable, primarily regarding the level and composition of public expenditure, which is still above 60% of GDP (the highest in the region). Such high public expenditure calls for major structural consolidation; if enduring, it could clearly represent a threat to medium-term growth and macroeconomic stability.

(3) Croatia

Croatia established an independent central bank in 1991 and for a short period relied on a fixed exchange rate, with the Croatian dinar pegged to the DM. Despite stabilisation attempts in 1992-3, there were rising inflationary pressures. A new programme was implemented in October 1993, which was rather successful. Annual average inflation by 1995 fell below 5% and since then has been maintained low, while the exchange rate stabilised after a brief appreciation. In May 1994 the Croatian dinar was replaced by a new currency, the kuna. Thereafter, the regime has been a managed float, with no pre-announced path for the exchange rate which is determined on the foreign exchange market. The national bank may, however, set intervention exchange rates which it applies in transactions with banks outside the inter-bank market.

Croatia achieved a high level of price stability using the exchange rate as nominal anchor. The national bank law defines exchange rate stability as the primary objective of monetary policy, but the effectiveness of monetary policy may be limited. Similarly to the other countries, the past structural excess liquidity, coupled with a weak payments system and liquidity management practices of banks, seem to have hampered the proper development of the money market. Currency substitution persists and confidence in the domestic currency has not been restored: three quarters of bank deposits and almost half of bank domestic placements are either in a foreign currency or indexed to one (European Commission, 2002, p. 32).

(4) FYROM

FYROM established an independent central bank in April 1992 and issued the Macedonian denar (MKD), initially in the form of coupons, which was not backed by gold or foreign exchange reserves; notes and coins were introduced in April 1993. The MKD was pegged to the DM and subsequently re-pegged to a basket of seven currencies. After 1995, the exchange rate regime has been a conventional peg. The exchange market operates at two levels: wholesale and retail. The National Bank participates in the wholesale market to maintain the value of the MKD against the DM (today €) at the level that meets balance of payments objectives. The MKD exchange rate is established freely on the basis of demand and supply of foreign currency, based on the reports from the banks participating at the foreign exchange market. The MKD/€ exchange rate serves as the intermediate target of monetary policy; money supply and interest rates are dictated by the exchange rate target, which since mid-1997 has been set at MKD61 = €1 (Bisev and Petkovski, 2003, pp. 12-3), and has been kept at that level (except in 2001, see below). Effectively, the central bank has been maintaining a stable MKD/€ nominal exchange rate.

After extreme macroeconomic instability in 1991-94 (as elsewhere in the region), a heterodox adjustment program brought about a significant and enduring reduction of average inflation: in 1996-98, it declined to 2.5%, 1.5% and 0.6% respectively, while in 1999 it was even negative. The military conflict in 2001 caused a major turbulence on the foreign exchange market, when the MKD nominal exchange rate reached its highest value against the euro (MKD66=€1). The National Bank defended the parity and tightened monetary policy, increasing interest rates and reserve requirement rates. The policy was successful: in the second half of 2001 the exchange rate returned towards its long-run trend of MKD61=€1 (Bisev and Petkovski, 2003, p. 12). By mid-2002 the foreign exchange reserves reached € 884 million.

(5) Serbia and Montenegro (formerly FRY)

In April 1992, FRY was created as a federation of two republics, Serbia and Montenegro. Until 1998-99, the NBY was in charge of monetary and exchange rate policies throughout the country. After 1998, Montenegro decided to distance itself from Serbia in practically all economic areas, whereas Kosovo abandoned the monetary union after the 1999 war, when it was put under the UNMIK administration. In what follows, therefore, until 1998-99 the policies will be considered for the country as a whole, and thereafter for the three entities separately.

In 1992, FRY opted for a fixed exchange rate regime, with the Yugoslav dinar (YUD) pegged to the DM, and this arrangement prevailed throughout the 1990s. Expansionary monetary and fiscal policies brought about a virtual collapse of the economy by late 1993 - a 50% drop in output and one of the highest and longest hyperinflations ever recorded in world history (annual average inflation rate of 116.5 billion). A heterodox stabilisation programme implemented in early 1994, based on a monetary reform, the exchange rate as nominal anchor, internal convertibility, successfully halted hyperinflation, reversed the trend of declining output and increased foreign exchange reserves. But by the end of 1994, inflation was again fuelled through credit expansion, convertibility was abandoned and the black foreign exchange market re-flourished. The YUD was officially devalued in late 1995 and in April 1998, but durable macroeconomic stabilisation had not been achieved. Though average inflation dropped from 94% in 1996 to 21% in 1997 and 29% in 1998, it again increased to 37% in 1999.

Major distortions have also been introduced by the extensive use of multiple exchange rates, applied on a completely discretionary, non-transparent and ad hoc basis. From April 1998 onwards, the official exchange rate was for over two years fixed at DM1 = YUD6, despite the black market exchange rate continuously increasing (by October 2000, it was five times the official rate, DM1 = YUD 30). Given the substantial foreign currency shortages, only the most privileged - the political and economic élite close to president Milosevic - had access to foreign currency at the official exchange rate, which was misused in various ways (e.g. only the “well connected” directors could buy foreign currency needed for imports at the official exchange rate).

Post-2000 Serbia

A major change in macroeconomic policies took place after the political changes in October 2000. The exchange rate was unified, the currency was devalued vis-à-vis the DM, internal convertibility and a flexible exchange rate (managed float) were introduced. Monetary policy has since been geared towards reigning on inflation, which was rather high following price liberalisation and major fiscal reforms. Average inflation fell from 91% in 2001 to 21% in 2002, reaching a single-digit figure (8%) by the end of 2003. The nominal exchange rate has been maintained stable for over two years, close to YUD 30 = DM1 (later YUD 60 = €1). The Central Bank governor Dinkic also introduced specific measures to reduce currency substitution (e.g. prohibiting payments in shops and restaurants in foreign currencies). Official reserves have continuously increased, to US$ 3.3 billion by September 2003. Due to the restored demand for dinars, purchases by the authorities of foreign exchange accounted for roughly half of the foreign reserves accumulated during 2001, while the other half derived from official aid (OECD, 2002, p. 57).

The nominal exchange rate has remained stable despite relatively high inflation, which brought about a substantial real appreciation of the YUD. It has been sustained that this has significantly decreased the competitiveness of the economy, given the continuous increase in the foreign trade deficit (see Popovic, 2001, p. 6; Kekic, 2002). Since mid-2002, the National Bank has allowed a slight nominal depreciation to around YUD 6.5 = €1 by mid-2003.

Post-1998 Montenegro

Although Montenegro was for years in a monetary union with Serbia, in 1997 it decided to gradually establish independence in practically all economic fields. In the monetary sphere, the first step was to legalise, in 1998, the use of the DM, which in November 1999 officially became the legal tender, while in November 2000, the sole means of payment (although *de facto* parallel circulation took place unhindered until March 2002). In January 2002, the € was introduced as the legal tender; although Montenegro had no official reserves, its introduction was backed by international donations. The authorities justified these drastic measures by the need to insulate the economy from the negative effects of expansionary monetary policies in Belgrade. However, the overall results have been less successful than expected.

The replacement of the YUD by the DM (today €) did not lead to an immediate and drastic reduction of inflation, which in 2000-1 remained rather high (24.8% and 28% respectively) and was reduced to 9.4% only in 2002. The introduction of a strong and convertible currency as legal tender has not returned citizens' confidence in domestic financial institutions; some estimates indicate that in 2002, two thirds of money in circulation remained under mattresses, while half of all economic transactions were in cash, avoiding the mediation of official financial institutions. In the fiscal area, the separation from the federal state has enabled faster implementation of certain fiscal reforms, but the core structural problems remain, judging from the very high fiscal deficit (16% of GDP in 2000) and non-fulfilment of the targeted decrease in 2001.

Post-1999 Kosovo

The UNMIK administration in autumn 1999 immediately legalised the circulation of currencies other than the YUD (Regulation 9/1999), though it fell short of declaring the DM the sole legal tender. As a result of rapid currency substitution, soon the DM (later €) became *de facto* the only currency in circulation. Kosovo has not formally established a central bank, although the Banking and Payments Authority of Kosovo was given the responsibility for bank licensing, supervision and prudential regulation. Since today its *de facto* currency is the €, it does not carry out any monetary or exchange rate policy. It remains heavily reliant on private and public transfers: expatriates have traditionally made significant remittances from abroad, which in 2001 amounted to €400 million (25% of Kosovo's estimated GDP; see OECD, 2002, p. 35).

On the basis of the above, we can conclude that the following elements have heavily influenced the choice of the exchange rate regimes in the WB.

(1) Considerations related to the soundness of the fiscal stance and capacity to control inflation, which have been instrumental in suggesting a hyper-fixed option in those countries where the capacity of the authorities to impose a certain degree of fiscal and monetary discipline was perceived as being weak (e.g. in B&H).

(2) The wide circulation of the DM in the whole region has constrained the choice of the peg. Given the wide acceptance and use, throughout the 1990s, of the DM as the traditional reserve currency, it was indeed chosen as the main point of reference.

(3) The lack of foreign exchange reserves at the outset of transition also determined the chosen options. In the case of the successor states of Yugoslavia, foreign exchange reserves were blocked in Belgrade, so the newly established central banks had no or very limited reserves.

(4) Historical and political factors have also crucially influenced the choice of the regime. Political factors underline the introduction of the euro in both Montenegro and Kosovo, whereas unsuccessful experiences with stabilisation programmes based on a fixed exchange rate in the 1990s have influenced the choice of a flexible regime in Serbia in late 2000.

3. Macroeconomic stabilisation: achievements and failures

We have illustrated how the WB countries have relied on very different exchange rate regimes in recent years. Despite such variety, however, the overall results have actually been rather similar, both regarding the main achievements of macroeconomic stabilisation programmes and their major failures.

In practically all countries, price stability and defence of the exchange rate have been the central objectives of economic policy in recent years. Indeed, the declining trend in average *inflation* in the WB countries has arguably been the main achievement of macroeconomic policies. Following the hyperinflation of the early 1990s, average inflation gradually decreased and stabilised, converging by 2002 to a single-digit figure. Serbia is the only exception, as it embarked on radical economic reforms (including price liberalisation) only in late 2000, but even here average inflation in 2003 has fallen below 10%. Still, the achievement of monetary stability clearly cannot be taken for granted; the possibility of reversals is always possible if the authorities depart from sound policy principles.

Another positive result is the maintenance of relative stability of the *nominal exchange rate* vis-à-vis the euro. Although we have witnessed short-term crises which have provoked major disturbances on the foreign exchange market in several countries, the central banks have been able to re-establish stability. Such exchange rate stability has been a fundamental element for restoring confidence in the national currencies and gradually reducing currency substitution.

The coexistence of a fixed nominal exchange rate and some, albeit modest, inflation has led to a certain degree of real appreciation of the national currencies. It is difficult to draw conclusions about the precise effect of such real appreciation on competitiveness, without a more thorough analysis of the evolution of nominal and real effective exchange rates. However, at least in the case of Serbia, there seems to be a strong positive correlation between the real appreciation of the exchange rate and the growing trade deficit.

There have also been some major failures of macroeconomic stabilisation programmes, which could undermine the stability of the macroeconomic environment in the medium term. In several areas of economic reform, the WB have clearly lagged behind the more advanced transition economies (see Transition Indicators, European Bank for Reconstruction and Development (EBRD), 2003, p. 16). We will recall only those elements which are most relevant for our present analysis.

(1) The relative stability of the fiscal stance has been achieved without major reforms in the *fiscal area*. Generally, all countries are characterised by an oversized public sector, a high level and 'erroneous' composition of public expenditure, and weak tax collection capacity. These problems, if not addressed in a coherent and comprehensive way, could endanger long-term stability.

(2) *Currency substitution* remains widespread in all countries, though less than a few years ago. In the presence of currency substitution, the central banks are less able to control the quantity of money in circulation and monetary growth targets are inefficient methods for controlling inflation (Bisev, 2000, p.14).

(3) Delays in *financial and banking reforms* have led to weak banking and payments systems, which have hampered the development of money markets and interest-sensitive monetary instruments, thus heavily constraining the conduct of an independent monetary policy. Central banks in the WB have relied on very few financial instruments and have not engaged in more active monetary policies.

(4) Indicators of the *real sector* are rather discouraging. All WB countries have experienced rather slow recovery of output, and all of them, except Albania, are today well below their 1989 GDP level. All countries except B&H have experienced between 1999 and 2002 one or more years of negative economic growth, and all have also very high official unemployment rates (14% to 41% of the labour force).

These elements seem to suggest the presence, in the WB, of a trade-off between growth and price stability. The policy mix which has been so successful in delivering price stability has obviously failed to produce high and sustained growth rates. This obviously does not mean that achieving macroeconomic stability was not a primary objective for the countries under review. It does mean, however, that the lack or slow progress in structural reform (including the failure to establish an appropriate institutional, regulatory and legal framework) has failed to generate the supply response that is necessary for reducing unemployment and generating sustained economic development.

4. The role of exchange rate regimes in macroeconomic stabilisation

More than a decade of experience of transition indicates unequivocally that the exchange rate regime has played a crucial role in macroeconomic stabilisation in the short term. In the medium-term, policy makers need to address the challenging issue of implementing a policy mix which is consistent with the chosen regime. In particular, it is necessary to find a balance between the necessity to continue using the exchange rate as an anchor in the stabilisation process, while limiting the impact of possible real appreciation.

(1) Pegging the exchange rate

Generally, the choice of a fixed exchange rate at the initial stage of transition in the WB has probably been unavoidable. Beyond political considerations, other factors may suggest that it is optimal to fix the exchange rate: the size of an economy, its degree of openness, the need to reduce the costs of the monetary overhang. Yet, two more general considerations are in order.

First, the choice of the currency regime is by far less important than the policy mix that should sustain it. Although at a price, even a CBA can rapidly become unsustainable, unless the overall policy framework is adequate. Such a policy framework must include appropriate fiscal and structural policies, including those concerning the financial sector. Similarly, the benefits of euroisation crucially depend on the credibility of the commitment, which is in no way automatic and is fundamentally linked to the type of government policies.

Second, the choice of the exchange regime is also heavily dependent on the country's policy priorities. Let us assume that the authorities give priority to catching up, while trying to avoid policy profligacy and minimising falls in output and employment. In this context, the choice of the exchange rate regime depends on the relative weight of the tradable and non-tradable sector in the economy. In the case of small open economies (like most WB countries), it may be optimal to fix the exchange rate, but this is not necessarily so in a medium-sized country, where it might be better to allow more exchange rate flexibility and target prices instead.

On this ground, none of the Balkan countries is big enough to justify alternative choices. Yet, in some cases, pressures deriving from the transition can jeopardise the sustainability of the chosen regime. It could be argued that real appreciation of the currency does not necessarily have an immediate negative impact on competitiveness. However, this could only be so if the country manages to benefit from economy-wide productivity gains, that in a transition economy are possible if appropriate structural policies are implemented. Yet, in most WB countries, the incapacity or the unwillingness of the policy makers to design and implement appropriate structural policies represents a major challenge for macroeconomic stability and exchange rate sustainability.

An extensive literature has analysed the rationale for pegging the exchange rate (Sachs, 1995, Bruno, 1995), offering three main reasons for introducing it at the outset of stabilisation. A pegged rate (Sachs, 1995, p. 149): (1) boosts the government's commitment to stabilisation by establishing clear targets and by tying the government's own hands; (2) helps price and wage setters coordinate their actions and expectations around a new low-inflation equilibrium; and (3) provides a convenient way for households and enterprises to rebuild their real money balances after a period of high inflation. At the start of stabilisation, economic agents desire to hold higher real money balances which, under pegged exchange rates, are satisfied automatically through the balance of payments, as agents repatriate their offshore capital or, in the case of the WB, dishoard foreign currency and convert it into domestic currency. Under a floating exchange regime, there is no automatic mechanism for households to rebuild their real money balances.

The central bank could support remonetization of the banking system by expanding domestic credit, but this would undermine the credibility of the stabilisation programme. Therefore, many central banks refrain from domestic credit expansion and the economy remains undermonetized, suffering from excessively high real interest rates and an overvalued currency. The result is that successful anti-inflation programmes under floating rates tend to be more contractionary than those carried out under pegged exchange rates and many attempts at stabilisation under flexible rates have simply failed (Sachs, 1995, p. 149). In the case of the accession countries, empirical evidence suggests that the early peggers outperformed the floaters both in terms of the success and costs of disinflation; even when stabilisation under floating rates was achieved, the costs seem to have been higher (Sachs, 1995, p. 149).

The experience of the WB clearly indicates that neither type of currency regime can compensate for the lack of structural reforms. In FYROM, the strategy of exchange rate targeting under a pegged regime seems to have had a number of disadvantages (Bisev and Petkovski, 2003, p.12). The exchange rate was not an outcome of the market forces, but was determined by the Central Bank's assessment of the equilibrium exchange rate; since the assessment for 1997 – 2002 was that the fundamentals did not change, the exchange rate remained fixed. Second, in order to secure the stability on the foreign exchange market, high instability was created on the money market; the volatility of the interest rates was very high, which adversely affected economic activity. Third, the exchange rate anchor should have coordinated the behaviour of all economic agents, including the government's fiscal policy; otherwise, low inflation is maintained through economic growth lower than potential (even recession) and balance of payment disequilibrium, or both.

In Croatia where, on the contrary, a managed float was adopted, the economy has similarly been suffering from excessively high real interest rates and an overvalued currency, which discouraged investment and growth. Although the National Bank had reduced its discount rate, this had little impact on interest rates charged on bank loans to individuals and businesses, so economic recovery came to an end in mid-1998 and was followed by a banking crisis. The growth of the economy was being held back by a structural balance of payments constraint, imports being far higher than exports (Bartlett, 2003, pp. 96-7).

As to longer-term policies, a policy regime appropriate for halting inflation may be inappropriate for longer-run economic management. In transition economies, there is a strong case for moving to a more flexible exchange rate once high inflation has been eliminated and the economy has been substantially remonetised. These economies suffer from chronic structural weaknesses that limit the flexibility of the domestic economy - a high degree of state ownership, wage-setting strongly influenced by insiders, inherited rigidities in wage-setting, moderate rather than high openness to international markets, chronic fiscal problems, including very high rates of taxation (Sachs, 1995, pp. 150-1). As a result, monetary and fiscal policies are likely to remain too expansionary in the medium term to underpin a permanently pegged rate and the economy is unlikely to possess the degree of flexibility needed to absorb adverse shocks. What is therefore suggested is the adoption, at a later stage, of a more flexible currency regime.

The most difficult practical problem is to evaluate the appropriateness of the nominal exchange rate target from the point of view of long-term international competitiveness (Sachs, 1995, p. 151). The policy challenge is to distinguish between the dollar-wage increases justified by rising tradables productivity, and the dollar-wage increases that result from internal inflationary pressure. Under conditions of major structural transformation, the policy of simply maintaining the nominal exchange rate unchanged is likely to provoke growing real appreciation.

Capital inflows are another source of pressure towards currency appreciation. If the peg is perceived as unsustainable, a pegged regime can precipitate major financial crises. There is still no consensus on the appropriate policy response to a sharp increase in short-term capital inflows. The recent financial crises in Argentina, Mexico and Venezuela demonstrate that undercapitalised banking sectors may exacerbate macroeconomic instabilities by engaging in large-scale foreign borrowing at the time of capital-market liberalisation.

(2) The case of the hyper-fixed regimes

Euroisation

Kosovo and Montenegro have pushed the concept of a pegged rate to the extreme, by adopting the euro as legal tender (referred to as 'unilateral euroisation'). Euroisation is a rather encompassing concept which extends the concept of currency substitution, a well-known phenomenon in many transition and developing countries. Currency substitution is clearly 'market driven': it cannot be influenced directly through government administrative measures, but depends on citizens' decision whether to hold savings in domestic or foreign currency. But insofar as the degree of currency substitution is inversely correlated with macroeconomic stability, economic policy matters and should be geared to sustaining macroeconomic stability.

The most powerful argument in favour of euroisation is related to the signalling properties of a 'hyper-fixed' exchange rate regime (Daviddi, 1999, pp. 3-4). The severe financial crises of recent years, from Asia to Russia to Argentina, seem to suggest that the mechanisms of forming expectations are rather rudimentary. Detailed knowledge of small and often distant countries is difficult and costly to acquire. This facilitates the development of "clusters of knowledge", which end up having a heavy influence on investors' choices. "Herd behaviour" tends to amplify the negative consequences of shocks and spreads panic. By committing themselves to what is hoped will be perceived by the market as an irreversibly fixed exchange rate, the authorities send a very strong signal to the market itself. They enhance their credibility and their reputation and 'borrow' at least part of the stability of the foreign currency. By eliminating devaluation risk, they can enjoy interest rates which are lower and less sensitive to 'contagion' from other countries than under a more flexible exchange regime. Other benefits include access to deeper financial markets, capital inflow, etc.

However, the option of euroisation means accepting the loss of domestic monetary independence. If an asymmetric shock hits the economy, EU monetary policy will not accommodate. In the event of a shock that calls for a devaluation, the adjustment will have to come from a reduction of domestic prices. If prices (and wages) are sticky, adjustment will take the form of reduced growth and higher unemployment. This could have been avoided if the country could have conducted its own monetary policy and could have relied on nominal devaluation.

It has been argued (e.g. Calvo, 1999) that the possible use of a devaluation is constrained by the pre-existing partial dollarisation. Admittedly, liabilities denominated in foreign currency are highly vulnerable to devaluation. If the banking sector has borrowed heavily in foreign currencies, a major devaluation can have disastrous consequences for the financial system and the whole economy. However, the degree of exposure of financial institutions to borrowing in foreign currencies in the Balkan countries is not as high as in some Latin American, or even transition, economies.

Beyond asymmetric shocks, the call for greater flexibility may derive from the undergoing process of deep structural transformation. In such an environment, inflation might have “real” origins, generated by the well-known Balassa-Samuelson effect. When a small economy opens up to international trade, the export sector’s prices are set at the world level. If the country is on its production possibility frontier, every increase in productivity in the traded goods sector will also lead to an increase in wages. But if wages are equalised through the traded and non-traded sector, and if the non-traded sector has a slower dynamics of productivity, this increases domestic inflation. In this case, inflation is a “real” phenomenon due to the catching up process. Coricelli and Jazbec (2002, p. 135) argue that real appreciation of currencies observed in transition countries can be interpreted as a “qualified” equilibrium process, because it is only after 5-6 years into transition that the Balassa-Samuelson effect tends to dominate the real exchange rate dynamics; but, based on evidence for Slovenia, a *de jure* flexible nominal exchange rate is not an insurance for low inflation.

The literature identifies two further arguments against euroisation. The lack of a lender of last resort may prevent the timely provision of extra credit in case of a bank run. This problem seems surmountable (Calvo, 1999), insofar as a stabilisation fund, or a contingent pool of resources, can be provided on a standby arrangement by private banks. However, similar arrangements attempted in the case of Argentina have not been particularly successful. In addition, a country which opts for full euroisation will have to accept losing its seigniorage revenue. Given the transition economies difficulties to raise revenue, this seems to be a more relevant issue. The loss of seigniorage can be seen as the counterpart for the benefits of stability and enhanced credibility accruing to the country that adopts the euro.

Euroisation or a CBA were advocated also for Serbia in late 2000, especially given that the euro was already in use in Montenegro and Kosovo (Gros, 2001). In addition to the traditional arguments against hyper-fixed exchange rates (Nuti, 2001, pp. 7-9), several other reasons led to the refusal of euroisation (Popovic, 2000, pp.2-3). Throughout the 1990s, the country has experienced continuous monetary instability, as all stabilisation programmes had always failed. The loss of enormous amounts of citizens savings through pyramid schemes and other channels had additionally contributed to the loss of confidence in the national currency (see Dinkic, 1995, Chapters 3 and 4). An arrangement more flexible than a CBA was necessary in Serbia, together with the reaffirmation of the dinar as a national symbol (Dinkic, 1998, pp. 13-18).

Currency board

It could be argued that a CBA can better serve the purpose of an economy than euroisation. A CBA should not be considered a second best, but a policy choice to be preferred to the alternative (although there may be cases, as in Kosovo, where for political reasons the choice between the two was not available). However, the temporary nature of this option should be clear in the minds of policy-makers from the outset.

A CBA presents most of the advantages of enhanced credibility and reputation of euroisation, especially if the commitment is perceived as being sufficiently strong and if it is supported by an appropriate policy mix (arguably the case for all exchange rate regimes). However, contrary to euroisation, a CBA has the advantage of making an orderly exit strategy possible. Even in the case, like e.g. in Estonia, in which modifications of constitutional laws are necessary to change the way the CBA functions, it is still possible to envisage that it can be discontinued once its sustainability is put into question by the appearance of major economic disequilibria. Clearly, the willingness to contemplate an orderly exit strategy should not be pre-announced, as it would weaken the commitment and therefore would require a higher risk premium.

In B&H the CBA, together with the establishment of an independent and reputed central bank, helped significantly the stabilisation process, if simply judged in these terms. Shortly after its introduction, Warren Coats noted that “The ultimate test of the CBA in B&H will consist of the extent to which the public shifts over time from the DM … to the KM, which will shift the seigniorage now earned abroad to the CBBH and lower the cost of transacting” (Coats, 1998, p. 31). Currency substitution has undoubtedly taken place, as the KM is widely accepted, is circulating in the country, and is even exchanged in neighbouring countries.

However, monetary stabilisation has not been paralleled by a revival of economic growth. Decreasing growth rates, high unemployment and poverty are still characteristic features of the Bosnian economy seven years after the end of war. Exports and new investment are low, the current account deficit very high. Somehow paradoxically, the lack of sustained response on the real side has alleviated pressure on the CBA, which could endanger its sustainability. In practice, the marked tendency to real appreciation deriving from fast productivity growth in the tradable sector experienced in most transition countries does not apply to B&H. The main parameters of current economic policy are still determined by the CBA. There is still no unique institution in charge of the fiscal deficit, though the Governing Board of the Indirect Tax Authority could be considered its first embrion.

As in other transition economies with a CBA (Estonia, Bulgaria), the choice of the euro as an anchor for the CBA also in B&H was the most appropriate, insofar as it reflects the economic and trade relations of the country and the composition of its external debt, as well as the degree of confidence of the markets in the anchor currency.

(3) Flexible exchange rate regimes

The experience of Albania, Croatia, and Serbia seems *prima facie* to militate in favour of a more flexible exchange rate regime since an early phase of transition. In reality, however, the degree of freedom in such a choice is much more limited if one looks at the way in which these supposedly flexible arrangements have been working in practice.

Albania has de facto been pegging its currency, though officially it has an independent float. Since the Bank of Albania calculates and announces the daily exchange rates for major currencies, effectively the lek has been informally pegged to the US$ (more recently, the euro). In Croatia, the nominal exchange rate of the kuna/euro has also been maintained relatively stable. Thus the lack of competitiveness of Croatian exports has become a key problem (Bartlett, 2003, pp. 118-9). Some have argued in favour of a devaluation to promote development and stimulate exports; but as stressed by others, without accompanying measures to control inflation, this would lead to higher prices and wage costs, so the key is to cut public expenditure. In Serbia, although the post-2000 regime is officially a managed float, it has also been referred to as a "near-pegged exchange rate" (EBRD, 2002, p. 146) since for two years the National Bank has kept nominal exchange rate stability vis-à-vis the euro. The main cost of such a policy, as stressed earlier, has been a substantial increase in the trade deficit.

It follows that not even those countries that have rejected a fixed or hyper-fixed option actually use the advantages of a more flexible exchange rate regime. Policy objectives and actual outcomes have been so similar across WB countries, that the variety in currency regimes has not really made a big difference.

5. Medium-term perspectives

Since in 1999-2000, the EU Stabilisation and Association Process has offered WB countries prospects of EU membership, it is also of interest to consider the medium-term perspectives related to EMU membership.

Although some WB countries have since then signed Stabilisation and Association Agreements with the EU, obviously they will not be able to become EU members for some time to come. Moreover, they will not be expected to join the EMU immediately. As for other countries, in order to qualify for the EMU, the WB countries will also need to fulfil the Maastricht criteria. Here it is worth stressing that convergence is expected to be sustained, implying that the institutional, legal and policy framework should be such as to guarantee the fulfilment of the convergence criteria on a permanent basis. Still, in the same way that the convergence criteria *have not been* the accession criteria for the candidate countries, they will not be in the event of future EU enlargements.

This does not mean that the convergence criteria are of no significance for potential future members. In due time, their participation in the euro area will be judged on the basis of these criteria, as the Treaty makes no distinction between initial and later participants in EMU. In this respect, the convergence criteria should be viewed as medium-term points of reference for stability-oriented macroeconomic policies, also in the WB.

It is by far premature, and also quite difficult, to evaluate the performance of many Balkan countries with respect to the Maastricht criteria. In particular, their fiscal position and long-term interest rates (when they exist) are not comparable to the definitions adopted by the Treaty. Still, it is clear that a premature and excessive focus of the policy mix on the fulfilment of the Maastricht criteria could represent an excessive constraint for countries just starting to implement deep structural transformation.

Particular cases in point are the regimes in areas which have already euroised or have adopted a CBA. In the former case, the adoption of the euro as legal tender is obviously totally unrelated to the country's ability to take part in the definition of the eurozone's monetary policy. As for the CBA, the choice between its maintenance, or the introduction at some stage of an alternative regime, should depend primarily on a careful assessment of the appropriateness and sustainability of the currency board itself, more than its being aligned to the *acquis* in the area of exchange rate policy.

6. Conclusions

The analysis of exchange rate regimes and policies in the WB permits the following conclusions.

First, all WB countries seem to have very limited room for manoeuvre in actual macroeconomic policies. Despite the variety of exchange rate regimes, the actual policies applied have been strikingly similar, implying that the choice of the currency regime has been far less important than would seem at first sight. The success or the failure in terms of economic growth, increase in employment, or fight against poverty, has been determined primarily by the governments' fiscal policy and implementation (or lack) of appropriate structural policies. The conduct of monetary policy has, in any case, been heavily constrained by the requirements of macroeconomic stabilisation, in almost all cases codified in conditionality, negotiated and agreed with the IMF through various assistance programmes. Even in countries which have opted for a more flexible regime, the conduct of an active monetary policy has not been exploited. The policy mix has remained restrictive and bears close similarities with policies followed by countries under a more rigid regime, like a CBA.

Second, the choice of a fixed, or hyper-fixed regime, is not sufficient, per se, to guarantee the resumption of sustained economic growth. The commitment to a fixed or hyper-fixed exchange rate has helped reach a fair degree of monetary stability, but economic recovery and growth depend crucially on the design and coherent implementation of an appropriate policy mix, which needs to foster inter alia substantial structural and institutional changes.

Third, as in other transition countries, also in the WB different exchange rate regimes may better serve different phases of transition. At an early stage, a fixed exchange rate can play a key role as the nominal anchor in the stabilisation process. Later, it becomes necessary to introduce more flexibility to adjust for the trend towards real appreciation. In this context, the stronger the exchange rate commitment, the more costly and more difficult to exit and to make room for such flexibility.

Fourth, recommendations cannot be generalised. Solutions chosen by governments need to take into account the specific conditions prevailing in each country, as there is no one single model of foreign exchange rate policy in transition. An unconditional support for a fixed or hyper-fixed regime at all costs seems unwarranted. The case of Serbia supports this view very strongly; past failed attempts to attain stabilisation through a hard peg have recommended a more cautious approach in late 2000, so far with acceptable results.

Finally, it is still too early to focus the policy mix in the WB on the fulfilment of the Maastricht criteria. Stability-oriented policies are clearly essential, but considering that WB prospects of joining the EU are medium to long-term, there is no need to impose excessive constrains on the policy mix at a still relatively early stage of transition.

NOTES

[1] Euroisation is clearly a neologism derived from the more widely used term dollarisation. Currency substitution (or dollarisation/euroisation) refers to the holding of a significant share of cash and assets by residents denominated in foreign currency.

[2] A "hyper-fixed exchange rate" refers to the adoption of an irreversibly fixed exchange rate regime, sometimes (e.g. in Estonia) requiring constitutional amendments to exit the regime. Such a regime can take the form of a currency board and/or the adoption of the euro as the sole legal tender.

[3] The source of all macroeconomic statistics reported throughout the paper are from EBRD (2002).

[4] Public expenditure is to a very large extent confined to wages and social transfers, with negligible capital investment.

Comment
by
David Andrews

These chapters address a range of issues concerning the sources and implications of Europe's changing monetary configuration. To begin with, Zimmermann provides an overview of the political debates that have accompanied the evolution of Europe's monetary affairs of the past half century, and Fitzgerald supplements this analysis nicely with more focused attention to the evolving positions of Ireland and the United Kingdom with respect to EMU. Both papers provide useful insights into present political problems, with Zimmermann attending more to the transatlantic dimension of these questions. This might be a useful point of departure for my comments.

Zimmermann argues convincingly that EMU has consistently been advocated as a means of increasing Europe's global influence, and specifically to reduce its reliance on the US. Having achieved monetary union, he wonders whether these goals will actually be realized. He expresses concern that, absent the participation of the UK, EMU lacks its full financial potential; and similarly he wonders whether the euro-zone's complicated governance arrangements will permit Europe to punch its weight in global monetary negotiations. To get at these questions, he recommends attention to Susan Strange's distinction between structural and relational power.

I think that this indeed is a useful suggestion. Relational power refers to the ability of actors (is this case governments, at least for the most part) to persuade their counterparts to accept their point of view and to adapt their policies accordingly. Structural power, on the other hand, tends to operate in ways that are both indirect and, at least occasionally, even unintentional. By shaping the environment in which others act, outcomes can reflect the interests of the powerful without ever requiring their direct or conscious intervention. To profit from Strange's formulation we would therefore need to address ourselves to the implications of the structural-relational distinction for a whole range of issues related to monetary relations, including seignorage, differential borrowing costs, and above all the distribution of adjustment costs.

These matters have, I think, far more important consequences for international power than does the issue of currency valuation at any given moment. Changes in currency values do undoubtedly create winners and losers, but they do so at least as much within states (or, in the case of the euro, economic zones) as they do between them. With an appreciating currency, like the euro in recent months, consumers are benefited and exporters hurt, at least as a first approximation; in the case of a depreciating currency, the opposite results can be expected. It is altogether unclear, however, what the consequences of these developments are for interstate power relations; to evaluate this would require taking into account a whole range of additional considerations.

This brings us to the Della Posta paper on the euro-USD exchange rate. Exchange-rate forecasting, rather like weather forecasting, is an inexact science even under the best of circumstances. With the introduction of the euro – a currency without a history, without a fully transparent governance structure, and corresponding to an economic area for which there was little pre-existing composite data (and no functioning econometric model) – it is little wonder that forecasters have run into heavy weather. Given the failure of models based on either economic fundamentals or anticipated portfolio adjustments to predict, even broadly, movements in the euro-USD rate, Della Posta suggests attention to psychological issues and specifically the "framing" of investor expectations. This seems plausible, although probably better as an explanation of residuals than as a leading indicator.

My larger point is that if the behaviour of exchange rates is complex and sometimes mysterious, the analysis of international monetary power is necessarily even more complex. Thus de Gaulle's monetary offensive of the 1960s, described by Zimmermann, was not only unsuccessful, it was almost certainly unwise. By that I mean it was undertaken without a correct understanding of what its implications would have been had the United States proved unable to resist France's revolutionary tactics. After all, Washington did ultimately threw in the towel with respect to a continuing defence of the dollar's gold parity just a few years later; but the result – the Nixon shocks of 1971 – was entirely at odds with what de Gaulle had hoped to achieve. Like the economic forecasters described by Della Posta, de Gaulle had the wrong model in mind. Contrary to his analysis, it was not America's desire to maintain an overvalued currency (far from it!), nor was that overvaluation either the source or even a manifestation of American strength. The dollar may well have conferred an exorbitant privilege on the US, but the General failed to understand what the nature of that privilege was.

Thus Zimmermann is doubtless correct to assert that the eurozone has developed a considerable and growing reservoir of structural power, quite apart from whether that influence is ever translated into effective relational power—

that is, power at the bargaining table. But this increased structural influence for the most part assumes the form of "non-events" or, in the words of Sherlock Holmes, dogs that fail to bark. What are those non-events? Certainly among them must be listed the fact that a major swing in the euro-dollar exchange rate has so far not resulted in any demonstrable pressures for European states to engage in significant adjustment measures.

In times past, such a massive decline in the value of the dollar would almost surely have resulted in extraordinary pressures on intra-European exchange rates, and would probably have required Europe's non-German states to tighten policy significantly in order to maintain any semblance of parity with the D-mark (which, as the dollar's pre-EMU counterpole, would have been the chief recipient of funds seeking to escape denomination in the American currency). Nothing like that has occurred. Instead, there have been tortuous negotiations within the EU regarding the Stability and Growth Pact, and especially its non-observance by Germany and France. These discussions are significant, and are indicative of the governance problems raised by Zimmermann. But it bears noting that these discussions are taking place in a purely European context, with the participants insulated, to an unprecedented degree, from the effects of a colossal shift in transatlantic currency values.

Regardless of EMU's defects, and they are many, the single currency has thus already achieved a major ambition of its founders. The problem is that this fact is not widely recognized, and hence not widely appreciated. Monetary power is complex, and now Europe has a great deal more of it than it did previously. For the most part, though, Europeans have no more appreciation of their enviable position than did Americans during the dollar's heyday.

General discussion

A Comment

by

Jürgen Kröger

Some challenges of integrating the accession countries into EMU

1. Introduction

The question of how soon the candidate countries should adopt the euro mirrors the debate in the pre-history of Economic and Monetary Union (EMU) between "Economists" and "Monetarists" about the degree of real (& structural) convergence necessary for the construction of Monetary Union. On the one side there are the advocates of a rapid adoption (CESifo summer 2000, Daniel Gros, CEPS), who give prominence to the (supposed) advantages of early EMU entry and consider the possible (unfavourable) effects on the euro area negligible – the main argument is that the accession countries have little economic weight (less than ten percent of the Gross Domestic Product (GDP) of the euro area).

On the other side are those who warn against illusions (CESifo summer 2001, Kröger/Redonnet). They argue that there is no simple path to monetary integration: early entry into EMU would disguise the adjustments that are needed, and the effect of failure would be too great a political and economic risk, both for the monetary union and – above all – for the countries concerned themselves. The financial crises in south-east Asia and Argentina, and the crisis of the EMS in the early 1990s, clearly indicate the need for a cautious approach, and demonstrate that the exchange rate as an instrument of economic policy should not be given up too soon.

Although my contribution is mainly concerned with the implications of an early EMU entry for the accession countries, it is often argued that EMU itself – i.e. its credibility and attractiveness – would be rather unaffected by EMU membership of other countries mainly because the small economic weight of the accession countries. But even barring their likely greater voice within the European Central Bank (ECB) compared to the GDP weight, the common currency might still suffer from a reputational damage on foreign exchange markets and on Foreign Direct Investment (FDI), should the situation in some even small countries deteriorate. This is in essence a moral hazard problem.

At a highly aggregated level a national economy has three important prices at its disposal: the prices of labour and capital as factors of production, namely the (real) level of wages and the (real) interest rate, and the (real) exchange rate, which determines an economy's competitiveness in relation to other national economies. Successful economies revalue, less successful ones devalue. A real-economy catching-up process should be linked to a revaluation of the currency relative to other countries. This interdependence of real exchange rate flexibility and successful integration carries with it considerable dangers for the accession countries if they were to adopt the euro too soon.

Giving up national monetary policy, including the exchange rate as an instrument for adjustment, has serious consequences for other national economic policy instruments too. Fiscal policy can no longer confine itself to pursuing medium-term, allocative goals (investment in infrastructure), but would also have to compensate for an inadequate monetary policy situation at the national level. The one-size-fits-all problem is clearly much more serious for the accession countries than for the current members of EMU, because a far smaller degree of real convergence has been achieved.

Fixing the exchange rate would require a high degree of flexibility in wage levels (if unemployment is not to increase) which does not exist in the candidate countries. There is a serious danger of inflated wage expectations, especially as the geographical proximity of high-wage (high-productivity) countries increases the pressure for alignment. Any downward adjustment of wage levels, however necessary, is highly unlikely.

Reducing the number of economic policy instruments will presumably make the process of structural adjustment more difficult, since economic policy should actively assist a real catching-up process. During the investment phase, based on positive expectations, a relatively restrictive monetary policy should prevent overheating. Fiscal policy should, on the one hand, give positive support for the catching-up process in the form of infrastructure measures and, on the other, cushion the social impact of rapid structural change. The resulting real revaluation and current account deficit should be accepted because they demonstrate high investment.

If high levels of investment now lead to high productive potential, the resulting gap in demand must be filled. Monetary policy must become more accommodating in this phase, in order to stimulate foreign demand in particular (i.e. the nominal exchange rate must depreciate). This would correct the real overvaluation and reduce the current account deficit. Clearly, with fixed exchange rates, an interest rate set from outside the country and a fiscal policy aimed at strictly balancing the budget, the catching-up process will be diverted down.

These considerations suggest that an assessment of the nature of the current account deficit is essential. Here we see a difference of current account deficits in a true monetary union where regional current account differences do not matter and the EMU case where current account imbalances between participating countries matter more. This might look puzzling because also in EMU, the financing constraint is removed in principle. However, a deficit leads to growing external liabilities and debt service requirements or in other words there will be a growing gap between output (GDP) and national income Gross National Product (GNP) available for spending of domestic residents.

Therefore, an analytical distinction is necessary between a current account deficit that reflects catching-up, FDI and high investment and one that would reflect over-consumption and a lack of competitiveness. Countries may be tempted to argue that a current account deficit is due to catch-up, ignoring signals on structural problems.

2. Historical background

The process of integration in the European Union (EU), which ultimately led to EMU, was conceived as a long-term process. It reflects forty years of integration of the real economy, sectoral adjustment and the harmonisation of institutional and economic policy targets. Only at a relatively late stage, in the mid-1980s, was financial integration pushed forward by the internal and external liberalisation of financial markets. In this respect, the Maastricht Treaty on economic and monetary union is the conclusion of this process of integration. It takes the integration of the real economy – the internal market – as a given and builds on it. It starts from the assumption that all countries have liberalised their capital movements and that their national financial systems are stable. It lays down the nominal aims of economic policy that countries must follow if they wish to participate in EMU, i.e. the convergence criteria, and introduces co-ordination mechanisms, such as the stability pact, intended to prevent nations from following a path which could harm the monetary union.

Meeting the nominal convergence criteria was the priority in the 1990s. However, it still took seven years for a majority of the member countries to achieve them. The emphasis on the nominal convergence criteria is a handicap in weighing up the accession of the new member countries to EMU in the sense that the other criteria – internal market, sound financial system – were peripheral to the economic policy debate, yet decisive in sustaining the achievement of the nominal criteria. But reaching a high level of integration was an implicit and fundamental precondition for participation in EMU.

The challenges for the accession countries are far greater than in previous enlargements. They will join an economic area, which is much more integrated than previously in the EU's history, and they will do so much faster. It should also be borne in mind that in earlier enlargements the acceding countries were organised predominantly on market economy lines. This is not generally the rule with today's candidate countries.

The accession countries have committed themselves to comprehensive internal and external liberalisation of their domestic capital markets. France achieved this only in the mid-1980s; before then it also used the financial sector as an instrument for steering economic policy. In the case of the candidate countries, it is a problem that they do not yet have fully functioning national financial markets and also that they are not fully integrated in global financial markets. This could change with integration, and the role of the financial sector will grow.

In the current environment, foreign banks would clearly benefit more than existing domestic banks from the construction of a financially efficient sector. Their expertise in banking, attractiveness for savers and their ability to choose the most attractive borrowers puts the existing banks at a disadvantage, especially when they are still facing a bad loan problem. A different question in this context then is of how to get rid of these bad loans. Obviously, the options of a proper sequencing of taking bad loans off the balance sheets is very limited in view of the opening up of financial and capital markets.

3. Catching up and nominal convergence

Early adoption of the euro would require the countries in question to adopt the Maastricht criteria as economic policy targets to work towards right from today. However, this would clash with the goal of a rapid catching-up process in their real economy.

A successful catching-up process, in other words an adjustment of real productive capacity measured by per-capita income in the candidate countries, would require rapid growth in productivity, particularly in industry. This would bring a real revaluation in its wake, which could be brought about either by a revaluation of the nominal rate of exchange or through a higher rate of inflation with fixed exchange rates. But in EMU, the exchange rate would be fixed, and the result would indeed be a higher rate of inflation. In other words, a successful catching-up process stands in contradiction to the simultaneous achievement of a stable rate of exchange and a low rate of inflation.

In addition, there will be price level adjustment. This means that in some sectors the inflation rate would be high. If monetary policy now wanted to achieve an inflation rate of under two percent for the economy as a whole, it would have to push the other sectors that are sensitive to monetary policy – a small but important part of the national economy, organised on market economy lines – into deflation. This would certainly not help the investment climate.

Some observers conclude from this that a looser interpretation of the criteria – particularly the inflation criterion – would be appropriate for these countries. But this itself would jeopardise the catching-up process. A higher inflation rate, which, where exchange rates are fixed, can be attributed to a higher rate of productivity growth, would push real interest rates disproportionately downwards and create serious economic management problems for the national economy.

Given the unavailability of monetary policy (interest rates *and* the exchange rates) and the obvious distortionary character of monetary conditions – too low real interest rates – the burden on the policy-mix to address imbalances would get strained. A very high degree of labour market (wage) flexibility and the use of fiscal policy to stabilise private sector demand relative to supply would be necessary.

Thus, there might be a second trade-off between the Maastricht goal of sound public finances, defined as a balanced budget in economically normal times, and pursuing a successful catching-up process. If a country has created the conditions for rapid structural change, and, in real terms, is aiming for high growth rates (e.g. around four percent per annum) while maintaining moderate inflation (4%), nominal growth might be eight percent. This kind of structural adjustment process should be accompanied not only by public structural investment but also by social protection, since it is essential, for example, to reduce the agricultural sector in many countries (such as Poland). Otherwise there would be a social backlash which, in turn, would have a negative effect on the real adjustment process.

4. Supposed advantages of early entry

Generally, two advantages of early entry are mentioned. First of all, it is argued the country would import the low interest rates of the euro area through the credible fixing of the exchange rate and thus reduce the risk premium for capital imports. The lower interest would then encourage investment and consequently accelerate the catching-up process. Of course, the argument to anchor expectations and to reduce uncertainty and risk premia has its merits, up to some point.

However, if the conditions for a successful catching-up process exist, then the expected real rate of return on investments should be high. Investors would invest in spite of high (real) interest rates. An artificial reduction in the interest rate, on the other hand, would, at a microeconomic level, lead to a misallocation of capital. Investment would not be made where expected returns were highest, for example in manufacturing, but where the supposed risk was most limited, such as buying and building houses or financing of consumer durable. Since the interest rate would in nominal terms be pushed down to that of the euro area, but would in real terms lie far below, there would be serious distortions in behaviour at a microeconomic level. Too many investment plans would be profitable, too much consumer spending would be brought forward. The financial markets, being completely liberalised, would not be in a position to help allocate capital efficiently.

The macroeconomic effects are clear. The national economy would overheat, wages would rise faster than productivity, and this would boost consumer spending. Inflation would rise and would lead to a further drop in real interest rates in the currency union. Both developments would increase the number of wrong microeconomic decisions, since real interest rates would continue to be negative and revenue expectations would be too high. Overall it would be an unstable process, which of course is also a serious challenge in the euro area today.

In time, the country would become less competitive as it overheated; one indicator would be a growing current account deficit, no longer accounted for by investment. Declining exports, investment without profits, rising unemployment and pressure on government budgets would ensue. Bad loan problems in the banking sector would then make it clear where things had gone wrong, generally too late for a correction, as the case of Argentina has shown. There could then be a credit crunch, since the banks – foreign banks – would react much more quickly to the growing risk than they would if a domestic banking system could be propped up by the national central bank acting as lender of last resort.

It would then be necessary to rebuild competitiveness, but within monetary union this would be very difficult and costly because it would mean undershooting the inflation rate. Nominal wage cuts deflation and then, in this phase, very high real interest rates would be too much to ask for the country – economically, politically and socially. The way out could be a bail-out by the EU, with high political costs in terms of the country's independence.

5. Conclusion: a step-by-step accession scenario

The Treaty lays down a clear path to accession for the candidate countries. They will join the EU as countries with a "derogation" from the adoption of the euro. This status is preserved in the accession treaties. The new member countries must regard their exchange rate policy as "a matter of common concern", and it is expected that they will join the Exchange Rate Mechanism (ERM) II. Accession to EMU presupposes that the convergence criteria are fulfilled, and sustainably so. The Treaty presupposes that these countries can withstand the competitive pressure of the internal market; this can also be seen as an element of sustainable fulfilment of the nominal convergence criteria. This path precludes the possibility of the euro being introduced directly upon accession to the EU.

It should also have become clear that a strengthened real and structural convergence should have priority over a complete nominal convergence. Furthermore, the Maastricht criteria are supposed to be applied to comparable economies, which in this case means that the countries in question are competitive in the internal market. Any transitional rules with a macroeconomic impact – for example in capital movements, or important sectoral exceptions – should have some bearing on an assessment of nominal convergence. Therefore, no new convergence criteria are necessary.

Membership of ERM II offers the accession countries enough flexibility to accommodate a variety of exchange rate policies, although not all are compatible with an eventual euro adoption e.g. fully flexible exchange rate system. Indeed, the Treaty requires that exchange rate policy is a matter of common concern. Nevertheless, in principle, a "currency board" could even be kept until the eventual introduction of the euro, albeit only as a unilateral obligation of the country in question and not under the responsibility of the ECB. However, any country that joins the ERM II would have to accept that the decision on the central exchange rate with the euro is a decision for all those involved.

To sum up, it should be borne in mind that there is no simple path to integration of the real economy. Too early an adoption of the euro would dramatically restrict the policy options. Although there is no doubt that an independent monetary and exchange rate policy is not easy, the dangers of joining the euro area too early for the country in question are serious.

THE ROLE OF STANDARDS AND LEGAL TENDER IN EMU

Chapter 14

The Role of Standards in Governing Financial Markets' Stability: A Glance throughout International Cooperation and EMU Economic Governance

by

Maria Chiara Malaguti

Abstract: The use of standards in governing financial stability represents a specific instrument of governance deserving careful legal analysis, as standards are not compulsory but represent a typical example of soft law. In addition, they are elaborated through long negotiations between government representatives, central banks, independent supervisory authorities, the market and possibly relevant international organizations, such as the International Monetary Fund (IMF) and the World Bank. Within the European Community, the European Central Bank (ECB) has produced standards as preconditions for securities settlement systems to be used for central bank credit operations, that present the same features as international standards, also in terms of their assessment. In addition, following the recommendation and within the institutional and legal framework proposed by the Lamfalussy Report, the Committee of European Securities Regulators (CESR) was recently established, also in charge of elaboration of standards not only for coordination of practices between regulatory authorities but also to implement Community measures. It is frequently believed that the described qualities of standards limit their efficiency. This article tries to prove that on the opposite these may be considered as expressions of a "new legal order" based on persuasion rather than prescription and on mutual cooperation to reach commonly agreed objectives

Keywords: Financial markets' stability, international cooperation, standards, soft law, Community acts, ECB Standards, Lamfalussy Report, Committee of European Securities Regulators (CESR)

1. International cooperation and financial markets' stability

1.1. Regulators and oversight

Scope and nature of international monetary and financial cooperation have changed significantly over the last two decades in response to new policy challenges, due in particular to rapidly increasing cross-border private capital flows and the emergence of new economies participating in the globalisation process. As a result, international cooperation has mainly shifted from a predominant focus on exchange rate matters to the design of optimal policy frameworks to foster global financial stability. The ultimate objective shall be to prevent currency, external debt and banking crises by reaching a consensus on best practices in policy formulation and improving the transparency and accountability of policy making, and this mainly by increasingly relying on a set of internationally agreed standards and codes.[1]

This is also the inherent consequence of the shift from the traditional tools employed by central banks to conduct monetary policy to a wider range of measures, nowadays commonly employed to implement monetary policy and ensure financial stability. In particular, cooperation to foster global financial stability is centered in *oversight*, i.e. the monitoring of systems, arrangements and financial instruments mainly to prevent systemic risk:[2] if the primary task of central banking is the "protection of money", this should include not only the conduct of monetary policy but also the protection of the overall stability of the economic system. As commonly known, central banks have traditionally pursued this goal by means of direct control over money production and circulation, as well as by supervising the banking system.[3] This second role is more widely geared towards the preemptive control of the well-being of the financial system by way of control over individual operators. Oversight is connected and interferes with both supervision and monetary policy functions, as aimed at the inherent stability of the financial system and consequently at the "protection of money" (as a "macro-concept") by means of control over "systems" acting within financial markets somehow mirroring supervision ("micro-context").[4] Yet, oversight implies a series of different considerations: in the first place, in addiction to the fact that oversight addresses any circumstances which might infer systemic risk (systems, arrangements, instruments) rather than soundness of individual operators as an insulated phenomenon, it is usually operated by means of a combination of suasion and regulatory pressure.[5] In the second place, this function is often shared between central banks and financial authorities, being the former usually competent for the stability of the banking sector and of the financial markets as far as this latter interferes with monetary stability, and the latter usually competent for stability of the financial markets as such. Finally, oversight often involves an active role of the market itself in both the production of rules, their implementation and their control.

1.2. From the "international monetary system" to the "international financial system"?

The above considerations bear an influence *in primis* in international law. More specifically, while it seems undisputed that a set of rules of international origin exist in relation to monetary matters, in relation to what is usually referred to as "the international monetary system", no binding regime exists for financial markets' stability as such. Yet, a number of G7 Reports clearly indicate States commitment to cooperate in the matter,[6] to the point that the Financial Stability Forum (FSF) was established in 1999 to play as catalyst of various instances.[7] According to such Reports, also endorsed by the G10 and by international financial institutions, cooperation relates to various policy matters for both the prevention and the management of financial crises and simultaneously involves, although to different extents, the national public sector, international financial institutions and the market itself.[8]

One of the main instruments of cooperation to prevent financial crisis is the implementation of common standards elaborated by international committees, alternatively or simultaneously formed by government representatives and/or national independent authorities, and the market.[9] As it is known, central banks of the G10 have constituted a series of committees and working groups specifically devoted to stability matters. Already in 1974 the *Basle Committee on Banking Supervision* (BCBS) was established, composed by around thirty working groups and task forces of central bankers and representatives of national supervisory authorities, and directly responding to the Governors of G10. This Committee is aimed at harmonizing prudential supervision by means of standards and recommendations directly approved by the G10 Governors. More recently, the *Committee on Payment and Settlement Systems* (CPSS) and the *Committee on the Global Financial Systems* (CGFS) were also established, the one focusing in particular on netting and settlement procedures (including oversight on systems), the other more generally on policy guidelines to strengthen financial markets structure. In parallel, Committees were established among supervisory authorities of both securities and insurance sectors, such as the *International Organization of Securities Commissions*

(IOSCO) and the *International Association of Insurance Supervisors* (IAIS). CPSS and IOSCO also work jointly on recommendations for securities settlement systems. Finally, "mixed groups" (i.e. groups formed by representatives of the public sector and of the market) have been established, equally aiming at the drafting of standards and recommendations, such as the G30.[10]

A number of these standards have been identified by the FSF as "key standards", meaning standards which play a relevant role in the promotion of financial markets stability and whose implementation is highly recommended at international level.[11] Indeed, the IMF and the World Bank have recently started to assess the well-being of countries also on the basis of the implementation of such standards.[12] Assessment is also operated by the European Central Bank (ECB) for its own standards as user of specific systems - as it will be discussed below -, and national authorities do the same in the field of their competence. Mechanisms of self-assessment are operated by operators or associations of operators. The whole of these factors can take to the conclusion that a body of principles is gradually shaping a framework for a "international financial system", presenting specific features in particular in terms of tools for governance. The Community regulatory framework on this field is generally consistent with these features.

1.3. Role of standards and their legal qualities

Standards are a typical tool of governance, especially employed by independent authorities, used to combine regulation, negotiation of rules with the addresses and moral suasion.[13] Although representing "new means of governance", standards-setting and their consequent assessment do not necessarily amount to soft law: in our field, once elaborated by an international committee the standard can be implemented by national legislation or regulation, i.e., by a binding instrument usually combined with an express sanction, and reach such a level of detail to strictly impose a specific behavior. Yet, in the majority of cases standards only play as benchmarks, that is to say as goals to be reached by means of behaviors to be adjusted according to the circumstances, or as guidelines which authorities and the market itself directly apply in the specific situation, without being filtered by any national legislation or regulation.

In fact, it is not possible to strictly insert standards as elaborated in the mentioned international committees in clear-cut categories or simply reach general conclusions as per their legal qualities. To start with, the way these have been qualified by their own drafters cannot help: some are called "recommendations",[14] some "principles" ("principles",[15] "core principles",[16] "objectives and principles"[17]), some "guidelines»[18] and some "standards",[19] without however these representing different kinds of measures.[20]

Nor additional help is given by the analysis of their specific content or drafting techniques: if *objectives* and *principles* seem to only state the results to be obtained without usually imposing the means to reach such results, while *standards* more specifically identify behaviors to be taken, *recommendations* indifferently refer to measures whose main quality seems indeed only to be their non-binding value. Yet, if a difference can be drawn between *recommendations* on the one side and *principles* and *standards* on the other, this might rely in the fact that the former individually address either States, national authorities or operators, while the latter more generally refer to anyone who could find itself in the position to implement them, according to the specific situation.[21]

Indeed, the only element which seems to qualify these instruments independently of their name is their opposition to binding and stringent measures: the final goal of said measures is to provide minimum standards to which States, national authorities, actors in the market must try to conform according to their specific circumstances and roles. The common objective seems to be to permit a gradual progress to raise the level of compliance of commonly agreed principles permitting a step-by-step process in which responsibility of the action is transferred on the addressee, who is the real producer of the "rule" when it applies the commonly agreed standard to the specific case and circumstances. The sole classification of standards that might bear a role in this context is probably between standards elaborated by a specific association for their members (these being States, national authorities or market operators, according to the case) and standards produced to influence the entire structure of the market. In this second case the standard acquires a general value of common understanding of the community as such which justifies its implementation by each member of such community for the sole fact of its being part to it.

The fact that standards are the result of a common agreement is in the first place due to a continuous negotiation with all parties involved. All of the mentioned standards are drafted by working groups that permanently present their preliminary results to the general public, and re-draft them in accordance with such consultations. This emerges also from the language of said standards, always meant to reflect the common understanding underlying them. Indeed, sometimes these expressly report of being nothing but the formulation of a principle already generally accepted by the community: although this can also be the result of a rhetorical exercise, more often it represents the true, or at least a specification of a common understanding.

The fact that standards are based on persuasion rather than prescription also emerges from the wide use of explanatory notes, where the scope and in particular the reasons for the specific measure are clarified. This reinforces the conclusion that standards are specifically meant to provide the addressee with all necessary information to implement the standard, so "producing" itself the "rule" on the basis of its understanding of its rationale. This is also reinforced by the provision of methodologies for assessment, frequently based on self-assessment: self-assessment confirms not only that standards in principle shift the responsibility of implementation on the addressee, but also that it is the addressee that indeed produces the "rule" by testing the reasonableness of the principle in the specific case and adapting it to the case. In fact, self-assessment might lead not only to recognition of non-conformity by the addressee, but also to unreasonableness and need for adaptation of the standard itself.

This also emerges from authorities' regular practice when performing their duty to assess standards. Irrespective of the provision of a "sanction" for non-respect of the standards, it seems that the primary objective of the authority – especially if considered in its long-term assessment activities – is to take the operator to apply the standard by lengthy negotiating its implementation on the basis of the specific circumstances. In the general context of assessment of standards, the process of negotiating a solution seems more relevant than the actual sanction eventually inferred.

2. Standards for financial markets' stability within the EMU

2.1. Role of the ECB Standards

On January 1998, the European Monetary Institute (EMI) issued a set of *Standards for the use of EU securities settlement systems in ESCB credit operations* as preconditions for securities settlement systems (SSSs) to be used for central bank credit operations. According to Article 18 of the Statute of the European System of Central Banks (ESCB) and the European Central Bank (Statute), "the ECB and the national central banks may (…) conduct credit operations with credit institutions and other market participants, with lending being based on adequate collateral". Within this framework, a broad list of eligible assets for collateralizing central bank operations has been defined and the mentioned standards have been drafted, against which SSSs involved in the ESCB credit operations are regularly assessed.[22]

These standards have been issued by the ECB [European Monetary Institute (EMI)] as "user" of systems and not in its oversight capacity.[23] In fact, the debate is still ongoing whether according to the Treaty and the Statute, the ECB has oversight over SSSs. The analysis of this issue (indeed, of utmost relevance in the debate of ESCB[24] competence and subsequent allocation of powers within the ESCB between the ECB and National Central Banks (NCBs) in the regulation of the financial markets) is outside the scope of this contribution. Yet, some brief considerations need to be exposed for the sake of the reasoning on ECB Standards: although it is undisputed that these *are* "user standards", it is not possible to automatically exclude any "regulatory" inference solely on the basis of their language (or of that of the Explanatory Report).[25] In the introductory section of the Report devoted to policy objectives, it is clearly stated that the objectives of the ECB and the NCBs are threefold, including: (i) the efficient and safe execution of central bank credit operations, (ii) the smooth functioning of payment systems and the stability of the financial sector, and (iii) the smooth functioning of the Single Market.[26] In addition, it is clearly stated that in lack of commonly agreed international standards it is necessary to refer to specific user requirements for ESCB credit operations,[27] thus taking the reader to the reasonable conclusion that if such standards had been available, the ECB would most probably not have been in the need for drafting specific standards for its own credit operations. Finally, it is clearly stated that ECB and NCBs (some of which are indeed entrusted with the task of the oversight of SSSs) intend to further elaborate on such standards in order to ensure that there is an adequate framework for the oversight of SSSs.[28]

On the other hand, also leaving unprejudiced the above question, it cannot be denied that these have factually arose in the course of the years to benchmarks going far beyond the protection of ESCB specific risks, up to a more general protection of the financial markets as such.[29] In addition, the recently started cooperation between the ECB and NCBs on the one side, and CESR on the other – as will be discussed below – to elaborate common European standards for securities clearing and settlement systems leaves the question open whether once these shall become effective the ECB will withdraw its own standards.

In any event, what is most relevant to the present analysis is that the ECB assessment of said standards, is characterized by the same features as other international standards: although the Report concludes with the statement that all standards (but one) must be fulfilled by the start of Stage Three of

EMU, and that to the extent that SSSs are not able to implement the standards, they will not be used by the ESCB, this also contemplates as sufficient to satisfy the assessment criteria, that SSSs have taken the necessary steps to meet said standards within a reasonable time-frame, and that when necessary and in coordination with the EMI/ECB and the NCBs, SSSs will define a development plan to meet the standards and a timetable for its implementation. Under the latter circumstances, with the agreement of the ESCB, the NCB of the country where the SSS is located, instead of not using it for ESCB operations, may opt for agreeing a development plan with the SSS with a defined timetable for meeting the standards and using the SSS, possibly on a limited basis and on condition that adequate measures against risk are adopted. Indeed, looking at ECB behavior in assessing SSSs against these standards in the course of the years, it can be concluded that the ECB has never excluded a SSS from its credit operation; on the opposite, long negotiations have been undertaken to find commonly agreed solutions between the ECB and NCBs on the one side, and the relevant SSS on the other. This has always taken to flexible solutions, specifically construed to adapt to the specific circumstances, being the production of the relevant "rule" a long-lasting and gradual process of continuous adaptation.

2.2. Lamfalussy Report and the role of CESR

The use of standards in EMU economic governance is not the sole prerogative of the ECB. Indeed, a number of standards have been elaborated by the recently established *Committee of European Securities Regulators* (CESR), which takes the place of the previous *Forum of European Securities Commissions* (FESCO).

CESR was established by EC Decision[30] following the recommendation of the Lamfalussy Report[31] as endorsed by the European Council at its Stockholm conference.[32] According to the European Council Recommendation, CESR's tasks are twofold: this should serve as an independent body for advice to the Commission, and contribute to the consistent and timely implementation of Community legislation in the Member States by securing more effective cooperation between national supervisory authorities, carrying out peer reviews and promoting best practice.[33] Although the Commission Decision establishing the Committee only provides for its institutional role to advise the Commission, either at the Commission request or on the Committee's own initiative, in particular for the preparation of draft implementing measures in the field of securities (Article 2),[34] CESR recognizes as its tasks a wider range of actions, including to (i) improve coordination among European securities regulators, (ii) act as an advisory group to assist the European Commission, (iii) work to ensure more consistent and timely day to day implementation of Community legislation in the Member States.[35]

Of particular interest is that CESR Charter provides that “the Committee will foster and review common and uniform day to day implementation and application of Community legislation. It will issue guidelines, recommendations and standards that the members will introduce in their regulatory practice on a voluntary basis” (Article 4.3). This additional task relating to implementation of Community legislation, further to that of advising the Commission, is inherently linked to CESR role in coordinating European securities regulators’ oversight activities. Indeed, the Stockholm Recommendation seems to compact these two tasks when stating that CESR should “contribute to the consistent and timely implementation of Community legislation in the Member States by securing more effective cooperation between national supervisory authorities”. In the same line, CESR Charter combines oversight activities and the implementation of a common conceptual framework of principles for the regulation of European financial markets.[36]

This seems to be the exact implementation of what was recommended in the Lamfalussy Report, founding regulatory reform – as well known – on a four-levels legislative structure: whilst “level 1-measures”, consisting in EC regulations or directives, should only contain framework and implementing principles, it is for “level 2-measures”, i.e., Commission measures only adopted after consultation with the European Securities Committee and advice of CESR (where CESR is expected to prepare measures in consultation with market participants, end-users and consumers), to provide for implementing details.[37] In addition, “level 3-measures” have the scope of strengthening cooperation by way of consistent guidelines for administrative regulations, joint interpretative recommendations and common standards.[38] In particular, CERS is expected to work on joint interpretation recommendations, consistent guidelines and common standards in areas not covered by EU legislation, peer review and compare regulatory practice to ensure consistent implementation and application.[39] As stated by the Lamfalussy Report, “the outcome of this work would be non-binding although clearly it would carry considerable authority” (p. 38).[40]

Both these functions are thus carried out by means of standards: while the use of such measures in oversight can be reconnected to the above general discussion on tools for governance, here a new element emerge. Standards seem now to be recognized as also being a viable instrument to ensure both implementation of EC legislation where this exists, and harmonization in domains where this does not.

2.3. Place of standards in the framework of Community acts

One of the main open issues on ECB competences and decision-making relies on legal instruments at its disposal. Briefly, these are usually divided into two categories: ECB legislation intended to produce external effects, and ECB legislation intended to produce legal effects among the component parts of the ESCB.[41] As per Article 110.1 of the Treaty and Article 34.1 of the Statute, the first (and general) category includes regulations, decisions, recommendations, and opinions. Articles 12.1 and 14.3 of the Statute provide for two further legal instruments, which can be used to primarily address the legal relationships inside the system, qualified as "guidelines" and "instructions". Yet, standards cannot be included in any of such acts,[42] with probably the only exception of standards being included in ECB guidelines (possibly instructions?) addressed to NCBs: in case for instance of common standards on regulation by national central banks (in sectors of their competence within EMU), these could be inserted in guidelines pursuant to Article 12.1 of the Statute, addressed to national central banks and implemented by means of administrative measures.[43] However, this would simply be a case in which standards or codes are incorporated into a specific binding act and consequently transformed in their legal nature. Indeed, this would not conceptually differ from the mentioned case in which standards or codes are incorporated into a binding national legal instrument, transforming such instrument from a soft law measure into a binding national law or regulation. In addition, it cannot be forgotten that ECB guidelines and instructions are specific legal instruments (new to the general Community legislative framework) particularly designed to cope with the special features of the ESCB and consequently functional to its structure and organization (its peculiarities), while standards as are intended in this paper include a very fluid category of instruments potentially addressed to all subjects involved in or affecting in some way the market, thus eventually pertaining more to the category of acts "intended to produce legal effects outside the ESCB", if this distinction makes any sense in relation to this kind of instruments.[44]

In the field of markets stability, these considerations need also to be confronted with Article 22 of the Statute, reading that the ESCB "may provide facilities, and the ECB may make regulations, to ensure efficient and sound clearing and payment systems within the Community and with other countries".

The ECB competence under this Article to take legislative measures is highly controversial as per its scope (both *ratione personae* and *ratione materiae*), this in particular being one the main fields of discussion in the above mentioned debate on the competence of ECB/ESCB in oversight of SSSs. According to some scholars, ECB competence to issue regulations under Article 22 would *inter alia* be limited in scope *ratione personae*, to only include payment systems and consequently exclude securities systems. This on the basis of the letter of Article 22, which with "clearing and payment systems" would not make reference to SSSs.[45] The theories refusing competence to the ECB in this field reconnect the elaboration of ECB standards to Article 18 of the Statute, so confirming the view of the ECB acting in its "user" capacity.

Yet, once again leaving aside considerations on oversight of SSSs, it should be commonly agreed that in those cases in which ESCB/ECB *have* regulatory competence, these can act also by means of standards-setting, although these are not expressly included in the Treaty or in the Statute. The ECB will thus use a regulation when it believes that a binding measure is more appropriate under the circumstances, but this would not be preclusive of power to issue standards, as a governance tool commonly recognized as legitimate on the basis of practice. Indeed, in June 2000 the ECB Governing Council adopted a "*Statement on the role of the Eurosystem in the field of payment systems oversight*" where it stated that "the enforcement of the common oversight policy stance can be ensured by ECB regulations – in accordance with Article 22 of the Statute – or guidelines. Where applicable, enforcement can be effected by legal instruments available to an NCB. More traditional, informal tools (e.g. moral suasion) can also be used" (p 3).[46]

On the other hand, it should not be underestimated that CESR and the ESCB have initiated cooperation to draft common standards for securities clearing and settlement systems in the European Union.[47] The nineteen standards which are currently under study are based on the CPSS/IOSCO recommendations for securities settlement systems of November 2001 and follow the same regulatory paths. ESCB thus concretely participate into standards-setting under the same circumstances as CESR and in this respect the two bodies could be considered in parallel.

Incidentally, it should however be noted that the Committee of Wise Men, while publishing the Lamfalussy Report, indicated its intention to revise and reconsider its four-levels scheme in 2004 in the light of both the Intergovernmental Conference announced in Nice, and the evolution of market conditions. The Committee will indeed have to reconsider the whole of the framework in the light of the new rules of the Convention, assuming that they will stay as currently stated in the draft Treaty establishing a Constitution for Europe of July 2003,[48] on the legal acts of the Union (Articles 32-37), contemplating *inter alia* legislative and non-legislative acts (Article 32), and delegated regulations to the one end (Article 35) and implementing acts (both regulations and directives as redefined) to the other end (Article 36). In this context, the ECB's competence to issue European [instead of ECB] regulations and decisions, as well as recommendations (Article 34) seems confirmed. It would also seem that the ESCB Statute will not be substantially amended.[49] As a consequence, the ECB legislative powers should not be modified in their essence. Yet, the new institutional and legal framework could take to reconsider the whole general legal context in which these matters are dealt with.

3. As a conclusion: what role for standards?

It is frequently believed that the described qualities of standards, making these a instrument of soft law, limit their efficiency. Yet, relying on the background which has been described in the previous pages, it seems possible to introduce a new line of thinking: it could be argued that these are expression of a "new legal order" based on persuasion rather than prescription. Indeed, although the international and the Community' orders should of course be subject to autonomous legal analysis, in the specific case of standards-setting, where both the ECB and CESR directly rely on international standards and – more relevant – on regulatory competences and tools of governance being the heritage of a long tradition common to central banking and financial markets regulation nowadays more and more depending on internationally agreed parameters, these could be the basis for a general discussion on the role and relevance of this instrument as expression of a possible different scheme of governance.

This would be mainly founded on persuasion rather than prescription, and on mutual cooperation to reach commonly agreed objectives rather than authoritative relationships. Those who are the addressees of measures (meaning any public or private party resulting interested in the process in a specific situation) are at the same time also participating into the process of formulating the general rules founding this common exercise, not only by possibly participating into the negotiations leading to specific standards, but also by reporting on inconsistencies or unreasonableness from self-assessment or negotiating the means of their implementation in each specific case. Severe sanction in case of lack of cooperation shall indeed be the lost of trust in the party, ultimately leading to its exclusion from the community as a whole. Governance so proceeds by a continuous flow of adaptations towards a shared solution based on common trust, where the authoritative scheme which usually founds legal instruments under current legal theory is substituted by an "isonomic" scheme, i.e., the elaboration of legal rules by the community at large by means of continuous readjustment of the rule according to the reasonableness of its implementation in the specific case.

This of course does not mean to ignore that the authorities themselves often go into a different direction, opting for stricter enforcement measures. The latest expression of this is CESR Press Release of 7 October 2003, where it is declared that CESR's members consider insufficient to adopt an internationally recognized set of accounting standards without robust and consistent enforcement.[50] Yet, this does not seem inconsistent with what has been proposed as a new reading of these measures. In fact, what CESR seems to propose is to better coordinate enforcement procedures and multilaterally discuss decisions and experiences of enforcement agencies, without proposing any compulsory system of sanctions. On the contrary, this exchange of reciprocal experiences favors the creation of a common humus for circulation of common understandings and the production of rules exactly based on specific decisions adopted under the circumstances (the "rule" being produced by the implementation itself, not by a general and authoritative *a priori* production of such rule), where each following decision shall have to confront with past decisions of other authorities also placed under different legal systems.[51]

NOTES

[1] For more accurate policy considerations, see ECB, *Recent developments in international co-operation*, in *Monthly Bulletin*, February 2002, p. 53.

[2] "Oversight of payment systems: a central bank task, principally intended to promote the smooth functioning of payment systems and to protect the financial system from possible 'domino effects' which may occur when one or more participants in the payment system incur credit or liquidity problems. Payment systems oversight aims at a given system (e.g. a funds transfer system) rather than individual participants": BIS Glossary.

[3] "Supervision of financial institutions: the assessment and enforcement of compliance by financial institutions with laws, regulations or other rules intended to ensure that they operate in a safe and sound manner and that they hold capital and reserves sufficient to support the risks that arise in their business": BIS Glossary.

[4] "The oversight of payment systems, which is an essential function for modern central banks, aims at ensuring the smooth functioning of payment systems. Central banks are concerned about the smooth functioning of payment systems for a number of reasons. First, central banks aim to maintain systemic stability in payment systems, by containing the exposure to systemic risk. (...) Indeed, a major malfunctioning of payment systems could, under certain circumstances, undermine the stability of financial institutions and

markets. (...) Second, central banks are concerned with the efficiency of payment systems, which is a complementary objective to systemic stability. Third, they are concerned with the security of the payment instruments used by the public. The latter functions are material both to the confidence of the users of the payment systems and of the users of the payment instruments and, ultimately, to the maintenance of the public confidence in the currency. Fourth, since payment systems are an essential vehicle for the implementation of monetary policy, oversight is aimed at safeguarding the transmission channel for monetary policy. It follows that the oversight of payment systems is an essential function of central banks ... which is directly linked to their core functions, i.e. the definition and implementation of monetary policy to ensure price stability and their interest in the stability of the financial system, in the soundness of the currency and in the public's confidence in the currency", ECB, *Role of the Eurosystem in the field of payment systems oversight*, (2000).

[5] "Oversight [of payments] ... is different from banking supervision. Banking supervision involves monitoring individual banks/financial institutions with a view to ensuring their financial stability. It focuses on individual participants in a payment system, aims at primarily protecting depositors/bank customers, and is based on an extensive regulatory framework. Payment systems oversight, on the other hand, concerns systems, arrangements and instruments. Based on a combination of moral suasion and regulatory pressure, its primary objective is to protect the functioning of the system by examining their design and operation", ECB, *The Role of the Eurosystem in payment and clearing systems*, (2002).

[6] In the Heads of States Conclusions of the Halifax Summit of 1995 it was already stated that "close consultation and effective cooperation on macroeconomic policies among the G7 are important elements in promoting sustained non-inflationary growth avoiding the emergence of large external imbalances, and promoting greater exchange market stability. (13) [...] We have a shared interest in ensuring the international community remains able to manage the risks inherent in the growth of private capital flows, the increased integration of domestic capital markets, and the accelerating pace of financial innovation. (14) [...] Closer international cooperation in the regulation and supervision of financial institutions and markets is essential to safeguard the financial system and prevent an erosion of prudential standards (22)".

[7] This was established in the Bonn G7 Conference of 20 February 1999 following a recommendation of the Tietmeyer Group; Tietmeyer, (1999).

[8] "In this increasingly integrated global economy, in which policy responsibility still lies mainly with sovereign states, the challenge is to promote global financial stability through national action as well as through enhanced international cooperation. All countries, together with the international financial institutions and private sector financial institutions, must share this responsibility (5). This does not require new international organisations. It requires that all countries assume their responsibility for global stability by pursuing sound macroeconomic and sustainable exchange rate policies and establishing strong and resilient financial systems. It requires the adoption and implementation of internationally-agreed standards and rules in these and other areas. It requires the existing institutions to adapt their roles to meet the demands of today's global financial system: in particular to put in place effective mechanisms for devising standards, monitoring their implementation and making public the results [...]. It also requires the right structure of incentives for all participants in the international financial system, for national authorities as well as the private sector (6)", Heads of States Conclusions in the Halifax Summit, *supra*.

[9] "Over the past three years the international community has attached increasing importance to the work on standards and codes as a crucial element of crisis prevention. The interest in standards is not new: for many years standards have provided a context for discussions between national authorities and the Bank and IMF staff on specific policy and reform objectives, particularly in technical assistance (TA) activities. However, what is new – sparked by the crises in emerging market countries in the mid-1990s- is the realization that standards can serve as a framework to strengthen the functioning of markets and better focus policy discussions. There is now recognition that the rigor, context, and focus that have been added to the work on standards is essential to the crisis prevention efforts of the international community and the IMF, as well as efforts to better inform markets and assist the authorities' objectives for capacity building", IMF and World Bank, *Assessing the Implementation of Standards: A Review of Experience and Next Steps*, (2001).

[10] As it will be discussed, at European level the *Forum of European Securities Commissions* (FESCO) was established, now transformed into the *Committee of European Securities Regulators* (CESR), which also bears the role of consultative committee of the European Commission.

[11] See more: FSF, (2001).

[12] "Since the Asian crisis, considerable progress has been made in articulating standards, developing assessment methodologies, forging agreement that standards should be implemented over time and in light of country circumstances, and undertaking external assessments of progress in implementing a broad range of standards. The Bank and the IMF have played a major role in all of these efforts, including by experimenting with assessing implementation of standards using Reports on the Observance of Standards and Codes (ROSCs) as well as the framework of the Financial Sector Assessment Program (FSAP), which considers observance of relevant standards as an input into judgements on financial sector vulnerability and development needs", IMF and World Bank, *Assessing the Implementation of Standards: A Review of Experience and Next Steps*, *supra*, p. 3.

[13] See A. La Spina and G. Majone, (2000). Also: "Central banks (and hence also the Eurosystem) perform payment systems oversight. In many cases, they offer payment and settlement services directly and therefore have an operational role. In cases where the private sector manages payment and settlement systems, central banks perform an oversight function on those systems. Accordingly, the central bank's activity consists of: a) defining, implementing and ensuring compliance with, principles and standards which are established to promote safe, sound and efficient payment and settlement systems, whether these are operated by the central banks themselves or by private operators [...]",ECB, *Role of the Eurosystem in the field of payment systems oversight*, *supra*, p. 2.

[14] CPSS/IOSCO, *Recommendations for Securities Settlement Systems*, 2001.

[15] OECD, *Principles of Corporate Governance*, 1999.

[16] CPSS, *Core Principles for Systemically Important Payment Systems*, 2001; BCBS, *Core Principles for Effective Banking Supervision*, 1997.

[17] IOSCO, *Objectives and Principles of Securities Regulation*, 1998.

[18] World Bank, *Principles and Guidelines on Effective Insolvency and Creditor Rights Systems*, proposal 2001.

[19] IASB, *International Accounting Standards*, 2001; IFAC, *International Standards on Auditing*, 2001.

[20] The FSF itself indeed generically refers to standards to include all of the mentioned types of instruments, after having attempted a very loose classification of no substantial legal value: "Standards set out what are widely accepted as good principles, practices, or guidelines in a given area. Standards relevant for sound financial systems cover a broad range of areas. Many of them are functionally overlapping or interdependent. Standards may be classified by their scope or degree of specificity. The scope of standards may be viewed from sectoral or functional perspectives: Sectoral: these cover the economic and institutional sectors, for which many standards have been developed, such as the government and central bank, the banking, securities, and insurance industries, and the corporate sector. Functional: within each sector, standards have generally been developed along functional lines, covering areas such as governance, accounting, disclosure and transparency, capital adequacy, regulation and supervision, information sharing, risk management, payment and settlement, business ethics, etc. From an implementation perspective, a useful distinction among standards is in terms of their degree of specificity: Principles: these are fundamental tenets pertaining to a broad policy area. Principles are usually set out in a general way and therefore offer a degree of flexibility in implementation to suit country circumstances [...]. Practices: these are more specific and spell out the practical application of the principles within a more narrowly defined context [...]. Methodologies/guidelines: these provide detailed guidance on steps to be taken or requirements to be met and are specific enough to allow a relatively objective assessment of the degree of observance".

[21] By way of example, this seems to be the conclusion reached by the task force in charge of the CPSS/ IOSCO *Recommendations for Securities Settlement Systems* when choosing their *nomen*, although a more careful reading of some of said recommendations open doubts on the soundness of this classification, in light of their potential openess to various addresses only identifiable upon circumstances: Recommendation 1 states that "Securities settlement systems should have a well-founded, clear and transparent legal basis in the relevant jurisdiction". This would *prima facie* only refer to States. However, the Explanatory Note to this Recommendation states that "as a general matter, the laws, regulations, rules and procedures, and contractual provisions governing the operation of SSSs should be clearly stated, understandable, internally coherent and unambiguous", also referring to private agreements.

[22] "Within the framework of Article 18 of the Statute of the ESCB/ECB, the EMI and the NCBs, in selecting instruments and defining procedures for the conduct of the single monetary policy and in seeking to ensure the smooth functioning of the TARGET system in Stage Three of EMU, have paid special attention to the settlement procedures of debt instruments which will be eligible for collateralizing the monetary policy and payment systems operations of the ESCB. The implementation of the single monetary policy and the provision of intraday credit to participants in payment systems will call for the relevant securities settlement systems to be capable of ensuring: 1) reliable links between the ESCB and a broad range of counterparties; 2) speedy, smooth and safe transactions; and 3) safe and reliable procedures for the cross-border use of eligible assets (e.g. reliable links between SSSs). In particular, the EMI and the NCBs must ensure that central bank credit is granted through procedures which will: (i) prevent the central banks from assuming inappropriate risks in conducing monetary policy operations; and (ii) ensure the same level of safety for all central banks' operations throughout the European Union, regardless of the settlement method. In this respect, the primary objective of the EMI/ECB and of the NCBs is the establishment of benchmark criteria for assessing the soundness of those SSSs wishing to qualify for involvement in collateralized ESCB operations. This is particularly important with regard to the transfer, settlement and custody of securities, and the legal and technical environment in which such SSSs operate", point 1.1. of Section 1 – The efficient and safe execution of central bank credit operations, first paragraphs of ECB Standards.

[23] "The objective of the standards is to limit the risks to which the ESCB will be exposed in settling its credit operations, which, according to its Statute, must be based on adequate collateral. The ESCB will thus assess the securities settlement systems used by the ESCB in that respect, in the light of the standards set out in this report. The standards are not intended to reflect aspects of the oversight or supervision of SSSs.", Introduction to the ECB Standards.

[24] For the sake of precision, it should be distinguished, according to the circumstances, between ESCB and the Eurosystem, i.e. those cases in which representatives of NCBs only include countries taking part into the Monetary Union. The term "Eurosystem" was coined by the ECB and commonly used but is not currently included in statutory Community legislation.

[25] This is on the contrary the opinion of C. Keller, (2001-2002/3), in particular p. 462.

[26] Section 1 – Policy Objectives, third paragraph.

[27] Point 2.1. of Section 2 – Scope of the application of the standards, first paragraph.

[28] "This chapter elaborates on the three main objectives mentioned above. However, the standards address the first objective more specifically. Given the time constraints and the long lead times required to make possible changes to the existing infrastructure, it was important to focus on the requirements of the single monetary policy and payment systems at the start of Stage Three, the preparation of which will be imperative before the start of EMU. The other objectives will be considered as part of further work to be carried out by the EMI and the NCBs in order to ensure that there is an adequate framework for the oversight of SSSs".

[29] This is partially recognized also by the opponents to this reconstruction: "Of course, any such assessment under the standards may as a matter of fact serve the overall stability of the financial system. It may in addition have a "labeling effect". A signal is given to the markets that a certain settlement infrastructure is reputed sound by the central banks.", C. Keller, (2001-2002/03) p. 462. The ECB position, in favor of a factual regulatory role of its standards, is reflected in ECB, *The role of the Eurosystem in payment and clearing systems, supra*: "Although the standards were set by the Eurosystem as a user of securities settlement systems, securities settlement systems themselves have made considerable efforts to comply with these standards. This clearly shows that the standards have acquired a de facto regulatory value" (p. 58).

[30] Commission Decision of 6 June 2001, *Establishing the Committee of European Securities Regulators*, OJEC L 191 of 13 July 2001, p. 43.

[31] Committee of Wise Men, *Final Report on the regulation of European securities markets*, Brussels 15 February 2201. This calls for the establishment of two committees, the European Securities Committee, comprising high- level representatives of Member States, and the Committee of European Securities Regulators, comprising senior representatives from the national public authorities competent in the field of securities in order, *inter alia*, to advise the Commission.

[32] European Council resolution of 23 March 2001.

[33] Sixth paragraph of point 6 of the Stockholm European Council resolution.

[34] Yet, the Commission does recognize a wider role of CESR in the whereas of the Decision (see in particular whereas 8 and 9).

[35] CESR Charter, effective as of 10 September 2001.

[36] "Considering that the objectives of protecting investors, ensuring the integrity and transparency of markets and securing the proper functioning of the financial system are fundamental to achieving and maintaining sound and stable financial markets; considering that close co-operation and information exchange between regulatory authorities are essential for the successful oversight of the European financial markets; having regard to the importance of greater supervisory and regulatory convergence for the achievement of an integrated internal capital markets in Europe; having regard to the need to base all its actions around a common conceptual framework of overarching principles for the regulation of the European securities markets to be established by the European Union…".

[37] "Level 2 is composed of an actively functioning network of national securities regulators, the European Commission and a new European Securities Committee to define, propose and decide on the implementing details of framework Directives and Regulations, determined by the co-decision procedure in Level 1. It is therefore proposed that two new Committees are formally established – an EU Securities Committee (ESC) which will have a primary regulatory function and an EU Securities Regulators Committee (ESRC) with advisory functions", p. 28.

[38] "The initial report stated that Level 3 should encompass a "…framework of enhanced and strengthened cooperation and networking between (national) regulators with a view to ensuring consistent and equivalent transposition of Level 1 and Level 2 legislation…". National regulators were also encouraged to agree joint protocols for improving implementation and a peer review process to ensure consistent enforcement practice in the ESRC. The Committee confirms this approach", p. 37.

[39] Indeed, the Report is clear in stating that "the ESRC [CESR] should be a Committee with two hats. In Level 2 it would act as an advisory committee to the European Commission. In Level 3 it would act alone as a fully independent committee of national regulators to ensure more consistent implementation of Community law", p. 31.

[40] To further confirm the coexistence of coordination of oversight functions and "level 3" role, the CESR Charter states that all understandings, standards, commitments and work agreed within FESCO will be taken over by the Committee with the same consequences for the present and future members (Article 9.1).

[41] See ECB, *Legal instruments of the European Central Bank*, in *Monthly Bulletin* (1999), p. 53.

[42] For a wider analysis of the scope of each measure, see for all C. Zilioli and M. Selmayr, (2001), (in particular, Chapter 3), also for relevant bibliography.

[43] See C. Zilioli and M. Selmayr, (2001), p. 90.

[44] What is of substantial relevance is, that the ECB can impose obligations on particulars only through regulations and decisions, generating guidelines and instructions obligations exclusively inside the ESCB.

[45] "…pursuant to Article 105(2) of the EC Treaty and Article 3.1 of the Statute, the Eurosystem has the task of "promot[ing] the smooth operation of payment systems" only and no mention is made of securities settlement systems. In the same vein, Article 22 of the Statute grants regulatory powers to "ensure efficient and sound clearing and payment systems". Again, no mention is made of securities settlement systems. […] As far as securities settlement systems are concerned, the Statute makes no mention of such systems. Nor is "clearing" a specific feature of securities transfers systems" C. Keller, (2001-2002/03), at p. 460. *Contra*, ECB, The role of the Eurosystem in payment and clearing systems, *supra*, in particular from p. 51. Beyond employing other arguments, the ECB states that "Article 22 contains the terms "clearing" as well as "payment" when referring to "systems". The text therefore suggests that "clearing" has a meaning on its own, different from the term "payment". This textual interpretation may therefore lead to an affirmative answer to the question as to whether Article 22 encompasses securities clearing and settlement systems" (p. 52).

[46] In the same policy statement it is affirmed that oversight may or may not be based on explicit legal provision, also developing on a non-statutory basis (p 2). The use of non-statutory regulatory measures should be consistent with the recognition of such principle.

[47] Cooperation was first announced with a joint press release of CESR and the ECB as of 25 October 2001. On 1 August 2003 a CESR/ESCB Consultative Report on Standards for Securities Clearing and Settlement Systems in the European Union was divulged (CESR/03-274), leading to a public hearing whose results have not been made public yet.

[48] As presented to the Italian Presidency on 18 July 2003 (CONV 850/03).

49 See ECB, *Opinion of 19 September 2003 at the request of the Council of the European Union on the draft Treaty establishing a Constitution for Europe*, JOEC C 229 of 25 September 2003, p. 7 (on this point, see in particular paragraph 6).

[50] CESR, *Co-ordinating enforcement of Financial Information*, Press Release of 7 October 2003, CESR/03-362b. This Press Release launches a consultation paper proposing greater co-ordination of enforcement activities by supervisors of financial information in Europe (see CESR 03/317b "Draft Standard 2 on Financial Information – Co-ordination of Enforcement Activities").

[51] Draft Standard 2 builds on CESR's work in the area of enforcement which began with the adoption in April 2003 of the CESR Standard 1 on "Financial Information: Enforcement of standards on financial information in Europe" (CESR/03-074). This previous document had proposed a definition of "enforcement action" that seems to fully confirm our thesis: "Principle 17: Actions taken by the enforcers should be distinguished from sanctions imposed by the national legislation. Actions are measures generally aimed at improving market integrity and confidence".

Chapter 15

Copyright Protection of the Euro and the Hungarian National Legal Tender[*]

by

Péter Munkácsi

"Moneta debet esse quasi quaedam lex et quaedam ordinatio firma"
(*Nicolas Oresme*)

Abstract: The main aim of this chapter is to present and to systemise the current status, or lack of status, of the copyright protection of the euro banknotes and coins in the context of Economic and Monetary Union (EMU) Governance. Furthermore, I present the thought-provoking findings of the Hungarian Council of Copyright Experts. This is a unique copyright administrative institution in international comparison, which for the first time examines in depth copyright questions concerning the pictures of the banknotes. Finally, I conclude, focusing on divergences and similarities from a comparative perspective.

Keywords: European Community law, Economic and Monetary Union, governance, harmonisation, copyright protection, national legal tender, Hungary

1. Introduction

It was in 1950 that Jacques Rueff, one of France's most influential liberal thinkers and economists of the 20th century, declared: "Europe will become united through its money or not at all." It was not an easy task of the European Central Bank (ECB) and Member States to introduce euro banknotes and coins respectively as the prophecy predicted, but this was realized on 1 January 2002.[1] "The euro is much more than just a currency," Willem F. Duisenberg, the former ECB president said, "It is a symbol of the European integration in every sense of the word."[2]

[*] The author is grateful to Chiara Zilioli, Gábor Faludi and Pedro Machado for their helpful comments on earlier drafts and to the editors for further suggestions and revision.

Upon EU accession, Hungary will join the Economic and Monetary Union (EMU) with the status of a "Member State with a derogation" which will be the next major step in the country's European integration. For Hungary as a new Member State in the EU, introduction of the euro will not be an option but an obligation. The foreseeable accession to the Eurosystem by the National Bank of Hungary on 1 January 2010 will entail abandoning the national currency and adopting the euro as the domestic legal tender currency. Therefore, it is useful to analyse the integration process from the perspective of copyright law. I would like in this regard to draw attention to the Opinion No. SZJSZT 09/01 of the Hungarian Council of Copyright Experts, which for first time examines in depth some copyright questions on the designs on banknotes.

On a European level, until 2003, the ECB decisions established the rules on reproduction of euro banknotes on the basis of copyright. From March 2003 onwards, according to the recent ECB Decision of 20 March 2003 on the denominations, specifications, reproduction, exchange and withdrawal of euro banknotes (ECB/2003/4) which repealed the earlier Decisions ECB/2001/7 and ECB/2001/14[3], copyright was left outside the scope of such rules (since there is no community copyright substantial law as far as the notion of the copyright work is concerned.) There are clashes between the Member States' legal orders, most of which did not grant copyright protection to their national currencies and the challenge of the EMU to this tradition. To solve the conflict, Röttinger (2001) argues for the literature, the copyright protection of euro is an ancilliary material to the penal and/or administrative measures. In addition, following my view, the copyright protection on euro could be significant only for permission of secondary uses, for example the use of visual art creations for the purposes of publicity and advertising. The authorisation of use relates in general to a single publication, in the form and scope indicated therein. Although the ECB has an active role in the prevention of the euro banknotes against counterfeiting and the detection thereof- these are public law institutions - , the enforcement rules do not form part of my examination.

This section does not deal with the issue of the euro symbol. Although the ? was inspired by the Greek epsilon pointing back to the cradle of European civilisation and the first letter of Europe, crossed by two parallel lines to indicate the stability of the euro, the symbol was not protected by copyright, but by trade-mark.[5] The Commission also registered it with the International Standardisation Organisation (ISO), which is responsible for the glyphs/fonts, keyboards, character transmission codes etc., with a view to enabling the insertion of the symbol into computer systems.[6]

2. Copyright protection of banknotes at international level

There are approximately 150 national laws on copyright. They are all different, the texts and content of the laws not being identical. There are practically limitless possibilities for countries to provide in their copyright laws for protection of material which is not specified in the international instruments, or to grant rights which are not mentioned in such instruments. The copyright protection of banknotes on a national or European level is a case in point. Danish banknotes are protected by the Danish Copyright Act No.194 of 11 March 1997, which also offers protection to the design of euro banknotes if the design is protected under any international convention, whereas only Ireland and the United Kingdom has express statutory provisions granting express copyright protection to banknotes.

The protection of copyright on banknotes is a separate question. There has only been one high court decision at the EU level: pursuant to a ruling of the Austrian Supreme Court (Oberster Gerichtshof – OGH) dated 10 June 1975, banknotes issued by the Österreichische Nationalbank constitute a "Werk der bildenden Kunst" in the sense of Article 1 of the Austrian Copyright Act, and therefore enjoy copyright protection.[7]

However, in some EU Member States (Greece, France) the design of the banknote, as a form of applied art, is protected by their statutes. These countries only have administrative provisions on reproductions of banknotes, not on copyright[8]. Moreover, many countries (e.g Switzerland) exempt banknotes from copyright protection. The exemption clause is based on the international copyright treaties. Article 2 (4) of the Berne Convention for the Protection of Literary and Artistic Works (Paris Act 1971) provides that "it shall be a matter for legislation in the countries of the Union to determine the protection to be granted to official texts of a legislative, administrative and legal nature, and to official translation of such texts".

Article 3 (and the agreed statement concerning the article) of the 1996 WIPO Copyright Treaty stresses that Contracting Parties shall apply *mutatis mutandis* the provisions of Articles 2 to 6 of the Berne Convention in respect of the provision provided for in this treaty. Article 13 of the TRIPs Agreement applies the three-step formula of Berne Convention Article 9 (2) for exceptions to the reproduction right to all exclusive rights in literary and artistic works.

A recent case-law of the *Cour de Cassation* rejected the copyright protection for the banknotes.[9] The Bank of France brought an infringement action against a numismatic magazine which had illustrated one of its issues with pictures of banknotes. According to the appellant's plea the protection of banknotes by the penal provisions dealing with breaches of public trust, *i.e.* counterfeiting means of payment, was not incompatible with and did not preclude the copyright protection to which intellectual works are entitled. The dismissal of the Bank's claim was based on the fact that a banknote is a means of payment the unlawful reproduction of which is punishable only as a criminal offence under specific provisions. In other words, a banknote cannot be at one and the same time a means of payment and a work protected by copyright, otherwise, the reproduction of banknotes may not be regarded as a reproduction in copyright terms.

In its ruling rejecting the appeal, the French court stated that the 'incompability between the exercise of the regalian activity of the Bank of France and the protection of copyright claimed by the appellant'. Hence the Bank of France could be considered neither an 'author', nor an assignee of rights in the banknotes.[10]

3. Governance, policy-making and copyright within the European Union

An analysis could be made as to in which sense copyright protection on banknotes and coins is a tool to exercise governance over the Eurosytem. Putatively, the ECB legal acts adopted in the domain of copyright protection on euro banknotes may constitute a good starting point for relating the issue of copyright to governance, particularly as regards to specific problems of eletronic reproductions and the print-outs thereof.

The search for a link between the issue of copyright and governance on European level might lead us down wrong paths. The notion of new governance is one which has come into prominence in recent decades in Europe. In early 2000 the Commission identified the reform of European governance as one of its four strategic objectives. The document, so-called 'Governance - White Paper',[11] underpinned five principles: openness, participation, accountability, effectiveness and coherence.[12] The result of the wide public consultation on the White Paper presented by the Commission in 2003.[13]

Although the term 'governance' remains a rather general and hazy concept, there are a number of dimensions which can be identified and analysed. It is often used in the context of postnational and international regulation, and policy-making. In that sense, it is useful to analyse the evolution of intellectual property, in particular the copyright protection in the EU. The harmonization process in this field belongs to the Community's multi-faceted and ambivalent policies. Maybe it is because of measures which have already been taken that the draft EU Constitution states the protection of intellectual property.[14]

With a European Economic Community (EEC) the framers of the Treaty of Rome wished to create a vast area comprising their combined territories within whose boundaries goods, persons, services and capital could move freely. Barriers to the trading of goods were perhaps the most visible obstacles which would have dismantled, and the early part of the Treaty is devoted to this task. But no articles in the Treaty deal with intellectual property or copyright. Nevertheless, the European Commission has developed this area by means of the goal of the harmonisation of copyright in order to avoid barriers to the Internal Market.

Ten years after the publication of a basic and comparative study of copyright law in the European community, which was prepared by Prof. Dietz (1978)[15], in 1988 the Commission, recognising the importance of the subject, published a Green Paper on *Copyright and the Challenge of Technology*[16]. The Green Paper identified six areas where the copyright laws of the EU Member States should be harmonised so as to foster the functioning of the European Union Internal Market.

During the 1990s five sectorial Directives were adopted, which harmonised the national copyright laws of the EU Member States and even those of all candidate countries from Central and Eastern Europe too. The first generation of harmonisation of the copyright laws covers the legal protection of computer programs[17], rental rights, lending rights and the main neighbouring rights[18], satellite broadcasting and cable retransmission[19], the duration of protection of authors'rights and neighbouring rights[20], and the legal protection of databases[21]. Five years later the sixth Directive on the artists' resale right (*"Droit de suite"*) of this first generation of copyright harmonisation on a Community level was adopted. Even the close cooperation between the European Parliament, the Council and the Commission has enabled recently the swift adoption of the Directive on the enforcement of intellectual property rights.[22]

The Directive on copyright and related rights in the Information Society ("INFOSOC Directive"; "Copyright Directive") is slightly different from the six directives mentioned.[23] It harmonises several essential rights of authors and four groups of neighbouring rightholders, limitations and exceptions thereto, the protection of technological measures and of rights management information and an important aspect of injunctive relief, i.e. notice and take down vis-à-vis intermediaries. The Directive, as a part of the new generation of copyright harmonisation, has the most horizontal impact of all *acquis communautaire* Directives.[24]

It should be noted, that a considerable harmonization has already been carried out. The Commission is not involved in the subject of copyright in the euro, there has been no case law on it before either the ECJ or the CFI, and future harmonization steps concerning the copyright protection of banknotes are not envisaged. Article 5.3.e) of the INFOSOC Directive contains an exception in the case of the use for the purposes of public security or to ensure the proper performance or reporting of administrative, parliamentary or judicial proceedings which could be an European exemption clausel form the copyright protection of the euro banknotes and coins.

From my point of view, the governance (in particular the EMU governance) - copyright relationship must be referred in the context of the better regulation initiative. The Commission proposed in June 2002 a broad action plan on simplifying and improving the regulatory environment, with the intended pupose to develop a new common legislative culture within the EU. The action plan outlines ideas, inter alia, on better policy preparation through improving the current procedures for consultation and impact assessment, enlarging the range of the various policy tools, limiting proposals to substantial elements and launching a programme on simplification of Community legislation.[25] In a framework of the simplifying programme would be useful to update and consolidate of *acquis* concerning copyright.

3.1 Legal instruments on copyright protection of euro

As it can be seen, the main legal measure of the copyright harmonisation within the EU is the directive. “A directive shall be binding, as to the result to be achieved, upon each Member State to which it is addressed, but shall leave to the national authorities the choice of form and methods” (Article 249 EC Treaty). A directive is not necessarily binding to all Member States; it may only apply to one or some Member States. All directives must be notified to the (relevant) Member States. The countries may choose the form and the methods of implementing the directive in their national laws. The directives are binding as far as the result that is to be achieved is concerned.

The EC Treaty and the Statute of the European System of Central Banks and of the European Central Bank confer upon ECB the competence to participate in the legislative process, in particular to adopt legal acts (Regulations, Decisions, Recommendations, Opinions, Guidelines, Instructions, Circulars).

The protection of euro banknotes by copyright is ruled by the legal form of Decision. ECB Decisions are binding in their entirety upon those to whom they are addressed and take effect upon notification. ECB Decisions may be addressed to any *legal or natural person*, including the euro area Member States.[26]

Copyright protection of euro coins

Regarding Article 106 (2) of the EC Treaty, Member States issue coins subject to approval by the ECB of the volume of the issue. Furthermore, the Council is entitled to adopt measures to harmonise the denominations and the technical specifications of all coins intended for circulation to the extent necessary to permit their smooth circulation within the Community.

According to Council Regulation (EC) No 974/98 on the introduction of the euro[27], coins denominated in euro, introduced as from 1 January 2002, are the only coins which have the status of legal tender of all participating Member States. Another Council Regulation (EC) No 975/98[28], amended by Council Regulation (EC) No 423/1999 of 22 February 1999[29], on denominations and technical specifications of euro coins intended for circulation lay down the all important conditions, inter alia the design of the coins. At the Florence European Council in June 1996, Member States decided that the euro coins will have a common face and a national face and gave a mandate to the Commission to organise a competition at European level to select the design for the common face of the euro coins. The winning designs of the European coin design competition were selected by the Amsterdam European Council on June 1997. As provided in the competition's terms of references, the copyrights on the winning designs were assigned to the Commission by the designer, the Belgian Luc Luycx.

The assignment raises the problem of the different treatment of copyright transfer between the countries following the *droit d'auteur* system (continental law) or common law tradition. In the common law countries the freedom of contract is the exclusive norm, based on the utilitarian norm. The *droit d'auteur* system tradition adopts two approaches to alienability of copyrights. The "dualist" approach (e.g. in France) treats author's rights in a work as consisiting of two separate elements: economic and moral right. The economic right is in principle, inalienable subject to certain expedient qualifications; under the French statute the moral right is perpetual. The "monist" approach to author's rights, followed in Germany, and Austria predicates that the author's economic and moral rights are thoroughly intertwined and that the economic aspect of the right inalienably adheres to the author no less than does the moral aspect of the right.[30]

From that view, it is open to question what the effects of the assignment are? Due to the lack of a Federal European Copyright Code, the assignment could happen under the law of the country of the exploitation of the work, i.e. the Belgian law. However, the Belgian legislation, following the “dualist” approach, validates assignments of economic rights in future works, but only for specified works and for a limited time.[31] It follows from that remark that the assignment would not be valid in other Member States.

However, following a Communication from the Commission[32], the copyright in the design of the common face of the euro coins belongs to the European Community represented by the Commission. The European Commission has assigned to each of the Member States participating in the third stage of EMU all the Community rights as regards the territory of such Member State. The Commission will assign the copyright to other Member States as each one moves to the third stage of EMU. The remaining questions are: Which copyright pertains to the European Community? The non-existent European Copyright Law or the different copyrights under the different national laws? Do these different laws constitute a bundle of laws? Certainly not, since all copyright has a territorial effect.

From the point of view of new Member States it could be remarked that only the Member States appear on the coins, and not the Map of the common Europe. On the common face of the one cent, two cent, and five cent coins the globe is superimposed, and the European Union (instead of the eurozone) is highlighted on the globe. On the ten cent, twenty cent and fifty cent coins the fifteen Member States are shown separately. On the right-hand side of the common face of the one euro and two euro coins is a representation of the European Union, where the borders between the Member States are marked with thin lines. Hungary, the other Central European and Baltic states disappear, and the North Sea and Mediterranean Sea flow together, and therefore Scandinavia and Greece look like islands. It would be a polite solution after the May 2004 accession of the new Member States to make some small modifications in design on the common face of the euro coins. According to a Report of the EP Committee on Economic and Monetary Affairs, the European Parliament calls on the Commission and the ECB to draw up a study into the feasibility of introducing one and two euro banknotes and to prepare an information campaign designed to make the general public aware of the thinking behind such a step.[33]

Copyright protection of euro banknotes

In February 1996 the European Monetary Institute (EMI), the forerunner of the ECB, launched a competition in which banknote designers nominated by the national central banks of the European Union were asked to sketch a series of banknotes. In December 1996 the Council of the EMI selected the winning designs on the basis of a public survey and a recommendation made by an expert panel. The winning designs were produced by Robert Kalina of Österreichische Nationalbank. His pictures were inspired by the theme 'Ages and styles of Europe'. The seven euro banknotes, ranging from ?5 to ?500, have their own colours and sizes. The higher the value, the larger the banknote. On the front of the banknotes, pictures of windows and gateways symbolise a spirit of openness, and on the verso, pictures of bridges signify co-operation, not only within Europe, but also with rest of the world.

Article 12 of Council Regulation (EC) No 974/98 on the introduction of the euro[34] rules that participating Member States shall ensure adequate sanctions against counterfeiting and falsification of euro banknotes and coins without any copyright aspects. As far as copyright protection is concerned, Article 1 paragraph 1 of Decision ECB/2003/4[35] rules that the copyright symbol © on euro banknotes indicates that the copyright belongs to the ECB. In accordance with this, recital (3) states that as successor to the EMI the ECB holds the copyright in the designs of euro banknotes, which was originally held by the EMI. The ECB and the national central banks enforce the copyright with regard to reproductions issued and distributed in breach of it.

This rule means that some elements remain in a state of uncertainty. With regard to the above-mentioned 'monist-dualist approach' in the *droit d'auteur* system, the authors in dualist countries can exploit their economic interests in a work through the transfer of economic rights; authors in monist countries, barred from assigning any of their rights, can achieve the approximate economic equivalent only through the grant of privileges to use the work that is approximate to but not identical to non-exclusive and exclusive licences in common law pratice.[36] More clarification would be useful on the notion of the term 'copyright belongs to the ECB'.

The primary aim of the recent ECB Decision, as stated in recital (4), is that the ECB should take measures to provide for a minimum level of protection in all participating Member States in order to ensure that the general public can distinguish genuine euro banknotes from reproductions. For that purpose it is necessary to establish common rules according to which the reproduction of euro banknotes will be permitted. However, the reproduction rules for euro banknotes in Article 2 of the ECB Decision, even in the two first ECB Decisions (ECB/1998/6[37] and ECB/2001/7[38]), do not refer to the copyright system; they have a more technical and administrative form, based solely on the Eurosystem's competence to issue euro banknotes and, following that competence, to ensure the integrity of euro banknotes (rights and titles under public law not under private law).

4. Copyright protection of the Hungarian national legal tender

An impressive development of the post-socialist laws of Central and Eastern European countries can be seen in the field of copyright as in many other fields inside and outside the broad concept of intellectual property. One of the tasks and challenges for the copyright legislators and enforcement institutions in the last decade was to find answers to the modern issues raised by technical and economical developments.[39] The Hungarian Act on Copyright No. LXXVI. of 1999 (hereinafter referred to as "CA") which entered into force on 1 September 1999, fullfiled these criteria.

The question of copyright protection of the Hungarian national currency (the Hungarian forint – HUF) banknotes was ambiguous until 2001. The Hungarian Banknote Printing Corporation requested an expert opinion from the Hungarian Council of Copyright Experts (hereinafter referred to as "Council of Experts")[40] indicating that there is no copyright protection on banknotes. In their opinion, the Council for first time clarified the relations concerning copyright protection.[41] The Hungarian Banknote Printing Corporation raised the following questions before the Council of Experts:

1. Is the application of Article 1 paragraph (4) of the CA concerning copyright in the HUF banknotes lawful?
2. If the above-mentioned provision is not applicable, what is the lawful process?[12]

Article 1 paragraph (4) of the CA: The protection provided by this Act shall not cover legal provisions, other means of state direction, court and official resolutions, announcements and documents issued by an authority or other official organ, or standards made obligatory by law and other similar regulations.

The Council of Experts took the facts of the case as a starting point for the opinion that the pictures (graphics) on the banknotes are drafted by a designer who is an employee of the Hungarian Banknote Printing Corporation, under predetermined conceptions. From the facts of the case, the Council of Experts infers that:

- Pictures on the banknotes are creations of visual art according to Article 1 paragraph (2) subparagraph h) of the CA,[43] which have an individual and original nature, therefore the banknotes concern subject-matter of copyright protection;
- Creation of the banknotes is the designer's responsibility;
- The facts are extended to the creations fixed and reproduced on coins.

As a first step towards examining the answer to question no. 1, the Council of Experts decided to formalise the relationship between the issuing process of banknotes and coins, and copyright exploitation. This problem receives great importance due to the so-called "twin-nature of the official documents" in Hungarian copyright law.

As has already been mentioned, Article 1 paragraph (4) of the CA excludes some elements from copyright protection on condition that, during their exploitation, they must be freely available to the public. Laws, regulations, and legal enactments are withheld from copyright protection. Nevertheless, they should have an individual and original nature. However, if the work excluded from the copyright protection can be used as "a document having an external effect", copyright protection exists. There is an illustration from judicial practice: a thesis for a scientific degree is an official document during the granting process (annex of the application). In that sense, a thesis is not considered a work protected by copyright.[44] Notwithstanding, should the author of the thesis publishes his/her work without any modification, it qualifies as a scientific work following Article 1 paragraph (1) of the CA.

The Council of Experts applied the "twin-nature"principle in their opinion *mutatis mutandis*. It has been established that the NBH shall have the exclusive right to issue banknotes and coins.[45] According to Article 31 paragraph (1) of the NBH Act [Article 37 paragraph (1) of former NBH Act] the NBH shall announce the issue of banknotes and coins, their denominations and distinguishing, features and the withdrawal of banknotes and coins from circulation in a public notice in the Official Gazette ('Magyar Közlöny'). The Council of Experts pointed out that the public notice in the Official Gazzette and its contents are an official document, which qualified as 'other similar regulations' with regard to Article 1 paragraph (4) of the CA. Furthermore, the public notice of the NBH in full accordance with the above-mentioned rule concerning banknotes and coins must be freely available to the public. Therefore, in this case the pictures (graphics) on the banknotes (or works reproduced on coins) are not under copyright protection.

A question also raised was that the other acts of the issue of legal tender constitute copyright exploitation of the work on banknotes. It is indisputable that first the work must be reproduced for issue by the Hungarian Banknote Printing Corporation, which is under Article 16 paragraph (1) and Article 17 subparagraph (a) of the CA exploitation.[46] The manner and the degree of reproduction is not based on the user's business decision it is rather a result of the state ownership within the monetary policy which is behind the emission. The State as owner, which is responsible for the stability of the market economy, transferred the part-competence of its right to ownership, and right to issue of the legal tender by law, to the NBH[47]. The position of the Hungarian Banknote Printing Corporation in this issue process is that of assistant to fulfilment. This kind of reproduction is a *differentia specifica* regarding reproduction in a copyright manner or all usual copyright exploitation.

The second step in the supplying of money is the distribution of reproduced banknotes as legal tender. In the copyright sense, making accessible to the public the original copy or the reproduced copies of the work through putting them into circulation or offering to put them into circulation shall be taken to mean distribution. According to Article 23 paragraph (2) of the CA, distribution shall in particular imply the transfer of the title of ownership of the copy of the work and the rental of the copy of the work as well as the importation into the country of the copy of the work with the aim of putting it into circulation. This cannot be applied to the notion for distribution in the case of the distribution of banknotes (and coins), because it is not a question of an equivalent, for value received, civil law contract; but rather an administrative act. The following are examples from the NBH Act: all persons shall accept banknotes and coins issued by the NBH at their face value in transactions which are conducted in the legal tender of Hungary. In respect of cash payment transactions, up to fifty coins of each denomination issued by the NBH must be accepted. This restriction shall not apply to credit institutions, tax offices and post office cash desks, which are required to accept any amount of coins as payment.

Counterfeit, forged or mutilated (punctured) coins shall not be accepted as payment. Coins which have lost a significant proportion of their weight or are difficult to recognise need not be accepted as payment. Coins which have lost a significant portion of their weight as a result of normal use or have become difficult to recognise shall be accepted as payment or exchanged at credit institutions, tax offices and post office cash desks, which shall exchange such at the NBH. Counterfeit banknotes and coins shall be submitted to the NBH without compensation.

The NBH shall pay compensation for the value of damaged (mutilated) HUF banknotes, if more than half of the banknote is submitted. Credit institutions shall accept damaged (mutilated) banknotes for replacement by the NBH. Damaged banknotes shall be replaced by the NBH free of charge. Compensation for the value of damaged HUF coins shall not be paid by the NBH, unless the coins contain precious metals. The NBH shall not pay compensation for the value of banknotes or coins which have been destroyed. Processes for destruction of banknotes or coins may not be initiated.[48]

The Council of Experts also examined the case of how to grant license to exploitation which is not related to the money supply. According to Article 34 paragraphs (1) and (2) of the NBH Act [Article 40 paragraphs (1) and (2) of former NBH Act] imitations of banknotes or coins in circulation for any purpose (use in theatre performances, television or film productions, education, etc.) may only be produced with the permission of the NBH. The regulations of the NBH shall be complied with in respect of the production, registration, safekeeping and destruction of imitations.

This provision provides the NBH with an exclusive licensing right for the reproduction. However, this right is not based on the copyright; rather, on the one hand, on government/owner monopoly of the money supply, and on the other hand, on taking measures against counterfeiting and for the originality of the official payment derived from public authority.

Turning to the second question, the Council of Experts clarified how to grant a license for the exploitation by the rightholder, referring to work created wthin the author's responsibility and remuneration. Employers regularly enter into contracts with their creative employees over the allocation of rights in works created in the course of employment. Countries of the *droit d'auteur* system, as in Hungary too, assumes that copyright in works created in the course of employment is vested in the employee-author rather than in the employer, so that a transfer from the employee will be required for the employer to obtain copyright. Nevertheless, often impied in the employment agreement is an assignment of copyright from the employed author to his employer.

According to Article 30 paragraph (1) of the CA, the delivery of the work to the employer shall imply the transfer of the economic rights to the employer as successor in title to the author, if the creation of the work is the author's responsibility, unless otherwise agreed. Article 30 paragraph (3) of the CA provides that the author shall be entitled to an appropriate remuneration if the employer authorises another person to use the work or transfers to another person the economic rights relating to the work. With regard to the findings of the Council of Experts concerning the first question, the lawful process would be if the Hungarian Banknote Printing Corporation as employer-rightholder of copyright transferred their economic rights on banknotes and coins to the NBH by gratuitous contract, and free of charge. The purpose of the money supply, which is a special kind of exploitation, can offer grounds for gratuitousness. Concerning the transfer, the NBH would permit the production of imitations of banknotes or coins in circulation for any purpose (use in theatre performances, television or film productions, education, etc.) or other exploitation on a copyright basis, too. If the NBH and the Hungarian Banknote Printing Corporation agree that the central bank grants a license to produce imitations of banknotes or coins, or to exploit any other copyright economic rights, the Corporation can exclude without misgivings the remuneration of the employee-author in a retroactive contract. If the NBH grants a license for these copyright exploitations for a consideration then, concerning the transfer, the employed author has more competence to claim remuneration. However, in that case the CA does not prohibit *expressis verbis* the contractual exclusion of the remuneration. If the employee-author(s) does (do) not agree with this, the court specifies the rate of the remuneration in dispute.

5. Conclusion

Through designs, engravings and images, a banknote or a coin may be considered an original work for the purposes of copyright. However, their normal exploitations does not fall within the scope of use in copyright terms. Exclusivity in a copyright sense is of no importance in either the supplying money or the putting it into circulation, because it is rather a monopoly derived from the public law.

The prohibition of the reproduction, imitation etc. of the euro on a Community level is not an copyright prohibition, and does not depend on who has a right to use the copyright symbol. But, on the other hand, as was remarked following the conference held at the EUI, the copyright law should be serve the purpose of the Eurosystem guaranteeing the integrity of the euro banknotes and thus as an appropriate legal instrument to act against all reproductions. In this case a legal tender is a work under copyright exclusivity in which the appropriate Community entity, the ECB, sets forth rules on the basis of which reproductions are deemed lawful if complying with the criteria therein laid down. After the ’first sale’ the exhaustion right and the right to private copy would come into the account. The latter can be not permitted in case of a legal tender. Therefore, in my view copyright protection on euro could be significance only for permission of secondary uses, for example the use of visual art creations for the purposes of publicity and advertising. The authorisation of use relates in general to a single publication, in the form and scope indicated therein.

As it was already mentioned, the assignment of the copyright of the euro coins and the notion 'copyright on the banknotes belongs to the ECB' occurs considerable uncertainty and coincidency between two legal traditions. Notwithstanding United Kingdom is not a member of the Eurosystem, it seems, that on the stage of EMU follows the common law traditions where the legislation makes copyright fully transmissible by assignment […] as personal or moveable property.[50] Within many of the actions outlined in the White Paper or its follow-up documents, in particular by the action plan concerning better regulation, could enhance the legislative quality and effectiveness of European governance in the monetary sphere.

NOTES

[1] See the communication from the Commission to the Council, the European Parliament, the Economic and Social Committee, the Committee of the Regions and the European Central Bank; the introduction of euro banknotes and coins – one year after. OJ C 36, 15. 2. 2003, p.2. It should also remarked that the euro is not only the common currency of the twelve Member States of the European Monetary Union, but has also been accorded legal tender status in certain States and ter"ritories outside the European Union. The chief problem that arose in this respect was ths shift of competence for currency affairs from the national level to the Union's level. More details in Christoph A. Stumpf, the introduction of the euro to States and territories outside the European Union, (2003) 28 *E.L.Rev.* Apr, p. 283.

[2] See: T. Barber (2001), p. 8.

[3] OJ L 78, 25. 3. 2003, p.16

[4] Moritz Röttinger, (2001).

[5] There are three '€' trade mark registration under the code and number QO 0956 (color) and 0957-0958 (black and white) on the database "Article 6ter" No. 04/2003 (last visited on 11 June 2004) which are in accordance with the situation of the communication made by the International Bureau of WIPO pursuant to Article 6ter of the Paris Convention for the Protection of Industrial Property as at 31 December, 2002. Regarding the matter of trade-mark and the euro symbol, there is already a judgement of the Court of First Instance from 10 April 2003 in Case T195/00, *Travelex Global and Financial Sevices Ltd., Interpayment Services Ltd. v. Commission of the European Communities*, in which the court dismissed the action for compensation for the damage allegedly caused to the applicants by the Commission's adoption, use and promotion of the official euro symbol, which is allegedly substantially identical to the graphic trade mark registered by the applicants. See case on the website (http://curia.eu.int/) .

[6] COM (97) 418 final on the use of the euro symbol (€).

[7] OGH 10. 6. 1975, "1000-S-Banknote", *Öbl 1975*, 15. For more details see Annex V of the ECB Report on the legal protection of banknotes in the European Union Member States, November 1999 and Moritz Röttinger, Das Urheberrecht in Rechtspolitik und Rechtsetzung der Europäischen Gemeinschaft – vom Handelshemmnis zum "Espace européen de la creativité". *UFITA Bd. 2001/I*, p. 9, see 5. 2. 2. p. 69.

[8] See Annex V of the ECB Report on the legal protection of banknotes in the European Union Member States November 1999.

[9] Bank of France v. Editions C. A. Cour de Cassation 1ère Chambre Civile, 5 février 2002, *RIDA 193 Juillet 2002*, p. 381

[10] Ibid.

[11] COM(2001) 428 final; OJ C 287, 12. 10. 2001, p. 1.

[12] Ibid.

[13] European Commission, *Report from the Commission on the European Governance*, Luxembourg, 2003.

[14] Draft Constitution for Europe; version from 12. 07. 2003. Article II-17, Right to property, subparagraph 2.

[15] Adolf Dietz, *Copyright Law in the European Community* (Sijthoff &Noordhoff 1978)

[16] COM (88) 72 final

[17] Council Directive 91/250/EEC of 14 May 1991, OJ L 122, 17. 5. 1991, p. 42

[18] Council Directive 92/100/EEC of 19November 1992, OJ L 346, 27. 11. 1992, p. 61

[19] Council Directive 93/83/EEC of 27 September 1993, OJ L 248, 6. 10. 1993, p. 15

[20] Council Directive 93/98/EEC of 29 October 1993, OJ L 290, 24. 11. 1993, p. 9

[21] Directive 96/9/EC of the European Parliament and of the Council of 11 March 1996, OJ L 077, 27. 3. 1996, p. 20

[22] Directive 2001/84/EC of the European Parliament and of the Council of 27 September 2001, OJ L 272, 13. 10. 2001, p. 32

[23] Directive 2001/29/EC of the European Parliament and of the Council of 22 May 2001, OJ L 167, 22. 6. 2001, p. 10

[24] Reinbothe; available at http://europa.eu.int/comm/internal_market/en/intprop/news/ reinbothe04-04-02.htm

[25] European Commission, *Report from the Commission on the European Governance*, Luxembourg, 2003, p.18.

[26] *ECB Monthly Bulletin*, November 1999, p. 55

[27] OJ L 139, 11. 5. 1998, p. 1.

[28] OJ L 139, 11. 5. 1998, p. 6.

[29] OJ L 52, 27. 2. 1999, p. 2.

[30] Goldstein, (2001), §5. 2. 2.

[31] Goldstein, (2001), §5. 2. 2. 1. D

[32] On copyright protection on the common face design of the euro coins COM (2001) 600 final

[33] Report on the international role of the euro zone and the first assessment of the intrduction of banknotes and coins [COM (2002) 332 – 2002/2259 (INI)] 21 May 2003, FINAL A5-0169/2003, p.14. EP Committee on Economic and Monetary Affairs. Rapporteur: Carlos-Alfred Gasóliba i Böhm.

[34] OJ L 139, 11. 5. 1998, p. 1

[35] OJ L 78, 25. 3. 2003, p. 16

[36] Goldstein, (2001), § 5. 2. 2.

[37] OJ L 8, 14. 1 1999, p. 36

[38] OJ L 233, 31. 8. 2001, p. 55

[39] Munkacsi (1998)

[40] Authors and other right holders are helped in the enforcement of their rights and in taking action against abuses of their rights by a wide range of legal institutions. Of particular importance among them are the Hungarian Council of Copyright Experts.

[41] The expert opinion can be read only in Hungarian. Szerzõi jog bankjegyképen, SZJSZT 09/01, Iparjogvédelmi és Szerzõi Jogi Szemle, 2001 október, pp. 36-43. The English translation will be available soon on the renewed website of the Hungarian Patent Office, at www.hpo.hu.

[42] The first question extended to the same provision of the former Act on Copyright (Act No. III of 1969), but it has no relevance to the matter in this paper.

[43] "Article 1 (2) All creations of literature, science and art – whether or not specified by this Act – shall fall under the protection of this Act, in particular:
h) drawings, paintings, sculptures, engravings, creations produced by lithography or in like manner, and designs thereof."

[44] BH 1979/285 (in English: Court Decisions 1979/285)

[45] Article 4 paragraph (2) of Act LVIII of 2001 on the National Bank of Hungary (NBH Act). At the time of giving an expert opinion the Act LX of 1991 on the National Bank of Hungary was in force. In the context of the paper only the numbering of the provisions were modified.

[46] Article 16 paragraph (1) of the CA:
Under the copyright protection the author shall have the exclusive right to exploit his work in any tangible or intangible form and to grant licence for each and every use of his work. Unless otherwise provided by this Act, authorisation may be obtained for the use of the work by a licensing agreement.
Article 17 subparagraph.(a) of the CA:
Uses of the work, in particular:
a) its reproduction (Article 18 and 19);

[47] Article 4 paragraph (2) of NBH Act.

[48] Article 31 paragraphs (1)-(7) of the NBH Act [Article 37 paragraphs (1)-(7) of former NBH Act].

[49] Goldstein, (2001), § 5. 2. 1. 4.

[50] For example United Kingdom, Copyright, Designs and Patents Act 1988 §90 (1).

Keynote address

by

Paul De Grauwe

Challenges for Monetary Policy in Euroland

1. Introduction

The launch of the euro has been an extraordinarily successful operation. The most visible sign of this success is the fact that it took only a few weeks for the euro to become the single European currency used in daily transactions from Finland to Portugal and from Ireland to Greece. Until recently few people dreamt that this would be possible in their lifetimes.

The success of the launch of the euro is not only technical and economic, it is also and foremost political. The euro is now the most visible and practical symbol of the progress towards a political union in Europe.

And yet despite the magnitude of the success, the challenges ahead are formidable as well. In this address I analyse some of these challenges. The first one has to do with the monetary policy strategy of the ECB; the second one with the enlargement of the monetary union to a group of potentially 27 member states. There is no doubt that the challenge arising from enlargement is the more important one, and as will be argued will require important changes in the operation of the monetary union in Europe.

2. The monetary policy strategy of the ECB

After more than three years of operations, it can be said that the ECB has done a reasonably good job at maintaining price stability and at dealing with the business cycle. During 1999-2001 annualised inflation in the Euro-area amounted to 2.1 % on average, while at the same time the euro-area' GDP expanded at a yearly rate of 2.6%. Nevertheless, there is an increasing consensus in the academic world and among market analysts that the monetary policy

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strategy of the ECB presents some flaws that can and should be amended. The criticism focuses on two problems with this strategy. One has to do with the objectives pursued by the ECB, the other with the instruments.

2.1 The objectives

The Treaty mandates the ECB to pursue price stability as the *primary* objective. It should be noted that the Treaty uses the word *primary* and not *sole* objective, as is sometimes erroneously concluded. According to the Treaty the ECB should also pursue other objectives like sustaining economic activity provided this does not endanger price stability.

The ECB, however, has given a new twist to this mandate. Its spokesmen are now claiming that by pursuing price stability it does the best that is possible to come close to the other objectives (growth, the business cycle). Thus, according to this view it is all right to pursue price stability as the only objective. In so doing the ECB also takes care of the other objectives the Treaty has mandated (see ECB, 1999d).

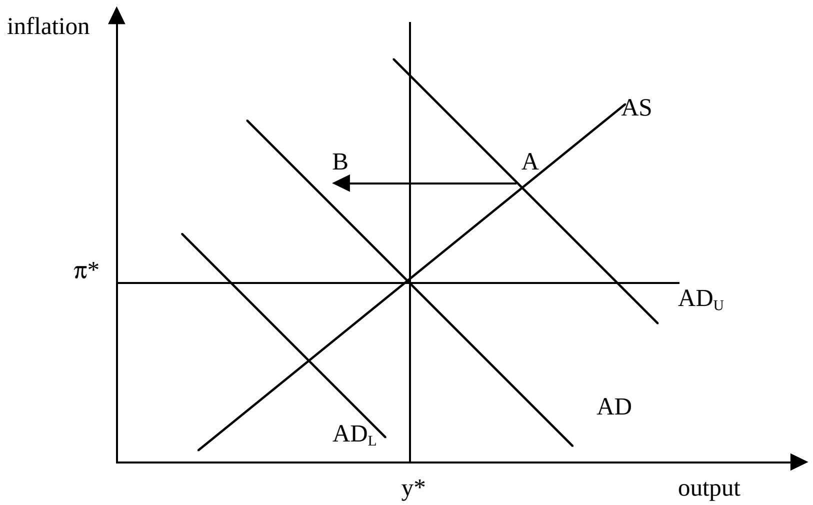
In reinterpreting its mandate the ECB has been influenced by the theory of flexible inflation targeting as developed by Svensson (1996, 2000; see also Alesina et al., 2001; Mishkin and Schmidt Hebbel, 2001). The central claim made by this theory is that inflation targeting makes it possible for the central bank not only to stabilise inflation, but also to do the best possible job in stabilising output around potential output (its “natural” level in long-run equilibrium).

The claim that flexible inflation targeting also stabilises output is obvious when shocks originate from the demand side. This is illustrated in Figure 24, which represents the aggregate demand and supply curves in the inflation-output space. Suppose there are positive and negative shocks in aggregate demand, leading respectively to the upper and lower levels of demand shown by the AD_U and AD_L curves. Potential output is given, shown by the vertical line at y*. The central bank cannot and does not try to influence this “natural” output level, which is determined by non-monetary variables.

Flexible inflation targeting implies that the central bank sets a target inflation rate, π*. In a boom (AD_U), the central bank raises the interest rate, thus lowering the AD curve. In a recession it does the opposite. Because prices are sticky the central bank allows for a gradual adjustment of inflation and output. An attempt to bring back the aggregate demand curve downwards too quickly could lead to a cycle where output declines from A to B. This is why this strategy is called “flexible” inflation targeting. Stabilising inflation around

π^* also stabilises output around y*. When a central bank follows a flexible inflation targeting strategy there is no need to explicitly target the output gap.

Figure 24: Flexible inflation targeting and demand shocks

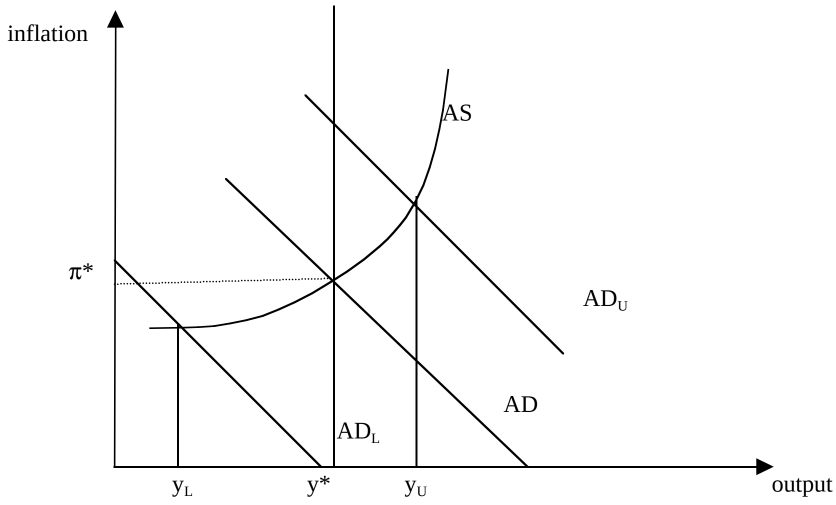


This conclusion only holds because it is assumed that the supply curve is linear. Figure 25 shows a non-linear supply curve, which is more realistic than the linear supply curve of Figure 24. When inflation is low, menu costs lead people to make infrequent price adjustments. Inflation then exhibits considerable inertia. When inflation is high, menu costs of price changes become trivial, and price adjustment are frequent.

The non-linear aggregate supply curve drawn in figure 25 is the counterpart of the "New Keynesian Philips curve" developed by Akerlof, Dickens and Perry (2000), Mankiw (2001), and Wyplosz (2001). When inflation is low, nominal rigidities matter a lot, and inflation is unresponsive to the output gap. The higher the inflation rate, the less significant are nominal rigidities and the more vertical the Phillips curve (in inflation-unemployment space) and the aggregate supply curve (in inflation-output space).

For empirical evidence of a non-linear aggregate supply curve (Phillips curve) in the US, see Akerlof, Dickens and Perry (2000); for several European countries, see Wyplosz (2001).

Figure 25: Flexible inflation targeting when supply is non-linear

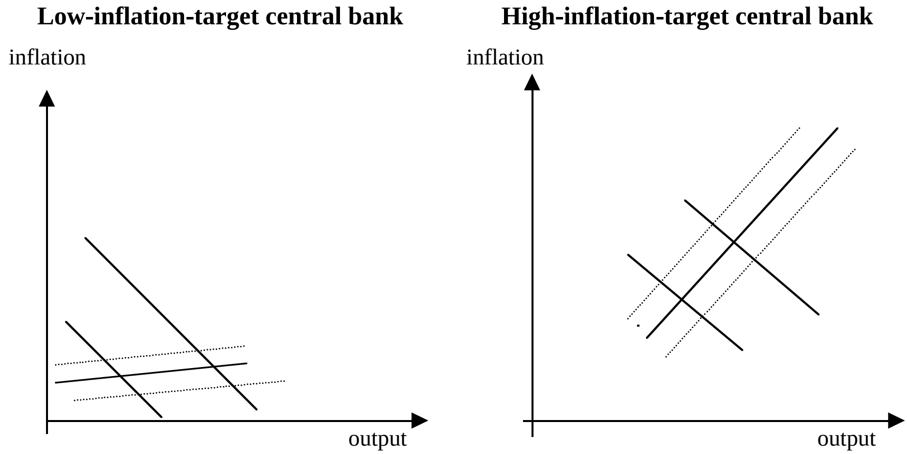


The existence of a non-linearity in the supply curve has an important implication. In a low inflation environment the rate of inflation becomes a less reliable signal of the strength of deflationary forces. To see this, suppose we do not observe the supply curve perfectly because of noise. Figure 26 shows a band around the supply curve, within which the supply curve moves up and down. We distinguish two cases: a low-inflation country where the supply curve is relatively flat; and a high-inflation country with a steeper supply curve.

Suppose that an adverse demand shock hits these economies. In the low-inflation country it is difficult to detect from movements of inflation alone that an adverse demand shock has occurred. The reason is that the signal to noise ratio is low. The signal comes from the demand shock, the noise from the random movements in the supply curve. The flatter is the supply curve the lower is the signal to noise ratio, and the less informative is the rate of inflation about cyclical movements in aggregate demand. In the limit, when the supply curve becomes horizontal, the rate of inflation is not informative about these output movements. Conversely, when the supply curve is steeper (as is generally the case when inflation is higher), inflation contains more information about movements in aggregate demand.

Thus, when inflation becomes very low, as in the euro zone, inflation is a less reliable signal in stabilising fluctuations in output produced by demand shocks. This forces the central bank to attach greater value to other signals (the output gap and other "real" indicators of the business cycle). Thus, a central bank like the ECB with a low inflation objective, but a mandate also to maintain high levels of employment and output, should give more weight to "real" signals of economic activity than central banks with a higher inflation target. We conclude that the reinterpretation the ECB has given to its dual mandate is not only unsound from a legal point of view but also from an economic one.

Figure 26: Different inflation-targets central banks



A second problem that arises with the objectives pursued by the ECB has to do with its practical implementation. The ECB has interpreted the objective of price stability to mean that inflation should be held within a band of 0% to 2%, over the medium run. It can be argued that this band is *too low* and *too narrow*.

There are several reasons why the *maximum* inflation of 2% pursued by the ECB is too low[1]. First, as economists have argued, some inflation is good for the economy in that it works as a lubricant and allows for more flexible adjustments in real wages. This analysis has been popularised recently by Ackerlof and Perry (2000). More flexible real wages in turn reduce the equilibrium level of unemployment. This analysis calls for a rate of inflation of 2 to 3% a year. By announcing a *maximum* of 2% the ECB is targeting a rate of inflation, which according to this view, is below the optimal level, thereby increasing the rigidities in the economy. This view leads to the conclusion that the pursuit of too low a rate of inflation increases unemployment structurally (see also Wyplosz, 2001) on this).

It should be stressed that this view is not shared by all economists (see Issing, 2001). The critics have argued that the money illusion, which underlies this view, may very well disappear in a new regime of low inflation, thereby eliminating the need to have positive rates of inflation in order to “lubricate” the system.

A second reason for arguing that the 0-2% band is too low is that the ECB is pushing the inflation rate too close to zero, thereby increasing the risk that inflation may drop below 0% at some point. We know from historical experience (and also from the recent experience of Japan) that falling prices are dangerous and that they can push the economy into a deflationary spiral. Once in such a spiral it is difficult to extricate the economy from it.

A third reason is related to the previous one. If the ECB is successful in pushing the inflation rate of Euroland within the 0 to 2% band it is almost inevitable that, since this inflation rate is an average of national inflation rates, the rate of inflation drops below 0% in some countries. This may then set in motion deflationary forces in these countries that are difficult to control (see Sinn and Reuter, 2001). This problem could be exacerbated by the Balassa-Samuelson effect. This is that less developed countries that experience high productivity growth in their tradable goods sector find that the resulting (non-inflationary) wage increases in the tradable sector spread to the non-traded sector, even though productivity in the latter is not keeping pace. As a result CPI inflation will tend to be higher in these countries than the CPI inflation in the more mature member countries. Put differently, the existence of Balassa-Samuelson effects increases the differences in national inflation rates, thereby increasing the risk that some countries’ inflation rates are pushed below 0%.

Finally the low inflation target of the ECB produces a bias against acting quickly to counter recessionary forces. This was made clear in 2001 when the ECB waited to lower the interest rate because the inflation rate was still above the 2% limit. The US Fed, which does not have such a low inflation target did not feel inhibited from acting quickly[2].

2.2 Optimal inflation rates

The arguments in favour of some positive inflation are illustrated graphically in the following figures. In figure 27 we show the costs and benefits of inflation. The cost curve represents the costs resulting from misallocations, inefficiencies and uncertainties produced by increasing rates of inflation (the "sand effect" of inflation). The most visible (but not exclusive) way these costs manifest themselves is by lower rates of investment and lower rates of economic growth. This cost curve is drawn in a highly non-linear way because the empirical literature suggests that for high rates of inflation these costs are quite substantial, whereas for low rates of inflation (say less that 10% per year) researchers have been unable to detect much. Thus a move from, say, 2% to 4 % inflation will not lead to increasing costs, but a jump to, say, 20% results in significant cost increases.

The benefit curve is the sum of two components, which we represent in figure 28. One is the credibility bonus, which is at its maximum when inflation is zero. With increasing inflation this credibility bonus declines exponentially. The second component is the benefit resulting from the "lubricant effect" of inflation, i.e. the greater flexibility in real wages provided by inflation. This effect tends to taper off, and even decline when inflation increases too much (see Akerlof, Dickens and Perry(2000) and Wyplosz(2001)). The sum of the two components is the benefit curve that is also used in figure 27.

The confrontation of costs and benefits in figure 27 then leads to the view that there is an optimum rate of inflation π^* greater than zero for which the difference between benefits and costs is at its maximum.

The view represented in figure 27 is not shared by all economists. There is an alternative view which can be called the "New Neo-Classical" (NNC) view which is also the ECB-view (see Goodfriend and King, 2001). We represent this alternative view, in figure 29. The main difference is that in figure 29 the existence of a "lubricant" effect is denied (see Issing, 2002). As a result, the benefit curve declines exponentially, so that the optimal rate of inflation is zero. One remarkable aspect of this view is that its proponents rarely advocate a zero inflation target. Not only because there could be a statistical bias in the measurement of inflation, but also because there is a zone, called "terra incognita" of deflation about which we know very little except that it is very unpleasant, possibly catastrophic. For the proponents of the ECB-NNS view there is some feeling that it is safer to keep some distance from this danger zone, despite the fact that their analysis calls for targeting a zero rate of inflation.

Figure 27: Costs and benefits of inflation

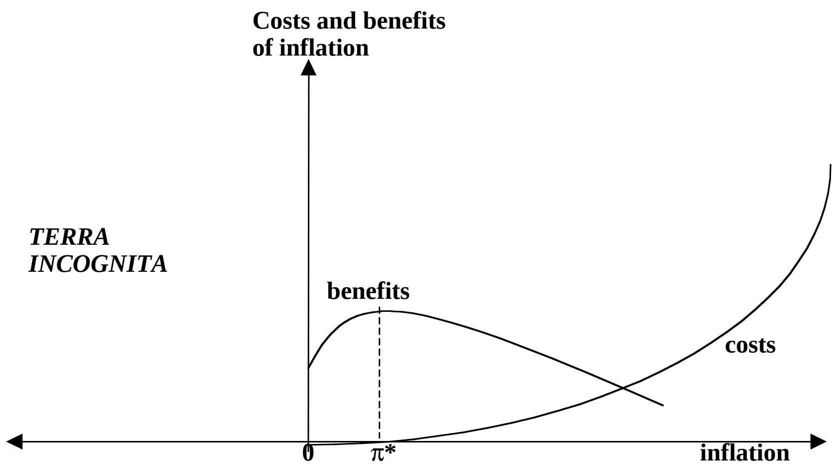


Figure 28: Benefits of inflation: lubricant and credibility

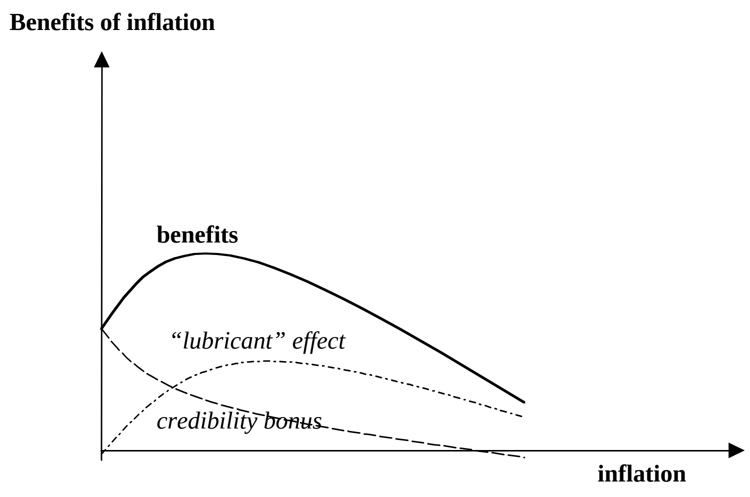
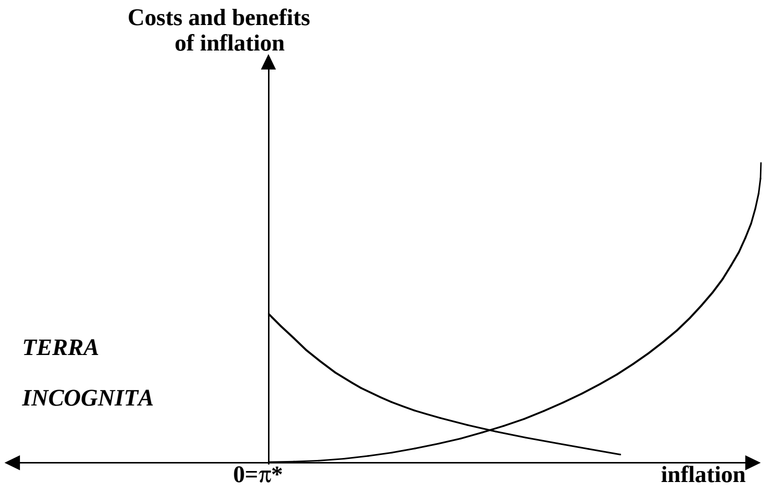


Figure 29: NNC-ECB view



Let me summarise what we know and what we do not know about the costs and benefits of inflation.

First, we know that very high inflation is very bad, not only for economic growth but also more generally for social and political stability.

Second, deflation is also very bad, although we understand the deflationary dynamics less well. But horror stories of the 1930s are strong enough to make us fear deflation.

Third, we know very little about the intermediate zone of low inflation. There are conflicting theories about the shape of the benefit curve, and the empirical evidence if it exists is not very reliable. In addition, although we are sure that with high inflation the costs become substantial, we know very little about the question of when these costs start to matter. Do these costs become visible when inflation exceeds 2%, or 5% or 7%. Nobody knows, because the empirical evidence for this low inflation range is simply not available.

This uncertainty has a number of implications for monetary policies. First, it implies that we beware of too much precision in setting the target for the inflation rate. When knowledge is imprecise it is generally not a good idea to pretend we possess precise information. Such an attitude can lead to a situation where systematic errors are made, and we would not even be aware of it.

Second, some flexibility is called for. When we do not know what the optimal inflation rate is, it is generally a good idea to keep one's options open by being flexible about the target.

Does the ECB asymmetric inflation target (inflation should be at most 2%) correspond to these two principles? My answer is no. The ECB asymmetric inflation target imposes the wrong type of precision. By restricting the possible inflation rates to the 0%-2% range it denies that the optimal inflation rate could be higher, although the scientific evidence about this is unclear. In fact the range is even smaller since the ECB has acknowledged some statistical bias in measuring inflation. If this is, say, 0.5% then the target range is even smaller[3] i.e. 0.5 to 2%. This is an example of too much precision. We simply do not know enough to be sure that this is the correct range to aim for.

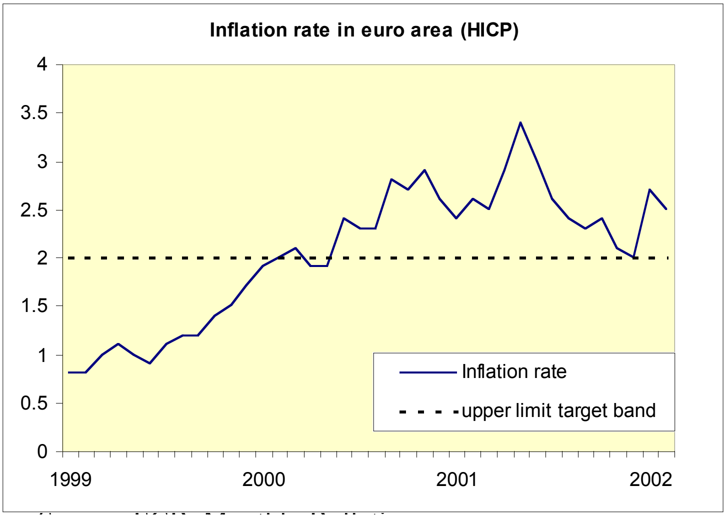
The 0% to 2% band is *too narrow* for another reason. The economy is often subjected to shocks making a precise control of the rate of inflation very difficult. The narrower the band, the less often the rate of inflation will be observed within the band. A narrow band therefore creates an issue of credibility. The ECB may face this problem. The 0% to 2% band makes it quite likely that the observed inflation will be outside the band much of the time raising questions about the credibility of the strategy. This may already be a problem. Since the start of EMU on January 1 the observed monthly rate of inflation has been outside the target band more than 60% of the time (see figure 30).

This criticism of the inflation target of the ECB calls for the formulation of a different target. One such new target band policy could be to define the target of 2% as the midpoint of a band of 3%, i.e. 1.5% below and above the midpoint[4]. Such a target comes closer to what is now considered to be the optimal rate of inflation and the margin is wider allowing the ECB to follow a more credible strategy.

It should be stressed that this proposed new target range will not undermine the anti-inflationary credibility of the ECB. Instead of a target range that the ECB has been unable to keep, the new target range is realistic and therefore more credible. In fact the formulation of this target would have allowed the ECB to maintain the inflation rate within the target band most of the time. It also comes closer to what other major central banks are doing today.

The previous discussion also calls into question the *goal* independence of the ECB. The literature on central bank independence has made a distinction between *goal* independence and *instrument* independence. There is a wide consensus that the central bank should enjoy instrument independence. There is much less consensus about goal independence. In fact, in several countries (e.g. the UK) the central bank enjoys instrument independence, but not goal independence, i.e. the government fixes the target and leaves the central bank then free to decide how best to achieve this target. This is a model towards which the ECB will probably have to move.

Figure 30: Inflation rate in the euro area



Source: ECB, Monthly Bulletin

2.3 The instruments

The ECB has been very much influenced by the Bundesbank legacy which itself was much influenced by the monetarist analysis made popular by Milton Friedman, i.e. that inflation is always and everywhere a monetary phenomenon. This view has led the ECB to give a prominent role to money in its monetary policy strategy (the so-called first pillar). In particular it has led to the formulation of a reference value for the growth rate of money (M3) of 4.5% that should not be exceeded. The ECB is careful in stressing that this reference value should not be applied mechanically[5]. Nevertheless it is striking that the ECB is now the only central bank in the industrial world giving such prominence to money in the formulation of its monetary policy strategy. All other central banks have, with good reason, abandoned this approach. There is a great deal of evidence that in a low inflation environment and in a world of frequent financial innovations the money supply numbers are very unreliable as signals of future inflation. Giving prominence to money can lead the central bank to make the wrong move.

The problem with much of the empirical research about the long run relation between money growth and inflation is that it includes a lot of observations on *periods* of relatively high inflation (in time series analysis) or on *countries* with high rates of inflation. This problem is well illustrated in the following cross-section evidence (figure 31). It shows a very tight relation between the 30-year average of inflation and money growth in a sample of more than one hundred countries. Subjecting this kind of evidence to regression analysis invariably finds that the hypothesis of strict proportionality between inflation and money growth cannot be rejected and that most, if not all, of the differentials in inflation between countries can be explained by differentials in money growth. This kind of cross-section evidence has now invaded textbooks to show that the evidence in favour of the quantity theory is overwhelming. (See for example, Parkin, Powell and Matthews, 2000).

When one looks at a subsample of countries with low inflation, things get fuzzier. We show this in figure 32 where we present a subsample of countries, which have experienced an average rate of inflation of 5% or less during 1970-1999. We observe now that there is very little relation between inflation and money growth in these 'low'[6] inflation countries. Put differently, long-term sustained differences in money growth between countries are uninformative about the differences in their rates of inflation, nor is the finding altered when one corrects for differences in the growth of output[7].

It is not difficult to understand this result. Money supply statistics are full of noise. In a low inflation environment where inflation is only a few percent a year, the observed differences in the money supply growth numbers contain mostly noise, and say little about differences in monetary policies (the signal).

All this confirms what many critics have been saying about the first pillar of the ECB monetary policy strategy, i.e. that the prominence given to money in guiding monetary policies is mistaken (see e.g. Svensson, 2001). Given that it is the ambition of the ECB to keep the rate of inflation below 2%, success on the inflation front will make the yearly money growth numbers even less informative about the inflationary potential in the economy than appears from figure 32, because the noise to signal ratio will be even higher.

In fact the ECB is aware of this problem. Since 1999, the growth rate of money (M3) has been above the target most of the time. The result has been that the ECB has had to ignore the money supply numbers most of the time. This leads to a credibility problem. The ECB announces a target for the money growth but in fact does not take this target into account in its policy decisions. In doing so, it gives signals about its intentions, which it then fails to follow. This is bound to harm the credibility of the ECB.

Figure 31: Inflation and money growth in a sample of more than one hundred countries

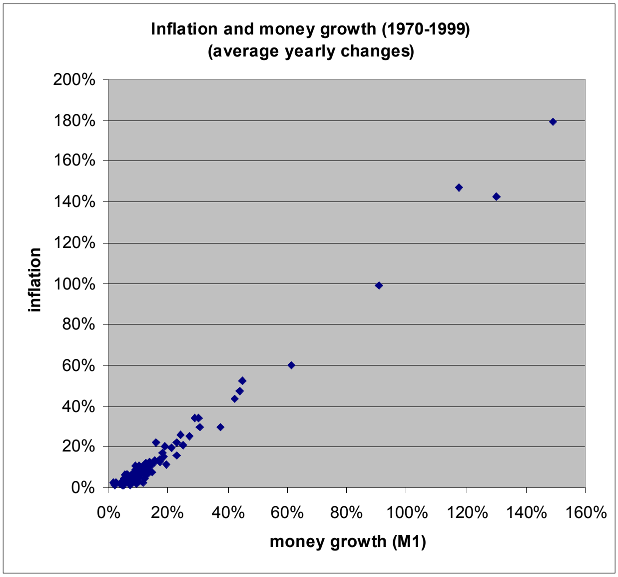
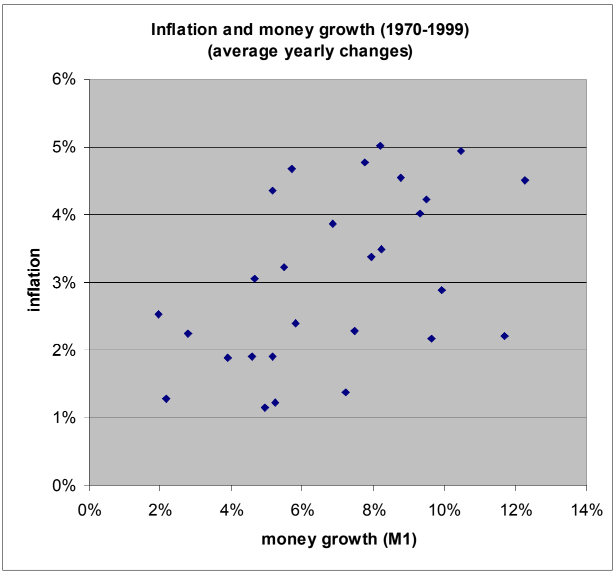


Figure 32: Inflation and money growth in "low" inflation countries



Source: IMF, International Financial Statistics, CD-Rom, Aug. 2001

In order to avoid this credibility problem in the future, the ECB will have to amend its “two-pillar” strategy and to drop the prominence it gives to the money stock in its monetary policies. As in the case of the inflation target, this will allow the ECB to gain in credibility. It will not be put in the uncomfortable situation anymore in which it has to explain all too often why it does not want to take the latest money growth numbers seriously.

In contrast to the ECB, the US Fed has learned this lesson. Since the second half of the 1980s it has systematically downgraded the importance of money growth numbers. Today, these numbers play almost no role in setting monetary policies. This has saved Greenspan the trouble of having to explain with a great degree of frequency why the money growth targets were not met.

3. The challenge of enlargement

The most important challenge facing the European monetary union is the enlargement with ten countries from Central Europe and with Malta and Cyprus. This enlargement creates two problems that have to be tackled. The first problem has to do with the effectiveness of monetary policies in the enlarged EMU; the second problem relates to the institutional reforms that will have to be introduced to make the system workable.

3.1 Is the enlarged EMU an optimal currency area?

With a potential of 27 members of EMU instead of the present 12 the challenge for the ECB to conduct monetary policy in an effective way will increase. The reason is that in such a large group the probability of “asymmetric shocks” will increase significantly. Thus some countries may experience a boom and inflationary pressures while at the same time others experience deflationary forces.

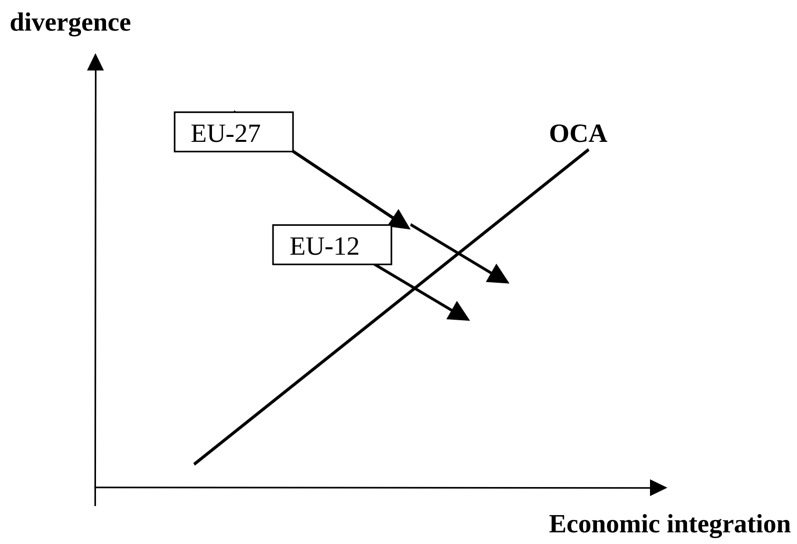
It has sometimes been argued that with the intensification of the integration process the potential for asymmetric shocks will abate. Maybe, maybe not. An optimistic view is represented graphically in figure 33. On the vertical axis we set out the degree of asymmetry of shocks between clusters of countries. We call this divergence. On the horizontal axis we set out the degree of economic integration among these countries. All the points to the right of the OCA line are points where clusters of countries form an optimal currency area, i.e. the benefits exceed the costs. The OCA line is upward sloping for the following reason. More divergence makes a monetary union more costly.

Conversely, more integration reduces the costs (increases the benefits) of a monetary union. As a result an increase in divergence must be compensated by more integration to make a monetary union worthwhile (in terms of costs and benefits).

The downward sloping arrows give us the dynamics of the relation between integration and divergence. In the optimistic view we present here, when clusters of countries integrate more they face less asymmetric shocks, and thus less divergence. The negative slope comes from the fact that economic integration increases intra-industry specialisation, which tends to make the economic structures of countries more alike.

In figure 33 we represent two clusters of countries. The EU-12 (the present Euroland) is assumed not to be an optimal currency area as yet[8]. However, the dynamics of integration (which is stimulated by the monetary union itself) moves it down along the arrows so that it will soon reach the OCA-zone. Here, the costs for individual countries of being subjected to asymmetric shocks and not being able to use one's national monetary policies to deal with them are small compared to the benefits of the union. In this zone the constraints imposed by a monetary policy that must fit all sizes are not perceived to create unacceptably high costs.

Figure 33: Degrees of divergence and of economic integration - the optimistic scenario



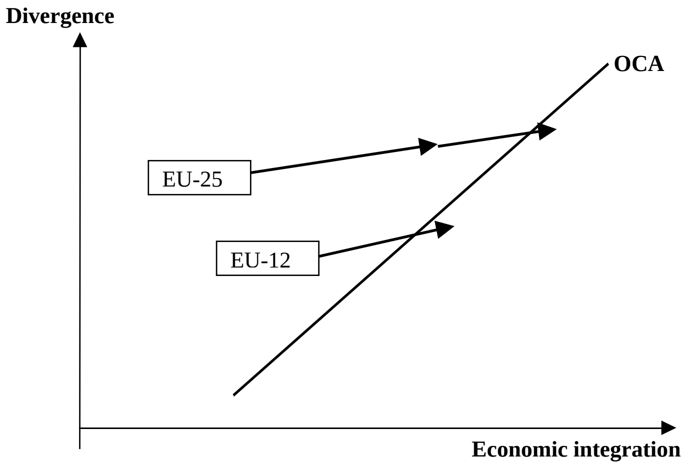
Consider now what happens when other countries join Euroland. We represent the full cluster of countries (of Euroland and newcomers) by EU-27. It is reasonable to assume that this cluster of countries will be located higher up on a downward sloping line, reflecting the fact that EU-27 is less well integrated than EU-12 and that it faces more asymmetric shocks.

The important insight from this analysis is that the original members of Euroland (who are also part of EU-27) will now have to wait longer until they reach the OCA zone[9]. Practically this means that since in the enlarged Eurozone the shocks are more asymmetric than in the original one, some of the original members will more often than today be outliers (in terms of inflation and output) compared to the average that the ECB will be focusing on. As a result, these members will perceive the policies of the ECB to be less receptive to shocks than it did before the enlargement. Some of the original members of the Eurozone may then find that the cost-benefit calculus about monetary union has become less favourable.

This analysis is not very much affected if we assume a pessimistic scenario about the relation between integration and asymmetric shocks. We show this case in figure 34. We now assume that the relation between integration and divergence is positively sloped, i.e. as clusters of countries integrate more, they become less alike, and therefore they are subjected to more asymmetric shocks. This scenario may prevail when the integration process leads to agglomeration effects that are induced by economies of scale (see Krugman,1993).

In this pessimistic scenario, the major conclusion of the previous sections still holds: the enlargement sets back the movement towards the OCA zone. As a result, countries that now consider the cost benefit calculus of monetary union to be favourable may very well think differently in an enlarged union. While today most of the members of Euroland probably find that the interest rate decisions of the ECB are consistent with their national economic conditions most of the time, this may no longer be the case in an enlarged EMU. It will happen more frequently that some countries consider the monetary stance taken by the ECB to be inappropriate to deal with the economic situation of the moment. As a result, the perceived costs of the union will increase relative to the perceived benefits of the single currency. Such a situation is bound to produce tensions both inside the decision making process of the Eurosystem as well as outside the system when some countries feel that their economic interests are not well served by the ECB.

Figure 34: Degrees of divergence and of economic integration - the pessimistic scenario



There is very little the ECB can do about this. By its very nature a monetary union implies that the power to set interest rates is transferred to a common central bank which can only set one interest rate. Fine-tuning of the interest rate to cater for different national economic conditions is made impossible. This is the price the members of the union pay for the benefits they obtain from the existence of one currency.

The only way to deal with these issues is to make sure that individual member countries have the instruments to deal with these asymmetric developments. In this context progress towards reform of the labour markets aiming at making these more flexible is of great importance. Flexibility is one of the major instruments available that allow eurozone countries to adjust to asymmetric shocks. In addition, a move towards budget balance will allow countries to exploit the margins of flexibility provided by the stability pact so that the automatic fiscal stabilisers can operate fully.

3.2 Enlargement and institutional reform

Enlargement is bound to have important implications for the decision making process within the Eurosystem. The present system is characterised by equal representation of each member country in the Governing Council through the presidents (governors) of the national central banks. When, like today, the number of countries is limited to twelve, such a system can work satisfactorily. If twenty seven countries have a representative on the Governing Council achieving a consensus about the stance of monetary policy will be much harder than today[10]. This is due not only to the larger numbers of persons involved in such a system, but also because, as we argued earlier, there will be more asymmetric developments in an enlarged euro zone. These asymmetries will necessarily lead to different perceptions among the national governors about what the most appropriate course of action is for the euro zone as a whole.

The problem can be illustrated using a very simple model in the following way. In figure 35 we present the interest rates that are desired by the twelve governors of the Eurosystem. We take the view that there are asymmetric developments leading each governor to compute an interest rate, which is optimal for his own country[11]. Thus each governor desires a different interest rate to prevail in the Eurosystem and we assume that these desired interest rates are distributed uniformly between 3% and 4.1%. This is shown by the horizontal line. Figure 12 also shows the relative size of each country as measured by GDP. For example, Germany's GDP represents 30% of the total and Germany desires an interest rate of 3.4%. We make the further assumption that the ECB Board (6 members) has the same desired interest rate and that this is obtained by an analysis of the euro-wide economic conditions. Thus the ECB-Board computes the optimal interest rate using the Eurosystem wide average of inflation and output. This implies that the ECB-Board takes a weighted average of the nationally desired interest rates, where the weights are the GDP-shares[12]. This yields the result that the ECB-board desires an interest rate of 3.5%. Thus, 7 members of the Governing Council (6 Board members and one governor) desire the same 3.5%. This feature produces a peak in the distribution of desired interest rates around 3.5%.

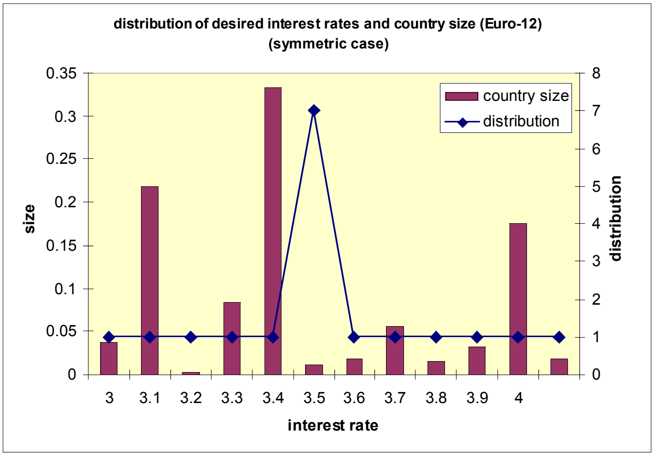
It is now obvious that the ECB-Board will have a strategic position in the decision making process. It will have to find only two extra votes to have a majority for its interest rate proposal. These can easily be found among the two governors that are close to the ECB-board's desired interest rate. Note that it will be very difficult for other coalitions to beat the ECB-board's proposal because such a coalition would have to span both those governors who desire a higher interest rate and those who desire a lower one. The nice thing about this result is that the Governing Council will select the interest rate that is optimal for the system as a whole, even if each national governor is only concerned about the economic conditions prevailing in his country. It is clear that if the national governors disregard the national economic conditions and care only about the Eurosystem's average economic conditions (as they claim they do) the result will be the same. Thus whether the national governors care about the

Euro-wide economic conditions or not does not make a difference.

The previous description is nothing but an application of the median voter theorem. The ECB-Board which is averaging the desires of national governors will be close to the desired interest rate of the median governor, (at least if these desires are symmetrically distributed). In a majority voting system the median voter's preferences prevail.

Note that since the strategic position of the ECB-Board is so powerful, it is unlikely that the members of the Governing Council will come to explicit voting. Everybody is aware that whatever the Board is proposing will almost certainly find a majority.

Figure 35: Distribution of desired interest rates in the eurozone (symmetric case)



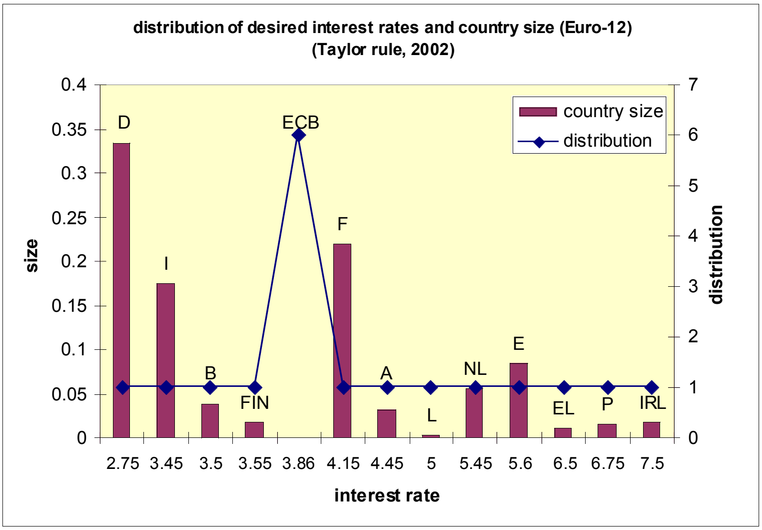
How is this result affected by other distributions of the desired interest rates? In order to analyse this question we computed the desired interest rates using a Taylor rule on real economic data for the year 2002. Thus each central bank computes its desired interest rate using the following Taylor rule

$$r^*_t = \rho + \pi^* + a(\pi_t - \pi^*) + b\, x_t \qquad (1)$$

where r^*_t is the desired interest rate, r is the long term real interest rate, π^* is the inflation target and x_t is the output gap. We assume that each governor uses the same Taylor rule (expressing identical preferences). The only difference between the governors is that their national inflation rates and output gaps differ. The ECB-Board does the same exercise, using the euro-wide averages of these two variables. We set $\rho = 3\%$; $\pi^* = 2\%$; a = 1.5 and b = 0.5. The latter two coefficients have often been found to have such orders of magnitude. (See Alesina, et al. (2001)). We applied the exercise to the year 2002 using OECD, Economic Outlook.

We show the result in figure 36. We now find that the ECB-Board's desired interest rate (3.86%) is different from the median desired interest rate (which is between 4.45 and 5%). This follows from the fact that the large countries experienced slow economic activity in the year 2002 compared to the other, mostly smaller countries, and that the former have a large share in the averaging procedure applied by the ECB-Board. Thus the ECB-Board desired interest rate is relatively close to the desires of the large countries which represent about 70% of the euro area's GDP.

Figure 36: Distribution of desired interest rates and country size (Taylor rule, 2002)



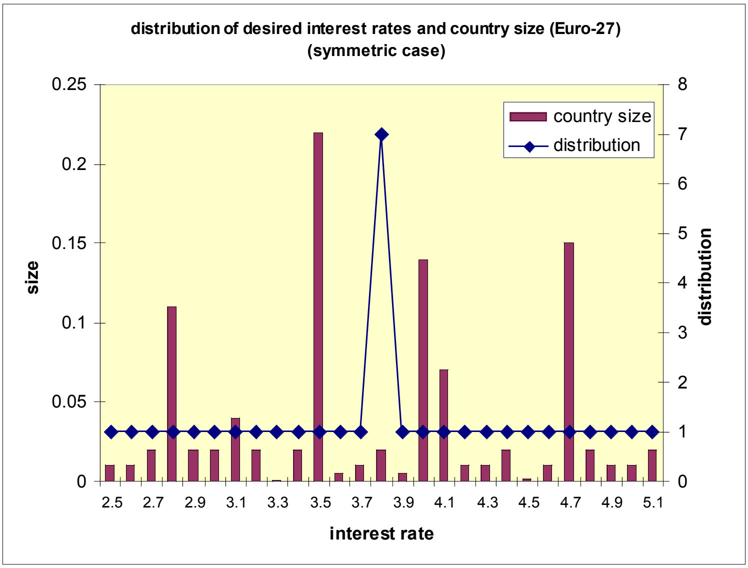
It can now be seen that despite the fact that the ECB-Board's desired interest rate diverges from the median, the ECB-Board should have few difficulties in forcing its desire to pass in the Governing Council. All the Board has to do is to find three votes for its proposal. It will likely find it among the three central banks whose desired interest rate is close to 3.86%. In this example this is the French and the Finnish governor. In addition, despite the asymmetry in the distribution there are only 8 governors available for a coalition in favour of a higher interest rate than 3.86. In order to beat the ECB-Board's proposal 10 votes are necessary.

We conclude that in the present situation the ECB-Board has a strategic position within the Governing Council, which is maintained even when the distribution of desired interest rates is different among large and small countries, as happened in 2002. As a result, the decision making process within the Governing Council ensures that the interest rate that will be decided is the optimal one from the point of view of the Eurosystem as a whole.

Things will be very different in an enlarged Eurosystem. We first present figure 37 which is similar to figure 35 and which presents the distribution of desired interest rates in the enlarged Eurosystem consisting of 27 members. Thus the Governing Council consists of 33 members, which means that an interest rate proposal must have 17 votes to obtain a majority. We first assume that the distribution of the desired interest rates among small and large countries is approximately symmetric. As before, the ECB-Board computes the desired interest rate for the Eurosystem as a whole (the weighted average of the nationally desired interest rates).

A first thing to observe is that the ECB-board's strategic position is weakened. It will now have to find 11 governors to back its proposal for its desired interest rate of 3.8%. Since one governor has the same desired interest rate of 3.8%, ten governors with different desires must be found to obtain a majority.

Figure 37: Distribution of desired interest rates and country size in the euro-27 (symmetric case)

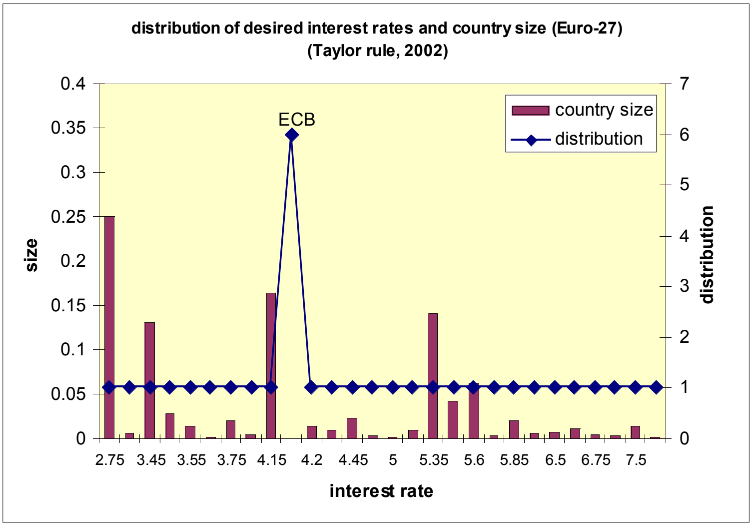


Despite the fact that the ECB-board must make a greater effort to find the backing for its proposal, it can also be seen that the ECB-board still has a strong position. The reason is that its proposal (the mean) is very close to the median proposal. As a result, coalitions to defeat the ECB's proposal will be difficult to find. For example, the number of governors in favour of an interest rate higher than 3.8 amounts to only 13 (remember that one needs 17 votes to form a majority). Similarly the governors desiring less than 3.8% can only muster 13 votes. Thus, the ECB-Board will most likely be able to find a majority.

We construct the asymmetric case in a similar way as in figure 35, i.e. using the same Taylor rule as in equation (1) using data for 2002. We did this for the present members of the Eurosystem and for the UK, Denmark and Sweden. For the accession countries we lacked data on output gaps. We, therefore, assumed that the desired interest rates of the accession countries would be distributed uniformly within the same range as the one obtained for the other countries. We assumed, however, that because of a Balassa-Samuelson effect, the observed inflation rates in accession countries are 0.5% above the inflation rates of the other countries.

The result is shown in figure 38. Our results are now very different. The difference between the ECB-board's desired interest rate, 4.18%, (the mean) is now significantly lower than the median desired interest rate, 5%. As a result, a coalition of mostly small countries desiring a higher interest rate than 4.18%

Figure 38: Distribution of desired interest rates in the euro-27 (Taylor rule, 2002)



can now be found, thereby defeating the ECB board's proposal[13]. It is therefore possible that an interest rate decision is made that suits the interests of a coalition of small countries that represent a small fraction of the Eurosystems's GDP. In the example of figure 38, this coalition represents only 34% of the GDP in the Eurosystem. This interest rate would not be optimal for the Eurosystem as a whole. If such a scenario were to materialise it would likely lead to grave conflicts within the Eurosystem. It is by no means implausible, because the Taylor rule used for EU15, captures reasonably well what central banks desire and the Balassa-Samuelson effect we assumed for accession countries is relatively small.

The problem we have identified can be summarized as follows. In the present set-up the ECB Board has a strategic position in the decision making process within the Eurosystem. This ensures that the interest rate decisions are made on the basis of the needs of Euroland as a whole. This is so even if the national governors are guided by the economic conditions that prevail in their own countries. It holds *a fortiori* if the national governors only take euro-aggregates into account in their decisions. Since the large countries (Germany, France, Italy) represent about 70% of the total, this decision making model also ensures that the large country's interests are relatively well served, despite the overrepresentation of the small countries in the Governing Council. Because of the strategic position of the ECB-Board a consensus can usually be reached easily around the interest rate proposals made by the Board. As a result, formal voting is usually not necessary.

In an enlarged Eurosystem this consensus model is likely to break down. The reason is that the ECB-Board will loose its strategic position. As a result, winning coalitions of small countries will become possible and national governors will face greater temptations to take into account national economic conditions in the decision making process. It follows that in an enlarged Eurosystem, the Board will be confronted by the possibility that its interest rate proposals will be overruled by coalitions of small countries who experience economic conditions different from the average (which is dominated by the large countries). This will create the possibility that interest rate decisions will be made on the basis of economic conditions that prevail in a relatively small part of Euroland. This is bound to lead to grave conflicts within the Eurosystem.

The essence of the problem is that the small countries are over-represented in the Governing Council and this over-representation will be aggravated in an enlarged Eurosystem. To lessen the risk that small countries in the Governing Council over-ride the Board's strategic position the over-representation of small countries would have to be reduced. This can be achieved in several ways. We discuss some possible formulas[14].

- The US Fed formula: this consists in allowing all governors to participate in the deliberations of the Governing Council but to restrict the voting rights to a limited number of governors (e.g. ten) on a rotating basis.
- The IMF formula: this consists in having small countries group together in constituencies and be represented by one governor.
- The centralised formula: this consists in restricting the decision making to the Executive Board of the ECB. Today the Board consists of six members. In this formula there is some scope for expanding the size of the Board.

The third formula is probably too drastic. The advantage of the first formula is political. By introducing a system of rotation in the voting, one does not have to discriminate between small and large countries. The effect on the outcome will be broadly the same whether it is small or large countries, which are allowed to vote since this rotation system reinstates the strategic position of the ECB-Board. Large countries, however, may not like this solution. As a result, a combination of the first and second formula could be a reasonable compromise whereby groups of smaller countries delegate one of their governors on a rotating basis[15].

4. Conclusion

The introduction of the euro has been spectacularly successful. This success should not make us complacent. The challenges ahead are formidable as well. We have argued that although the record of the ECB is a positive one, some changes in its monetary policy strategy are required. At present there is too large a discrepancy between the announced policy strategy and the policy actions of the ECB. This discrepancy hurts the credibility of the ECB. For example, in its monetary policy strategy the ECB claims that the growth rate of M3 (the first pillar) is the most important signal it is looking at, and yet the facts show that it barely takes money growth into account. In order to gain credibility, the ECB will have to abandon the importance it gives to money growth numbers.

A similar credibility arises with the ECB's inflation target. It has been set unrealistically low. As a result, the ECB has not been able to keep its promise of maintaining the rate of inflation below 2%. This hurts the credibility of the ECB, and may also be damaging to the real economy.

We also discussed the major challenge of enlargement. to a zone of potentially twenty-seven countries which will affect the effectiveness of the ECB in maintaining monetary and financial stability within the euro zone. This is so for two reasons. First, the enlargement is likely to change the perceptions of costs and benefits of the union for the present members of Euroland, increasing the costs relative to the benefits. Consequently, countries will face more often than today the possibility that ECB interest rate decisions do not reflect their national interests. There is very little the ECB can do about this. As a result, the pressure on countries to increase labour market flexibility will increase, which for most people in the labour market is not a comfortable prospect.

Second, enlargement creates the risk that the ECB-Board will loose its strategic position and that the interest rate decisions will stop representing the needs of Euroland as a whole. This could create strong conflicts within the Governing Council, and may necessitate a streamlining of the Governing Council to reduce the weight of the small countries in the decision making process. The challenges ahead are serious but can be overcome, provided timely reforms are undertaken.

NOTES

[1] Note that since the ECB considers 2% to be a maximum it must be targeting a rate of inflation below 2%.

[2] In Begg et al. (2002), it is argued that although the ECB reacted slowly to the emergence of the recession of 2001, it did reduce the interest rate in the end in a way that the Fed, had it experienced the same shock as in Europe would probably also have done.

[3] The Boskin report estimated this bias in the US to be between 0.8 and 1.6 % see Boskin Report (1996). There are no comparable estimates in Euroland, but it would be surprising if the bias were very different from the US one.

[4] It should be pointed out that some central banks, e.g. the Bank of England, do not have a formal band. We do not go into the issue here of the merits of formal versus informal bands.

5 For a thorough analysis and justification of the ECB two-pillar monetary policy strategy see Issing, et al. (2000).

[6] Many central bankers today would not call a yearly rate of inflation of 4 or 5% maintained during thirty years a low rate of inflation. If we restrict our subsample of low inflation countries to those countries with inflation less than 3% a year, the absence of a link between inflation and money growth is even more striking.

[7] See De Grauwe and Polan (2001), De Grauwe and Grimaldi (2001).

[8] As will become clear this assumption does not diminish the power of the arguments we are making here.

[9] If the EU-12 is in the OCA-zone when enlargement occurs, it will no longer be after enlargement.

[10] See Baldwin et al. (2001) for a detailed analysis of the decision-making problems in an enlarged European Union.

[11] Officially the governors are not supposed to do this. It is doubtful, however, whether governors do not take the national economic conditions into account. There is interesting evidence that even in the US Fed, regional interests play a role in monetary policy decisions. See Meade and Sheets (2002).

[12] See Aksoy, De Grauwe and Dewachter (2002).

[13] This does not mean that such a coalition will necessarily be found. The point is that it is now a serious possibility.

[14] For a detailed discussion of these various proposals, see Baldwin et al. (2001).

[15] It is unclear, though, whether this solution is consistent with the Nice Treaty which says that the rebalancing of the votes should not introduce discriminations between countries.

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