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The Euro: The issues for the future

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The Euro: The Issues for the Future

by Horst Siebert

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- The euro is a new currency, and the ECB as a new institution still has to establish its reputation. The best way to do this is for the ECB to deliver a stable money. The two-pillar strategy pursued by the ECB seems to confuse the markets because market participants are unclear about which of the two pillars is the dominating one. The ECB will have to rethink its strategy and move more in the direction of the monetary targeting approach.
- A central bank cannot have two nominal anchors for its currency, both the internal price level and the external value of a currency. Admittedly, a low external value may translate into inflationary expectations or expectations on further depreciations. These effects cannot be neglected by the ECB. Therefore, it has to factor in the impact of depreciation on the future price level.
- Member countries of the common currency area may free ride on the common currency. Although a Minhas Gerais problem in the European Monetary Union is unlikely, countries with high indebtedness may put pressure on the ECB to follow a rather lax monetary policy characterized by low interest rates and a (slightly) higher inflation rate than the one anticipated by financial markets. The stability pact has to shield the ECB against such pressures.
- National economic policies in the three major continental countries, Germany, France, and Italy, have severe difficulties in establishing the necessary institutional conditions in the national labor markets for a smooth functioning of the common currency. Interest groups in the member countries will defend their political position and will resist necessary institutional changes. Wage policy should be decentralized and not europeanized. Employment policy should not be europeanized either.
- In attracting new members, care must be taken not to increase the heterogeneity of the monetary union. This relates to the candidates for new EU membership; they will need the exchange rate for quite some time. For the UK, only a short time window in which the business cycle in the UK and that in EMU are in a similar phase will allow entry.
- Two types of conflict have to be distinguished: "Type-1 conflict" is a conflict between the monetary authority and politics on the weight that should be assigned to a stable money or to other targets. "Type-2 conflict" is a conflict between national political decision-making and the europeanized monetary policy in the case of a major national economic crisis. The worst case that can be envisioned for the new monetary arrangement is a fundamentally divergent economic situation in a major country while at the same time the other economies in the rest of euroland are doing fine. An ingredient of such a scenario would be a major national crisis, for instance a homemade crisis due to severe policy failure. Such a major crisis will be the real test for the euro.
- Politics has to accept the depolitization and the denationalization of the common monetary policy. Relying on goodwill may not be sufficient to solve potential conflicts. Mechanisms have to be developed that make sure that goodwill is not the only basis for withstanding a major crisis. One way is to change the democratic set-up of political decision-making by giving more weight to European aspects. This raises severe questions which relate to the political concept for Europe and its federal structure, to the issue of a European constitution, and to the very basic question whether a European sovereign — a European people — is beginning to exist. Another approach is to create a European audience for the ECB's policy as well as for economic policy issues in general. Establishing a European Council of Economic Advisers is a step in this direction.

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The Euro: The Issues for the Future

The euro has passed its freshman test after the first year of its existence. The transition to the new monetary regime was smooth, the monetary policy instruments have proven to be satisfactory, the new currency is well off the ground operationally, and the expansion of the European bond market can be seen as a first major positive impact of the euro. The open questions that remain may be teething problems of the young baby. Nevertheless, at this stage, the market participants do not have the new currency in their hands yet, and with the euro representing a new institutional regime, some stumbling blocks lie along the future road. Monetary integration is a process, and some aspects of the new institutional arrangement, especially of its implementation, are not yet completely settled. To look out for the stumbling blocks or the issues for the future means identifying the conditions for success of the new European common currency.

In the following I distinguish stumbling blocks that are engendered by monetary policy *per se*, traps that arise from the lacking preconditions in the institutional environment to the common currency as well as from political pressure on the ECB, and finally the ultimate booby trap that may be hidden in a conflict between the two levels of decision-making, one for monetary policy on the European level and the other for political decision-making on the national level.

I. Potential Stumbling Blocks from Monetary Policy Per Se

1. *A major issue for the euro arises if the ECB fails to establish its reputation.*

The euro is a new currency, and the ECB as a new institution still has to establish its reputation. The best way for the ECB to do this is to deliver a stable money to the market participants. It has set its price level target at below 2 percent. This is appropriate in order to define the target of price level stability. Especially as a new institution, the ECB did not really have the option to use a more loose definition of price level stability. The price level relates to the Harmonised Index of Consumer Prices (HICP) in euroland. This is also appropriate.

Monetary strategy. With respect to the monetary strategy, different options have been proposed to the ECB: inflation targeting and monetary targeting. Inflation targeting implies a forecast on what the price level will be in two or three years, starting with a given economic situation and applying a set of monetary policy instruments. Whereas the notion of the future price level is central to any monetary policy strategy (because monetary policy instruments only have a lagged impact on the price level), the credibility of an inflation targeting strategy hinges very much on the quality of the forecasting exercise. Everybody who has some experience in forecasting knows about the difficulties of such forecasts, which include exogenous changes in the economic environment and in expectations, and last but not least statistical revisions of macroeconomic accounting data *ex post* (albeit not revisions of price level data). Among these exogenous changes are developments in world commodity markets and currency markets.¹ If the price level forecast is off the mark and if market participants become aware of this, it is difficult, if not impossible, to stabilize inflationary expectations. Another difficulty is that the forecasting procedure (which model?) may not be transparent for the public. Besides this issue of credible external signaling, inflation targeting does not represent a mechanism by which a central bank binds itself in its decisions internally.

¹ Defining a core inflation rate is seen by some as a way to reduce the margin of forecast error; but this softens the role of a central bank to deliver a stable money.

Monetary targeting, i.e., steering the money supply, has the advantage of binding the hands of a central bank internally and, at the same time, of giving an important signal to the markets. A central bank may have to take recourse to enumerating “special factors” if it misses the target growth rate for its monetary aggregate (as the Bundesbank did in more than half the cases in the last 25 years). Moreover, a stable relationship between the quantity of money and the price level, i.e., a stable money demand function, is a prerequisite for this approach. With the beginning of the new monetary regime it was not clear whether this stable relationship existed, more specifically whether the stable relationship that prevailed in the pre-euro era would hold for the euro as well (for the Lucas critique, see Lucas 1976).²

The two-pillar strategy. It is for this uncertainty of a stable money demand function in a new monetary regime that the ECB developed its two-pillar strategy, where the first pillar relates to a reference value of M3 and the second to a set of additional factors including the price level and factors influencing it. This strategy gives the ECB some degree of freedom in its monetary policy, and it may very well be that such a strategy makes it easier to find a decision in the ECB Board with its slightly diverging preferences. Then, however, the two-pillar strategy camouflages an internal weakness. Unfortunately, the two-pillar strategy seems to confuse the markets because market participants are unclear about which of the two pillars is the dominating one. Thus, the ECB will have to rethink its strategy and move more in the direction of the monetary targeting strategy.

Communicating its monetary policy to markets and to citizens represented a problem in the first months of the ECB’s existence. The ECB has spoken with many voices, and with somewhat diverging ones. This may reflect the new situation that besides the international audience, citizens of eleven different countries have to be addressed, and — which complicates the task — they have to be addressed in different languages.

Greenspan-type reliability. In any case, a rule-based strategy in contrast to a purely discretionary or eclectic policy is pivotal for the ECB because its president can hardly establish the same level of reputation in a short time as a long-serving central bank chief, and even more so if his term should only last for the first half of the official length, as agreed upon in Article 112 of the EU Treaty. The next president will have to start anew in proving his credentials before a Greenspan-type reliability is established.

Diverging price levels in the monetary union. Restricting the increase of the Harmonised Index of Consumer Prices to less than 2 percent implies that in some regions of the monetary union the price level can rise by more than 2 percent. This can be expected for the countries catching up at a growth rate higher than the euroland average. In these countries the strong income increase stimulates the demand for nontradables, which leads to higher price increases due to the fact that productivity increases cannot sufficiently match the increase in demand (for the Balassa–Samuelson effect, see Balassa (1964) and Samuelson (1964)). A higher price increase in some regions necessarily means that in other regions prices rise at a lower rate; it also means that the region with the stronger economic expansion attracts a relatively larger share of the increase in the nominal money supply for its money demand.³

A higher price increase for nontradables in countries catching up such as Spain (Table 1) need not be a matter of concern because the real appreciation is necessary to stimulate the production of nontradables. It will reduce the comparative advantage of tradables; this can be considered as a normal

² A technical issue is whether there was more liquidity in the euro area during the transition period, i.e., more than the sum of liquidity of the 11 individual currencies (OECD 1999).

³ It is a fascinating question to describe the euro zone by a set of regional (country-specific) money demand equations and to analyze to what extent M3 increases at different rates in the regions of euroland. Statistically, this information might be obtained from data that are used to calculate the aggregated increase of M3 in the monetary union. The common short-term interest rate can not reduce the higher money demand in strongly growing regions; in addition, the higher price rise there makes for a higher nominal money demand.

Table 1: Harmonised Indices of Consumer Prices (Increase in percent)

	1999	January 2000 ^a
Austria	0.5	1.6
Belgium	1.2	1.8
Finland	1.5	2.0
France	1.5	2.0
Germany	0.7	1.9
Ireland	2.5	4.4
Italy	1.6	2.2
Luxembourg	1.1	3.5
Netherlands	2.0	1.6
Portugal	2.2	1.9
Spain	2.2	2.9
Euro area	1.1	2.0

^aYear over year.

Source: ECB, *Monthly Report*.

process. This argument, however, does not hold for Ireland because its per capita GDP is higher than the EU-11 average (forecast for 2000: 115.9 percent, as shown in Björkstén and Syrjänen 1999). It is also a different matter when the price level rises relatively faster in a country whose growth rate is lower than the EU-11 average. Thus, Italy tends to have a price increase roughly half a percentage point higher than the EU-11 average, and this in spite of a relatively low growth rate of 1.5 percent (1999) (and a lower per capita GDP than the average). If such a tendency becomes more pronounced, a country loses competitiveness for its tradables, and stagflation may lead to higher unemployment.

2. *The low external value of the euro raises the risk that the market participants lose confidence in the new European currency.*

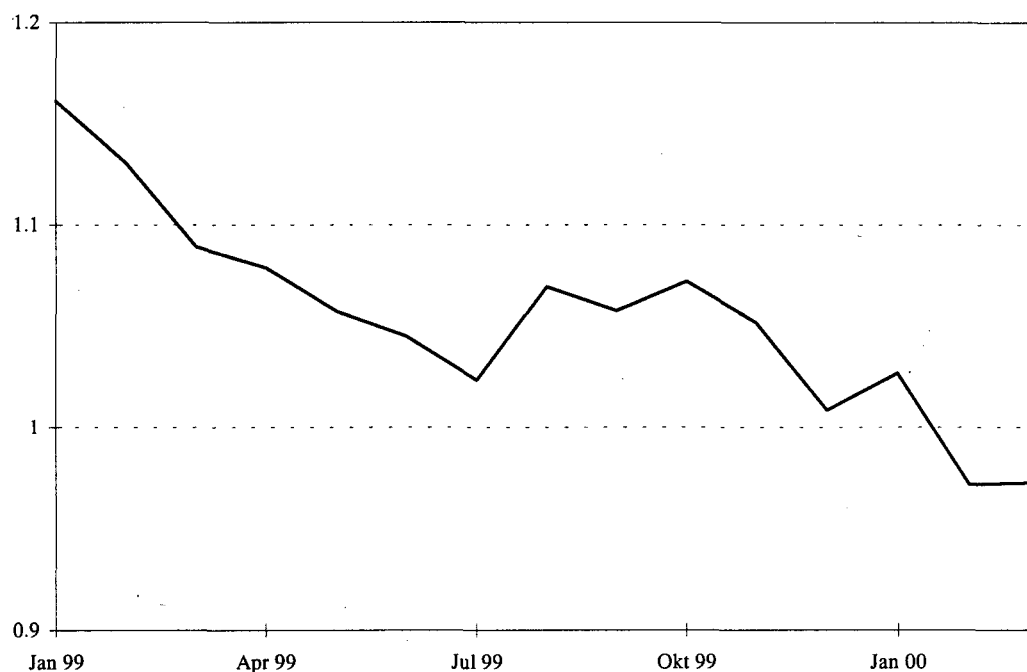
Only one nominal anchor. A central bank cannot have two nominal anchors for its currency, both the internal price level and the external value of a currency. This can be seen immediately from $\hat{w} = \hat{p}(\hat{M}) - \hat{p}^*(\hat{M}^*)$, where \hat{w} is the rate of change in the exchange rate of two countries, \hat{p} and \hat{p}^* are the rates of change in their national price levels, and \hat{M} and \hat{M}^* are the rates of change in their money supplies (a star denotes the foreign country). If the exchange rate is chosen as the nominal anchor, one of the national central banks must adjust the money supply such that the internal price level follows the price level in the foreign country. It is no longer free to choose its own price level. Whereas this strategy may be followed by smaller countries taken in tow by a stability-oriented larger country, the ECB cannot really apply this strategy. It would follow the Fed automatically step by step, and euroland would merely be a Fed district. Therefore, the internal price level must be chosen as the nominal anchor by the ECB. This implies that, according to purchasing power parity, the exchange rate will be the result of monetary policy.

Effects of depreciation on the price level. Things are more complicated when a marked depreciation of a currency occurs. In its first 14 months, the euro lost 12.7 percent of its initial external value relative to the US dollar (January 1999–January 2000; Figure 1).⁴ Such a change in the external value will have an effect on the internal price level so that both variables are not completely separated. One effect is that import prices rise if a currency is devalued; this is a once-and-for-all effect on the price level. The other is that the public audience may take a low external value as being a sign of a weak currency in general. Then, a low external value may translate into inflationary expectations or

⁴ The real effective exchange rate fell by 12.4 percent.

Figure 1: The US\$/Euro Exchange Rate (Monthly averages)

Dollar/Euro



Quelle: Datastream.

expectations on further depreciations. These effects cannot be neglected by the ECB. Therefore, it has to factor in the effects of depreciation on the future price level in its monetary policy decisions.

This reasoning implies a hypothesis on the impact of exchange rate changes on the price level and some notion on the type of exchange rate variation to be expected, especially on exchange rate expectations. Changes in expectations depend on many factors, one of them being the future strength or weakness of the economies of the currency area. They are also influenced by other aspects of stability policy such as the fiscal policy stance or wage policy. Thus, exchange rate expectations are not determined by the ECB alone; they are also influenced by other players in the wider field of economic policy.

II. Stumbling Blocks with Respect to Preconditions for the Monetary Union and Political Pressure on the ECB

Some issues may arise in the future because the economic environment may hinder the ECB in fulfilling its task. Among these issues is a technical one, namely to what extent the existing form of financial supervision in euroland is sufficient. More important issues are the risk of free riding of national governments, the failure of national governments to establish the necessary institutional setting for the common currency, the attempt of national interest groups to influence this setting in their favor, and the risk that new members will add to the heterogeneity of the monetary union and thus make the task of the ECB more difficult.

3. *Financial supervision is a precondition for shielding the European Central Bank against potential problems of financial instability.*

A major question is whether the euro as a common currency can get along with a banking supervision that is basically organized nationally or whether a unified system of financial supervision for Europe will eventually be required.

The task of financial supervision is to ensure the stability of the financial sector, more specifically, to prevent runs on a bank and a contagion of the financial system as a whole when a bank or a group of banks gets into trouble. The ultimate target of financial supervision is to rule out that the ECB has to step in as a lender of last resort. Two issues have to be solved: First, should financial supervision be separated from the central bank? In principle, it makes sense to separate the money-steering process from the supervision of the financial industry, i.e., to organize these two functions in different institutions. A conflict of interest is prevented. Above all, the central bank should not be influenced by looking at financial stability when determining monetary policy (Lannoo 1999). This does not mean that an intensive exchange of information is not necessary between the supervising authority and the central bank. For practical reasons, however, it may also be feasible to entrust the ECB with the supervision task, since the ECB has already been established as a European institution and a new supervising authority would not have to be established.

The second issue is to what extent financial supervision has to be europeanized. There are some arguments in favor of national supervision. One is the high degree of decentralized information which is a necessary ingredient of financial supervision. Moreover, some safety nets such as deposit insurances for the savings and loan associations or for the private banks are established nationally, and they represent important firewalls when a crisis breaks out. However, financial supervision in the monetary union is different from that in the pre-euro era. Now, a national run on a bank cannot easily be separated from the common currency. In addition, financial institutions will merge nationally and across borders; this means that the risk of a run increases for the currency area as a whole once a crisis breaks out, even if it is national. Moreover, a purely national supervision based on the home country control rule may get into moral hazard problems in playing down the risk of national problems since part of the impact of national failure will be borne by the currency union as a whole. Consequently, banking supervision in a currency union cannot be split up into a system of national supervising bodies as if the currency union had not been established. As a solution, a strong coordination of national supervision with firm procedures is mandatory; this involves a clearly delineated assignment of responsibilities with indisputable criteria for national authorities. Supervising transnational banks in euroland is a specific issue and will require to develop common criteria (Aglietta et al. 1998, OECD 1999, Padoa-Schioppa 1999).

4. *Member countries of the common currency area may free ride on the common currency.*

A Minhas Gerais problem in EMU? In the pre-euro system, countries could not really deviate strongly from a path of stability policy. When they did, they were subject to an implicit interplay of interest rate parity and purchasing power parity, in which interest rate parity determined capital flows and purchasing power parity formed the expectations on price level changes (Siebert 1999a). When a country deviated from the stability path, interest rates rose and, in the worst case, the country's currency depreciated. Governments were thus induced to prevent these effects. In the new system of the euro, member countries can in principle free ride on a stable euro by not following a stability path in their economic policy. Thus, if a member country increases its public debt, it may have to pay a somewhat higher interest rate but it may be able to shift part of the burden of its policy to the other member countries, for instance, by weakening the external value of the common currency and thus requiring a risk premium for all euro members. To put it to the extreme, the issue is whether a Minhas Gerais problem can arise in the European Monetary Union: In January 1999, Itamar Franco, the gov-

error of Minas Gerais, announced a 90-day moratorium on interest payment and redemption of public debt, and this precipitated the currency crisis of the Brazilian real.

Stability pact: Preventing expectations on depreciation. According to Article 103 of the European Treaty, the Community shall not be liable to assume the commitments of national governments; this also holds for the member states (no-bailout clause). In principle, neither the EU nor the other member countries will step in if a member country runs into a financial crisis.⁵ The issue is whether everyone will credibly stick to the no-bailout clause. In any case, it is prudent to prevent such a worst case scenario. Even the risk of such a scenario weakens the common currency. To reduce the risk of weakening the common currency by national free riding is sufficient reason for sticking to the stability pact.⁶

Stability pact: Preventing political pressure. Another reason is to shield the ECB against political pressure which arises if countries face severe economic problems. This holds particularly for countries with high indebtedness where political maneuvering space in the future is restricted by a high interest burden. Such countries may be interested in low interest rates, a rather lax monetary policy, and a (slightly) higher inflation rate than the one anticipated by financial markets because all this would ease their budgetary situation, especially as debts would melt away in real terms.

Central banks are always under political pressure. Of course, one could assume that the ECB is completely immune to such political pressure and administers monetary policy like a robot not influenced at all by political demands. For instance, in the case of monetary targeting, the ECB would steer the money supply automatically like a machine, expanding the aggregate money supply according to the growth rate of the production potential. Similarly, in the case of inflation targeting, it would stick to its preannounced target. In neither case would it take into account the business cycle nor the election schedules in individual countries nor any other economic or political variable. Then, no one would need to shield such a robot against political pressure. But this approach would be naive. The ECB does not operate in an institutional vacuum. Therefore, it is necessary to fend off political pressure put on the ECB. The criterion of the sustainability of national public budgets is well suited to shield the central bank from political pressure within the monetary union. Such a constraint on the fiscal policy of member countries becomes especially necessary if countries have institutional arrangements which are not conducive to solid governmental finances. A case in point is the weakness in Italy's constitution. Thus, the stability pact, in a way, serves as a substitute for lacking national constitutional constraints.^{7,8}

⁵ Article 100 Sec. 2, however, suggests another interpretation.

⁶ Note that the stability pact refers to public spending only. The more basic problem is that the depreciation of the euro may be a reflection of the balance of payments situation of euroland. In the monetary union, the balance of payments is still valid as a national budget restraint. An individual country may have a large deficit in the current account, and this deficit may influence the overall balance of payments of euroland and the exogenous value of the exchange rate. There is no mechanism in the EU Treaty addressing this problem except for the case that absorption of a national government is too high relative to its tax revenue.

⁷ One may argue that the reductions in the budget deficits of the EU-11 countries prove that budget policies have changed, possibly due to the stability pact. Note, however, that this may only be an episode in an upswing.

⁸ The general rule is that a budget deficit surpassing three percent of GDP is considered excessive. This only holds if GDP falls by less than 0.75 percent. In other cases, there are exceptions: A real decrease of GDP on a yearly basis of at least 2 percent is viewed without any further argument as an exception. In the intermediate range between 0.75 and 2 percent, a set of discretionary decisions of the ECOFIN council will have to be made. Whether an excessive budget deficit exists is unclear if a member state, after being put into delay by a formal resolution, indeed takes appropriate measures. Whether the measures taken are appropriate is decided by the ECOFIN council. Initially, only a non-interest-bearing deposit is required. This will be converted into a fine after two years if the budget deficit remains excessive. These discretionary steps raise the question whether the stability pact will be effective. Moreover, there is a conflict of roles, since those who are responsible for the excessive budgetary deficit will also be the ones to define it. In sum, self-confinement of the countries to a quasi automatism has only been reached in the case in which GDP declines by less than 0.75 percent. Proposals have failed according to which a budgetary deficit would be confirmed automatically, for instance, if the deficit surpasses 3 percent of GDP.

Restraint versus coordination. The issue of introducing a constraint on national budget policy is not identical to the issue of coordinating national stability policies, that is fiscal policy (within the limits of the stability pact) and wage policy. Coordination refers to the problem whether and how macroeconomic policies of various nations should be brought in line with each other and to what extent the optimal macroeconomic policy mix between europeanized monetary policy on the one hand and national fiscal and wage policy on the other hand should change in the currency union.

According to textbooks, in a currency union fiscal policy should gain a more important role in stabilizing the economy over the business cycle.⁹ However, experience does not suggest that fiscal policy has been able to satisfy this role. Rarely has fiscal policy been used to squeeze excessive aggregate demand in order to dampen the boom. Rarely has the political process been capable of balancing the budget over the business cycle: the stimulation of demand in recessions has usually been associated with public debt that ratchets upward over time. Thus, heroic rational behavior of politicians in the European Monetary Union would be required if fiscal policy were to play a role in stabilizing national economies over the business cycle. The politician who undertakes restrictive fiscal policy in a boom when tax revenues are spouting has been compared to a pug dog guarding a pile of sausages. For an anticyclical fiscal policy, the vegetarian pug has yet to be bred.

In practice, fiscal policy often has been volatile due to the political economy of expenditure and taxation and due to time inconsistency; the volatility of public expenditure has itself generated a cycle or aggravated a cycle. Such a stop-and-go policy or an ad hoc approach needs to be prevented in the monetary union. Steadiness of fiscal policy is required in order to smooth aggregate demand and expectations of the private sector. Moreover, each country will have to increase its efforts to improve the elasticity of its supply side so that fluctuations in GDP and employment can be reduced.¹⁰

The prescriptions for fiscal policy given here seem to be asymmetric. On the one hand, national fiscal policy may have to play a larger role in stabilizing national economies if one follows Keynesian lines; on the other hand, it has to have its hands tied in order to prevent political pressure from weakening monetary stability. This is not a contradiction. The overriding prescription is to prevent political pressure on the central bank: in no case should the stabilization role of fiscal policy lead to debt levels that would jeopardize price level stability. Keynesian-type stabilization, as doubtful as it may be anyhow, can only take place within the limits of the stability pact.

Worldwide locational competition as a constraint. An effective constraint on national budget and tax policies may come about by locational competition on a global scale. Countries compete for the mobile factors of production, i.e., for the mobile capital, for the mobile technical knowledge, and for the mobile highly qualified workers, with their public goods such as infrastructure and with their taxes (Siebert 2000b). This phenomenon forces countries to lower taxes (on mobile factors of production) and reduce government spending. This also implies a consolidation of public budgets and smaller budget deficits. Witness the shift in orientation of Germany's fiscal policy in 1999.

5. *The political environment will put pressure on the ECB to give more weight to goals other than price level stability.*

The trade-off between price level stability and other goals such as employment has always been a major point of discussion in monetary politics. If a short-run Phillips curve is assumed to hold, unemployment can be reduced under the condition that an increase in the price level is accepted. It

⁹ An institutional setup that relies more on flexible exchange rates reduces the role of fiscal policy; one that relies more on fixed exchange rates gives fiscal policy a larger role (Siebert 2000a, Ch. 16).

¹⁰ In this context, asynchronous business cycle situations between countries add, at least theoretically, a new dimension to wage policy in a monetary union. Wage policy must help to tone down demand pressure in a boom; at least wage policy should not break the boom by demanding excessive wages. In a recession, wage policy has to assist in bringing about an upswing, i.e., it must take into account the low (often negative) productivity growth in a recession in order to allow more employment to come about. More flexible wages, including a profit-related element, can help to make jobs more stable over the business cycle.

would, however, be a mistake to succumb to the fallacy of the short-run Phillips curve between the rate of inflation and unemployment. Economic agents with rational expectations would anticipate the higher inflation rate and require higher nominal interest rates, higher prices, and higher wages. The value of money would deteriorate and the European Central Bank would quickly lose its reputation. Eventually, the European Central Bank would be forced to put on the brakes, and a “stabilization recession” would be the result. Then, severe costs of disinflation would arise. In the long run, the Phillips curve is vertical anyhow.¹¹

Some people demand a more active role of monetary policy for smoothening the business cycle. They claim that especially in a recession monetary policy should reduce the interest rate in order to get out of the recession. It should be noted that in a recession transaction demand for money falls, and consequently the interest rate will be lower anyway. Explicitly reducing the interest rate in a recession in order to stimulate economic activities engenders the risk that monetary policy becomes unsteady, that market participants lose confidence, and that expectations become unstable. This raises the risk that monetary policy will itself initiate a cycle or aggravate a cycle. Quite to the contrary, monetary policy should stabilize expectations over the cycle and steer the money aggregate in such a way that the cycle is not aggravated. Very often people forget that it is only with a time lag that monetary policy impacts on economic activity and the price level. Unfortunately, the time lags of the money supply with respect to investment and with respect to the price level are quite different; it tended to be 3–4 quarters in Germany in the past with respect to investment, whereas the time lag with respect to the price level was 10 quarters.

Some people in the political arena also demand that monetary policy should stimulate economic growth, thus bringing the economy on a higher growth path. Reference is made to the “new economy” in the United States and Greenspan’s approach to the money supply. This demand suggests that growth can be stimulated by an increase in the money supply, a misleading idea. The relationship is the other way around: If an economy experiences a strong expansion of its production potential and if there is a high elasticity on the supply side, the money supply can increase faster than if an economy only has a low rate of expansion of the production capacity. Thus, it is the task of politics to make the economies of euroland more flexible in a first step; this is a precondition for the “new economy” to happen. In a second step, money supply can increase at a higher rate without causing inflation.

The political demand for accountancy¹² of the ECB is blurred with these issues which in essence relate to the weights to be given to economic policy goals other than price level stability. Of course, things are much easier for politicians in the short run if the monetary authority does not put too much weight on price level stability. In the long run, however, there are high opportunity costs of an unstable money. “It is important that area-wide political bodies, like the European Parliament, ECOFIN ... or informal meetings ... do not become vehicles for ... pressures” (OECD 1999: 70).

Institutionally, the issue which weight should be given to different targets is solved by the assignment of responsibilities. The assignment principle states that a policy maker should be responsible for the target for which he has been assigned the corresponding policy instrument. According to this approach, fiscal policy is responsible for providing public goods, the social partners who set the wages are responsible for employment and unemployment, and the monetary authority is responsible for a stable money. In game-theoretic models it can be shown that under a set of conditions cooperation towards an optimal policy mix can improve welfare, but blurring the assignment of instruments and responsibilities in practice may very well lead away from a desirable attainment of policy targets.

¹¹ It should also not be forgotten that even if monetary policy were to stimulate GDP in the short run, this would not transform into employment in the European context in a one-to-one relation because of the “employment threshold” (Siebert 1998a).

¹² Transparency is a different matter (see Buiters 1999 and Issing 1999). There are some good reasons why too much transparency may not be instrumental in strengthening the reputation of the ECB (OECD 1999: 79).

6. *National economic policies have severe difficulties in establishing the necessary institutional conditions in the national labor markets for a smooth functioning of the common currency.*

In the literature on common currency areas, the economic conditions for a successful monetary union have been discussed intensively. These arise from the fact that in a monetary union exchange rate (and interest rate) adjustments can no longer be used as an equilibrating measure if economic developments between countries diverge. Economic developments may diverge between the countries of a currency union when a shock affects countries asymmetrically and when the business cycles in the European Union are out of synchronization and a country is in recession whereas others are not. Prior to the monetary union, the country could have devalued its currency to regain competitiveness. Within a monetary union, a member country fully experiences the asymmetric shock: In the case of a negative disturbance, production falls, the utilization of the production potential decreases, and unemployment rises. The economy has to adjust by using mechanisms other than the exchange rate and the interest rate (Siebert 1998b, Dohse and Krieger-Boden 1998). Moreover, exchange rate changes can no longer be used when growth in some countries is weaker than in others, when home-made problems evolve in some countries, or when some countries respond more flexibly to a shock that is symmetric to the European Union as a whole.

How relevant is heterogeneity? How relevant diverging economic developments between the countries of the monetary union will be depends on a number of conditions. For instance, economic structures may differ so that external shocks have a different impact on the member countries. Empirical studies indicate that in the past there was much homogeneity among some European countries (especially Germany, Austria, Benelux, and, to a somewhat lesser extent, France) in the sense that these countries experienced shocks that were correlated to each other, which means there was interdependence between them (albeit to a smaller degree than between the regions of a country, for instance Germany; see Funke 1997). Contemporaneous correlations increased in the nineties relative to the eighties; they were also strong in the seventies due to the (symmetric) oil price shocks (Sachverständigenrat 1998: Figure 30). Angeloni and Dedola (1999) find that in the most recent period correlations of output, stock market indices, and prices have increased in euroland. But there is heterogeneity for a larger group of countries, which means weaker linkages. For instance, shocks in the United Kingdom showed a stronger correlation with shocks in North America in the past than with continental European countries.

It is an open question whether a common currency area will lead to greater specialization in space (Krugman 1993) or whether the economic structure will become more homogenous. The example of the United States suggests that spatial differentiation can play an important role in a large geographical area. Moreover, there was β - and σ -convergence in per capita output for a longer period of time, for instance for the last four decades (Sachverständigenrat 1998: Figure 31) or for the period 1980–1995 (Siebert 1999a: Figure 4.12), but there was σ -divergence between the mid-seventies and the mid-eighties, and there was quite a variance of growth rates in 1997–1999 (Björkstén and Syrjänen 1999). Thus, it is open whether the fundamentals of economic growth differ between countries.

Substitutes for the exchange rate. A cascade of equilibrating mechanisms exists which can be used to replace an exchange rate and interest rate adjustment (Mundell 1961). First, the migration of labor can take the place of a devaluation of the home currency. If workers leave a country which has been struck by a crisis and move to more prospering countries, unemployment decreases in the crisis area. The per capita income of the country in question will rise again. However, under European conditions, language barriers and cultural diversity will limit the mobility of people. Moreover, this is a “passive” cure. In addition, this form of adjustment will not be accepted by the countries to which

workers would have to emigrate. The willingness to absorb workers from abroad is low.¹³ Even though the free movement of labor is one of the four freedoms of the Common Market, it seems realistic that, unlike the United States (Blanchard and Katz 1992), labor migration will play a minor role as an equilibrating instrument in the divergent structural development in Europe.¹⁴

Capital mobility cannot replace labor mobility as an equilibrating mechanism in the case of regional crises. Consider the case of a region with a negative asymmetric shock. If capital instead of labor leaves a shock-ridden region, the pressure on wages is even higher. Thus, the outflow of capital is not an equilibrating factor. If capital moves to the regions with the higher rate of return, capital mobility is a mechanism that accentuates divergence and increases locational competition.¹⁵

Second, if labor migration is ruled out as a substitute to exchange rate adjustment, relative prices will have to do the job. In the case of a negative shock, a real depreciation improves competitiveness. This means that the relative price of nontradables must fall in order to stimulate the production of tradables. In bringing about this change in relative prices, wages as the price of the most important immobile production factor will have to bear most of the burden of adjustment. Under the conditions of a growing economy, wages in a problem area cannot rise as much as under normal conditions.¹⁶

Third, if wages do not react flexibly, differences in unemployment between the countries of the currency union are likely to develop. Then, financial transfers are a candidate that can take over the shock-absorbing role of a devaluation.

Institutional reforms of the labor market. If an increase in transfers is to be prevented, wages have to be highly flexible, and they have to be differentiated in the economic space of the monetary union.¹⁷ The political task is to make national labor markets more flexible in order to avoid additional unemployment and to reduce existing unemployment. This prerequisite is not satisfied in most of the continental European countries, especially not in Germany and France.

Many people hope that the monetary union as a new institutional regime will be a catalyst to enforce an institutional reform of Europe's labor markets. This impact has not yet been seen, and the national governments of the major continental European economies have not initiated any significant change in the national labor markets as required by the monetary union. Quite to the contrary, the discussion on retirement at the age of 60 and legal changes in Germany (Sachverständigenrat 1999) as well as the mandatory reduction of working hours in France go into the wrong direction.

7. *Interest groups in the member countries will defend their political position and will resist necessary institutional changes in the labor market.*

Interest groups in the currency area will attempt to influence politics in the monetary union in their favor. They will attempt to prevent the necessary institutional changes. Thus, trade unions will push for centralizing wage bargaining on a European level. This is in their interest because a joint wage policy and a joint influence on public opinion would strengthen their organizational power and their political position.

¹³ Evidence for this is given by the German discussion on the "Entsendegesetz;" this is an attempt to keep foreign EU workers out of some segments of the German labor market by making minimum wages mandatory in the construction industry.

¹⁴ Compare Decressin and Fatás (1995) who apply the Blanchard-Katz (1992) approach to Europe. Note that spatial mobility of labor, as far as it exists in Europe, is a phenomenon between regions of a nation and not so much a phenomenon between nations.

¹⁵ Capital mobility can, however, speed up the convergence process.

¹⁶ The reduced increase in wages does not stimulate the economy in the same way as a devaluation would: a devaluation re-establishes competitiveness for all tradables, a change in wages favors labor-intensive production and thus re-establishes the competitiveness of jobs.

¹⁷ The necessary adjustment is not only a matter of the flexibility of nominal or real wages. Existing restrictions on the employment of labor are implicit labor costs. Formally, such restrictions represent negative shadow prices of labor to firms and reduce their demand for labor. The labor markets in Europe are marked by such restrictions which cause high unemployment to a significant extent (Siebert 1997).

Europeanizing wage policy? Europeanizing wage formation is, however, a complete contradiction to the requirement of decentralization. It runs counter to what is needed to reduce unemployment in a currency union. It implies that the necessary decentralization of wage formation is prevented and that, consequently, an important condition for the monetary union is not fulfilled.^{18,19} Unemployment will tend to rise and political pressure to use monetary policy for solving the unemployment problem will tend to increase. Of course, if the ECB ignores these pressures, there is no problem. However, it may be more difficult for the ECB to raise its voice in a public chorus if wage policy is transferred to the European level.

Europeanizing employment policy? The employment chapter added to the EU Treaty at the Amsterdam Summit engenders the risk that governmental employment policies will be europeanized. Such an approach would suggest that the problem of unemployment can be solved on a European level, for instance by an employment program or an employment pact. Such an approach would blur the responsibilities and allow trade unions to shift part of their responsibility for employment and unemployment to politics and to the European level. The EU can be used as a scapegoat; this may end up as a severe damage to the European cause. Shifting unemployment policies to the European level may increase pressure on the ECB to follow an easy money policy and may make it more difficult for the ECB to convince the public of its policy. Europeanizing employment policy is as serious a misjudgment as europeanizing wage policy. In the EU, the unemployment rates differ considerably between countries. This suggests that the differentiation of national approaches to the labor market has been successful. Therefore, employment should remain a national responsibility.²⁰

A lax monetary policy as a substitute for transfers. Transfers will have to replace the exchange rate adjustment mechanism when labor is not sufficiently mobile and when wages are not sufficiently divergent between countries. Transfers may also increase the pressure on the ECB: If transfers have to be made in the end — in spite of liability being excluded — the donor of transfers may develop an interest to keep these transfers as low as possible, replacing them by a rather lax monetary policy.²¹

8. *In attracting new members, care must be taken not to increase the heterogeneity of the monetary union.*

Economic heterogeneity is a problem for a monetary union. If economic structures and processes are too divergent between the member countries it is difficult to explain the common monetary policy to

¹⁸ Some countries have strengthened the bargaining partners, i.e., trade unions and employers' associations, and the wage cartel by passing laws that, for instance, extend wage-bargaining results from one region to another region, that make wage negotiation results binding *per se*, or that make them binding pursuant to other laws which rule out exemptions even in the case of economic crisis. Supporting wage cartels in this manner should not be introduced on the European level.

¹⁹ Labor costs also include the costs of social security, which are politically determined. In some countries, these costs — the second wage — amount to nearly the level of regular wages; Germany is an example. Countries can keep their jobs competitive if they have a social security system which is more efficient, for instance, because it is shaped differently for historical reasons or because it is less complete. A harmonization of the social security systems in Europe would run counter to the differentiation of labor costs and would raise unemployment. In any case, these systems are now organized nationally in Europe; payments are only provided by the social security system to which the recipient has made his contribution (principle of territory). One realistically has to assume that a European social security system stretching from Portugal to Sweden is not feasible. Therefore, no attempt should be made to set up such a system. In a way, the monetary union and the social union are at odds. In any case, it is more difficult to establish a social union in a monetary union. Converging levels of social security can only result in the very long run — in a historical perspective.

²⁰ What can be done on a European level is to strengthen national governments against vested interest groups in the individual countries which prevent the necessary institutional changes.

²¹ Whereas a transfer mechanism may be acceptable in a political union it is hardly conceivable among still sovereign nation-states. Thus, since the European Monetary Union will not be accompanied by a political union, the willingness to agree on transfers should be lower than it is in the nation-states. The EU lacks an important condition in order to assign the right to tax to a central level, namely democratic legitimization (no taxation without representation). It is for good reasons that an increase in the budget of the European Commission is restrained, since decisions on tax policy have to be passed unanimously.

the public audience. Heterogeneity relates to such issues as differences in price level increases, in the national business cycles and growth, in specialization in space and in unemployment.²²

Heterogeneity also refers to new members. In principle, new members may add to the heterogeneity of the monetary union. Whereas an enlarged monetary union, i.e., size, makes the euro more attractive as an international currency (size effect), heterogeneity per se weakens the monetary union and its currency (heterogeneity effect). An important condition is that new members enter at an exchange rate that is not distorted. If the entrant's currency is overvalued, the new member experiences a real appreciation which will hurt its exports and economic activity in general. The country then will have to adjust to the real appreciation over time, for instance by reducing costs, including labor costs. Examples of a wrong exchange rate when entering a monetary union or some type of fixed exchange rate system are Eastern Germany and the German monetary union as well as Great Britain re-entering the gold standard in 1925 and the Exchange Rate Mechanism in 1990. If a currency were undervalued, the economy of a country would be artificially stimulated, implying distortions to the other members of the monetary union.

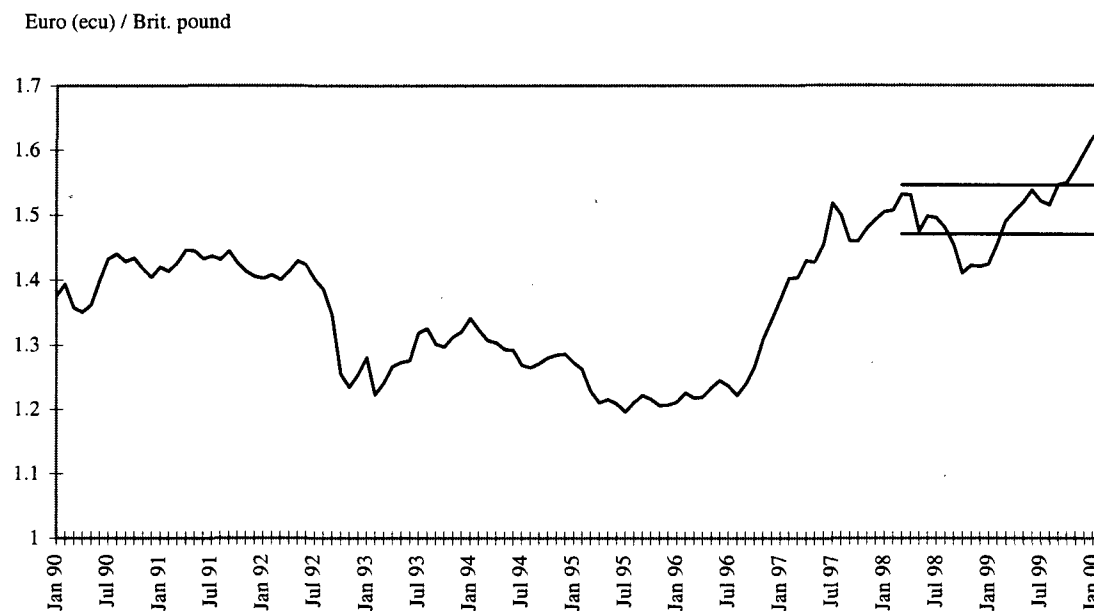
It is therefore necessary to apply the condition of Article 121 of the EU Treaty that the normal (narrow) margins provided for by the exchange rate mechanism of the European Monetary System are to be observed for a period of two years prior to entry without devaluation. If this condition is violated, the country should not join. The condition is necessary in order to make sure that the country in question fits into the monetary union. The condition is also necessary in order to reduce the damage to the club that a new member could cause. Unfortunately, the condition being fulfilled does not imply that an overvaluation of the currency may not exist when the country enters. This becomes apparent with respect to the United Kingdom.

In the case of the United Kingdom, one may have to wait until the weakness of the euro and the strength of the pound are more in line. Figure 2 illustrates the narrow band for the British pound for a two-year period. Taking the nineties as a frame of reference the choice of an entry rate seems to represent a severe problem if too high an entry rate is to be avoided. One way to reach a less distorted rate is that the countries of euroland revamp their national labor markets so that euroland introduces more flexibility in its economies and the euro appreciates relative to the pound. The other way is to wait for a period in which the business cycles and the interest rates are much more synchronized.

In the case of candidates for EU membership, transition countries like the Czech Republic, Poland, and Hungary are likely to face severe structural changes in their catching-up processes, and the nominal exchange rate will be needed as an adjustment mechanism (Siebert 1999a). It would therefore be unwise to include these countries in the monetary union early on.

²² Differences in the transmission of monetary policy between countries are likely to whither away over time.

Figure 2: The Euro, the British Pound, and the Entry Rate



Source: Datastream.

III. The Major Stumbling Block — The Conflict between the Common Monetary Policy and the National Interest

9. *The real test for the euro will be the conflict between national political decision-making and the europeanized monetary policy in the case of a major national economic crisis.*

Institutional arrangements must be storm-proof and must hold in situations of severe conflict. A potential for conflict in the European Monetary Union exists between a europeanized monetary policy and national economic interests. Monetary policy affects all member countries in the same way, but it is still judged in national political decision-making processes. A political union with communal decision-making and communal preference mechanisms has not come into existence simultaneously with a monetary union. Consequently, one has to take into account the possibility that an asymmetry between the more or less uniform incidence of a common monetary policy and the political evaluation of monetary policy by national decision-making might arise.

The worst case in terms of such a conflict that can be envisioned for the new monetary arrangement is when there is a fundamentally bad economic situation in one country while the economic situation in the rest of euroland is good. An ingredient of such a scenario would be a major national crisis, for instance, a home-made crisis due to severe policy failure, e.g., a time of social unrest with people protesting in the streets. A further ingredient of such a severe-crisis scenario would be that it is a major member country of the monetary union that is in trouble. If this happened in a situation in which the ECB would have to raise the interest rate in order to maintain price level stability, a clash between the national interest in one country and common monetary policy will result. Another less severe case could be a scenario in which one country's economic competitiveness deteriorates persistently over time, while other countries gain in competitiveness. An appreciating euro would then hurt the country in trouble.

It can be argued that a worst-case scenario will be less likely in the future. First, it can be hypothesized that the business cycles will be more uniform in the member countries, because at least one

policy instrument that is related to the business cycle is harmonized, namely, the short-term interest rate (as well as the long-term rate due to a single capital market with still some segmentation). The counter argument is that a greater specialization in space may occur and that this would imply a greater vulnerability of specific regions of the euro zone. Second, it can be argued that the stability pact will do its job and, even if it does not function perfectly, will prevent the worst case from happening.

Besides the worst case, there is a more or less permanent potential for political conflict.²³ Feldstein (2000) makes the point that the intensity of conflict may increase because the necessary institutional arrangements are likely not to be made. Thus diverging high unemployment rates and intra-euroland redistribution, financed by taxes of the member states, may be bones of contention in euroland; these issues could be used by national populist movements.

In looking at this potential for conflict, we may take comfort in Dornbusch's (2000: 33) assertion: "Only the most extravagant mind can imagine that in Europe politics gets to hijack the central bank." After all, the ECB has won the first round with politics when Lafontaine, Germany's former minister of finance, stepped down. This, however, was more a conflict over the priorities of the monetary authority vis-à-vis politics or a conflict over the relevant economic paradigm. I would like to call this a "type-1 conflict." The ECB is pressured to include other targets such as unemployment. In contrast, the "type-2 conflict" is a clash between the European and the national level.

In any case, the conflict over the weights of other policy targets than price level stability may intensify in the future. Moreover, the test was made easier so far because the euro started under favorable conditions: The business cycle is on the upswing and unemployment is falling, mainly for cyclical reasons and because of a reduced labor force. The political environment for the ECB may be less favorable if this fair weather is over, with more of "type-1 conflict." But what is more important for the European Monetary Union is that we cannot completely rule out a major crisis in a major member country, the worst-case scenario, that is a "type-2 conflict." Thus, the major test for the ECB is still to come.

What is the answer to this policy problem? Besides the economic preconditions for a currency union, the political condition *sine qua non* is some political homogeneity in the sense that the common monetary policy must be accepted by the member states. Historically, multinational currency unions (in contrast to national currency unions) have depended on the political will to support them. They broke up (Bordo and Jonung 1999, Fidrmuc et al. 1999) when the political will ceased to be sufficiently strong. EMU requires quite an amount of discipline on the part of national policymakers. Having a common currency, politicians in the member states must be prepared to accept two things. First, an independent European Central Bank has been entrusted with the authority to steer the money supply, i.e., to set the interest rates and determine other monetary policy instruments. Monetary affairs have been taken out of the hands of politics altogether, i.e., the process of money creation has been depoliticized. This relates to the "type-1 conflict" problem. Second, the money supply process has been handed over to a common institution on the European level, i.e., money has been denationalized. This relates to the "type-2 conflict" problem.

Unfortunately, the contractual arrangement of the euro cannot specify all future states of nature. A monetary union is an evolutionary process where not all possible developments are known yet. Thus, the European Monetary Union should be accompanied by a "policy learning process, where policy makers learn to cope with the shortcomings that emerge" (Bordo and Jonung 1999: 33).

The answer that politicians have to accept the depoliticization and the denationalization of the money supply process appeals to the goodwill of all participants. This may be a weak solution for a new monetary regime; the euro can only get a strong foundation if the states are sufficiently prepared to

²³ In this context, the issue to what extent monetary policy may have different regional impacts due to differences in the transmission mechanism can be viewed as a technical problem (OECD 1999).

support the common monetary policy. This can be accomplished if the European interest gains more weight in the objective functions of national political decisionmakers than the national interests and if the voter starts to think more in European than in national terms.

If such sentences are not to remain shallow and are to have some substance, one has to think of mechanisms which make sure that relying on goodwill is not the only approach to solve potential conflicts. One way out is to change the democratic setup of political decision-making by giving more weight to European aspects. This change raises severe questions which relate to the political concept for Europe and its federal structure, to the issue of a European constitution, and to the very basic question whether a European sovereign — a European people — is beginning to exist. Another approach is to create a European audience for the ECB's policy as well as for economic policy issues in general. For one, this is the task of the ECB itself to establish its audience and to build up its reputation in the European population so that individuals and markets are prepared to support the ECB's cause against politics and that nationals are willing to support the European cause (in monetary policy) against their own national interests. But the creation of a European audience is not a matter of the ECB alone. It must come about by the European press looking beyond the national fence. It must also be brought about by academia. The European institutions can help in organizing joint research and, for instance, joint business cycle outlooks in analogy to the joint reports that have been prepared for decades by five major economic research institutes in Germany.

A proposal that I would like to put forward is to establish a European Council of Economic Advisers (Wise Men). Under European conditions, the US example of a council being part of government is not appropriate. Therefore, the analogy to the German Council of Economic Advisers seems to be more fitting. The council should be independent and present its annual report to the European parliament where it should be discussed. The report should focus the economic policy debate in the European Monetary Union. The topics to be covered would thus be the problems of euro-land, including future topics, like its enlargement. Such a report could contain a business cycle outlook for the world economy, for Europe, and for the individual countries and address the major policy issues. In order to keep such a council manageable, it should consist of five to seven members preferably not chosen on a country principle but in a fashion similar to that of the members of the Board of the ECB.²⁴ The main function of the European Economic Council would be to establish a European audience for monetary and economic policy.

²⁴ An alternative would be to have rotating members with respect to countries, possibly with permanent members for some countries.

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