

Scharrer, Hans-Eckart

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Hans-Eckart Scharrer*

European Monetary Union: No Field for Political Compromise

European Economic and Monetary Union is currently in the course of preparation by an inter-governmental conference. What are the benefits and risks associated with European monetary union? What essential requirements need to be fulfilled when the agreements are concluded?

The plans for European Economic and Monetary Union (EMU) are not just an economic issue, but a thoroughly political one as well. Member countries will eventually have to surrender their monetary sovereignty irrevocably, transferring all their monetary decision-making powers to the European Community. The political intent of establishing EMU has already been declared by the European Council. The conditions under which it would be acceptable and also appropriate to cede monetary sovereignty need to be examined carefully by national parliaments, and this needs to be done before the intergovernmental conference's negotiations are completed. In view of the significance of the step to be taken, it would also be appropriate for national parliaments to make the formal decision, when the time comes, on entry into the final phase of EMU.

The Logic of the Community's Development

The continuing development of the European Community to establish European Economic and Monetary Union is in accordance with the logic underlying the course of economic and political developments so far:

□ Since the ratification of the Single European Act, there has been rapid progress in the establishment of the single market, both in legal and in practical terms. All the essential proposals in the single market white paper can indeed be expected to have been adopted at the Community level by 31st December 1992, and the directives will be translated into national law within the foreseeable future. Even today, businesses increasingly tend to regard the Community as one single, integrated producing and marketing area. However, one essential element is missing if the efficiency benefits of the single

market are to be completely realized, and that is a single currency. At one and the same time, this would both promote and symbolize the transition from a collection of national economic areas to a European one.

□ Since its foundation, the European Monetary System (EMS) has increasingly become a zone of price and exchange-rate stability. That is particularly the case for the core countries in the EMS, i. e. those which submitted themselves to the system of narrow bands of fluctuation from the outset (Germany, France, the Benelux countries, Denmark and Ireland). The convergence of price trends at a low level (albeit a rising one again since 1989) and the express – and increasingly credible – renunciation of the instrument of central rate changes against the deutschmark have led to convergence of the interest rates prevailing in these countries. The inflation and interest-rate differentials relative to the other countries participating in the exchange-rate mechanism (ERM) have also diminished, even though they are still substantial. Since the United Kingdom's ERM entry in 1990, ten of the twelve EC member states participate (Greece and Portugal have yet to join), and two of them operate within broader bands, namely Spain and the United Kingdom.

□ In political terms, the Community has established its worth as a forward-looking model of cooperation between equal partner countries within the framework of a supranational organization. Events in Eastern Europe are now helping to make it clear just how far Western Europe has already progressed in overcoming national boundaries and in bringing common policies to fruition. Up to now, monetary and exchange-rate policies have been pursued under national responsibility, but with the deutschmark increasingly taking on the function of an anchor currency, and the Deutsche Bundesbank also growing into the role of the leading central bank. Notwithstanding the successes which have been achieved in increasing monetary stability, this solution in

*Hamburg Institute for Economic Research (HWWA), Hamburg, Germany. Revised version of a statement by the HWWA Institute presented to a hearing of the Finance Committee of the Deutscher Bundestag on the European Economic and Monetary Union on 18th September 1991 in Bonn.

which the monetary authorities of the other member states adhere to the policies of the Deutsche Bundesbank (even if they do so voluntarily)¹ yet are unable to have any influence over them is increasingly seen to be a contradiction of the political idea of the EC as a "community" and a future political union. In the longer term, it is a problem for Germany too if it is seen to be "forcing" its (monetary) policies upon the rest of the Community, for that is a recipe for political conflict.

Benefits and Risks

The EC Commission has described, and partly attempted to quantify, the economic benefits associated with EMU in its study entitled "One market, one money".² These consist chiefly in the elimination of exchange risk and transaction costs in intra-Community payments, bringing consequent increases in efficiency and growth, in reduced interest margins between deposit and lending rates due to greater competition in an integrated European financial market, in what is expected to be a reduced susceptibility to external shocks on the part of the European economy, and in the strengthening of the Community's overall economic position and its policy stance in the multi-polar economic and monetary system.

Nevertheless, the Community in general and Germany in particular do also have something to lose from the move to establish EMU, for a stable ("anchor") currency and a credible (leading) central bank are precious commodities. They should not be relinquished unless there is a sufficient likelihood of the European venture's succeeding from the point of view of stability policy: only then could EMU's hoped-for economic benefits become a reality. One must be aware that it is impossible to give a guarantee of success, and that the transition to a new monetary structure inevitably involves certain risks. Even so, that transition ought to be planned according to conditions which minimize the foreseeable risks while maximizing the chances of successfully maintaining stability.

Among these conditions are: complete clarity as to the implications of EMU, a fitting legal and institutional framework, a good performance record on stability, over a prolonged period of time, for participating countries, and voluntary accession to the monetary union founded on the ability to cope economically. These are the basic

requirements which must be borne in mind when assessing the discussion to date and the results of the inter-governmental conference.

Implications of EMU

In Germany, the political discussion on the matter, to the extent that it has been discussed at all, has not brought out clearly enough what implications EMU might have. The draft treaty as it stands (in the version of 20th June 1991)³ gives the impression if it is read superficially that the main thing involved is to fix exchange rates on a lasting basis between national currencies which will continue to exist. However, much more than this is involved in reality, namely:

- ☐ the total, irrevocable abandonment of national sovereignty over the currency (monetary and exchange-rate sovereignty), transferring this to the European Community, which in turn means
- ☐ the relinquishment of each country's own currency to be replaced by a common European currency,
- ☐ the relinquishment of any control, based on any country's own responsibility, over monetary and exchange-rate policy, and
- ☐ the relinquishment of national central banks in any sense which would be deserving of such a description. The Bundesbank, like the other national central banks, would become a "branch office" bound by the directions issued by the European Central Bank, even if it did continue to exist as a separate legal entity.

A point to bear in mind here is that, in practical terms, the amount of control national central banks are able to exert over money supply, interest rates and price levels is already restricted today, given that both prices and interest rates are closely interlinked through European and international markets. The Deutsche Bundesbank, as the EC's (*de facto*) leading central bank, currently still enjoys a markedly higher degree of freedom than its counterparts in the partner nations. In that respect, then, Germany also has more to lose than the other countries.

The prime issue as far as the exchange rate is concerned is what policy ought to be followed towards the dollar. When the Federal German government took the decision to float the deutschmark against the dollar, this restored the control over the domestic monetary system which had been lost under the Bretton Woods system. Under EMU, guardianship of the exchange-rate regime, like all other monetary decisions, will be the responsibility of Community authorities.

We already have a situation today in which Germany's monetary authorities have virtually no control over the

¹ Entry into the EMS and abstention from making central rate adjustments against the deutschmark are fundamental national decisions which are freely entered into, and it is only on that basis that monetary policy subsequently becomes dependent upon decisions made by the Deutsche Bundesbank.

² Commission of the European Communities: One Market, one money, in: European Economy, No. 44, October 1990.

³ Cf. Draft Treaty on the Union, in: Europe Documents, Nos. 1722/ 1723, 5th July 1991.

deutschmark's exchange rate with other EMS core countries, for they have all coupled their currencies, either implicitly or explicitly, to the deutschmark and will see to it, for the sake of their domestic and international credibility (wage and price discipline, interest rate advantage), that they adhere to that policy. Even if it were thought desirable, it is now no longer possible in practice to revalue the deutschmark against any of these currencies. For that reason, any line of reasoning used against EMU which is based upon the exchange-rate argument is rather unconvincing, certainly as far as Germany is concerned. Conversely though, any possible gains in efficiency EMU is said to bring by obviating the need for an exchange-risk premium will also be slight in Germany's case: the interest differentials with our major trading partners are already very small today.

Passing on the Costs of Adjustment

As far as losses of monetary stability resulting from EMU are concerned, these might be expected to be relatively slight and tolerable if participation in the currency union is (initially) confined to the current "core group" in the EMS. During the last few years, these countries have achieved a great deal of convergence while maintaining monetary stability (a fundamental development which is not called into question by the deviation from the stability path occurring at present). Even so, (interest-rate) decisions taken by the Deutsche Bundesbank for reasons of stability have regularly brought forth criticism, from France in particular. The larger and more heterogeneous the group of participating countries, the more probable it would be that a European currency would perform markedly worse in terms of stability than the deutschmark has done in the key currency system.

If a large number of member states participate from the outset, there is also a larger risk that the adjustment costs faced by countries with greater inflationary tendencies will be passed on, directly or indirectly, to the Community at large. If their inflation rates are cut back quickly and sharply, the possibility of prolonged stabilization crises in these countries cannot be ruled out. That would most probably lead to an increase in the government deficit for consumptive purposes (social welfare payments). The ultimate effect would be the same if, after the creation of the monetary union, employment incomes were rapidly harmonized throughout the Community without taking regional and sectoral productivity differentials into account (as has been the case in east and west Germany). Any such deficits would have to be borne, to a certain extent, by the other member states, either directly (by way of increased payments out of the Community budget) or indirectly (by way of increased interest rates across the Community). However, financial and real transfers can

only be justified if they are likely to help reduce development differentials. Were they to be used to compensate for the damage resulting from premature accession to EMU, that would amount to an abuse of Community solidarity.

In the light of these considerations, it is appropriate to make it a condition of participation in the monetary union that strict economic criteria should be met, or in other words that only the core countries should participate in the first instance.

Legal and Institutional Framework

Among the requirements which EMU's legal and institutional framework must fulfil are:

- ☐ a legal obligation on the part of the European System of Central Banks (ESCB) to make the stability of the value of money its overriding aim;
- ☐ institutional and material independence of the ESCB, and personal independence of the members of its governing bodies;
- ☐ binding regulations to limit national budget deficits;
- ☐ no automatic adherence to timetables, and instead the laying down of unambiguous, precise conditions for participation in the institutional final phase of EMU, and indeed if possible for the transitional phase too;
- ☐ clear delineation of the roles of different Community bodies.

Beginning with the ESCB's obligation to maintain monetary stability, the provisions of Art. 3, para. 2 of the draft treaty and Art. 2 of the draft ESCB statute are such that monetary and exchange-rate policy of the ESCB, respectively, must be primarily (if not exclusively) oriented to this objective. These provisions must be welcomed. However, they also make it all the more important that Art. 105 of the draft treaty should be redrafted in order to ensure that the priority attached to monetary stability in the catalogue of purposes stated for the ESCB is more clearly brought out.

Essential elements of the ESCB's institutional independence are that the European Central Bank and the individual national central banks should all be constituted as separate legal entities, and that the ESCB should be vested with the sole decision-making power within its own terms of reference. It would appear from the draft treaty that these elements are safely in place. Nevertheless, there remains a lot to be done on the level of the national central banks, most of which are simply subordinate authorities answerable to their treasuries or finance ministries. Whether or not partner countries within the EC prove willing to grant independent status to their own

central banks will be a test of just how serious they are in backing EMU and an independent ESCB. Art. 109C of the draft treaty provides that the process of granting such independence should be embarked upon before entering into the transitional phase on 1st January 1994. This clause ought to be made rather more precise, perhaps by requiring that legislative procedures must be set in train before that target date.

Personal and Material Independence

As regards the personal independence of members of the ESCB's governing bodies (the executive board and the council), important prerequisites for this are that their terms of office should be sufficiently long and that it should not be possible to remove them from their posts for political reasons. This requirement is fulfilled for the members of the European Central Bank's executive board, who will have an eight-year period of office (Art. 108, para. 2 of the draft treaty). However, a provision which is not adequate is the stipulation that presidents of the national central banks, who are *ex officio* members of the ESCB council, should have a minimum term of five years (Art. 14 of the draft statute). It would appear to be a matter of urgency to have this term extended to eight years.

The immediate precondition for the system's material independence is that the ESCB has autonomous control over the instruments needed to perform the tasks it has been given. In most member countries, major instruments of monetary policy such as the discount rate are in the hands of the government or the finance ministry. If these instruments are transferred, without reservation, to national central banks to coincide with the establishment of their independence, that too will be a test of how seriously the parties concerned are taking the EMU project. At the same time, the instruments applied need to be harmonized, for there is no scope within a monetary union for regionally or nationally differentiated monetary policies.

Another aspect of material independence which is no less important is whether it is possible for government fiscal and economic policies, willingly or unwillingly, to run counter to the ESCB's stability-oriented monetary policy. The first conceivable such source of uncontrolled money creation would be the financing of budget deficits by the ESCB. As negotiations currently stand, that route would be virtually ruled out in future, for Art. 104, para. 1 of the draft treaty and Art. 21.1 of the draft statute prohibit the European Central Bank or any national central banks both from granting loans of any kind to public bodies (including the EC itself) and from making obligatory purchases direct from the issuers of public debt; in the latter case, the monetary authorities retain the right to purchase debt

indirectly, but only if this can be done without threatening the stability objective. At a national level, the prohibition of government funding by the central bank is to be implemented before embarking on the transitional phase on 1st January 1994 (Art. 109C of the draft treaty). An aspect of this provision which must be criticized is that no sanctions have been provided for in the event of the rule being breached.

A second possible source of uncontrolled money creation is foreign exchange market interventions designed to defend central rates not supported by underlying market conditions, or interest rate policies geared to stabilizing the exchange rate. Germany's experience in this regard in the latter days of the Bretton Woods system serves as a particularly telling example. The draft treaty as it stands does not banish the risk of monetary policy being made subservient to trends in the exchange rate. Art. 109, para. 1 stipulates that the determination of the Community's exchange rate system and the establishment, alteration or abolition of central rates relative to third countries' currencies will be the responsibility of the Ecofin Council, which is required to reach a consensus with the Council of the ESCB. Current foreign exchange policy is the task of the ESCB. To what extent the requirement that stability be maintained would hold sway is a matter for conjecture. As the provision currently stands, all would depend upon whether the European Central Bank were prepared, given a clash between a stipulated exchange-rate objective and the basic monetary stability objective, to risk a conflict with the Council of the Community and to suspend interventions in the interests of complying with the contractual obligation to give priority to monetary stability. The demand ought to be made that all competence for exchange-rate policy should be unreservedly placed in the hands of the ESCB. At the very least, a contractual guarantee must be agreed that any Council resolutions affecting the exchange-rate system must be made unanimously.

Need for Binding Budget Regulations

Especially from the German position, binding regulations to limit budget deficits have been pushed for again and again during the treaty negotiations. The economic significance of strict budget rules, however, does not always appear to have been understood. If monetary financing of the government deficit is excluded, there can then be no (direct) connection between the size of the deficit and the expansion of the money supply. Price stability can come under threat chiefly as a result of inflated aggregate demand; this may become relevant if several large member states simultaneously pursue an expansive fiscal policy. However, another aspect which will generally be of greater importance is the allocative one:

high public-sector demand for funds pushes up capital-market interest rates and thus tends to crowd out private-sector investment. Awareness of this link means that the demand needs to be made for the net funding requirement of the state, as is already the case in Germany, to be generally confined to the level of public investment (this is known as the "golden rule of budgeting").

No such rule is currently to be found anywhere in the draft treaty. Art. 104, para. 2 provides a clear demonstration of the member states' inability to agree on a concrete set of regulations; this is to be left to the Council. There can be no doubt that budget regulations of the type described above, if constitutionally underpinned at the national level before entering the transitional phase of monetary union (with intermediate arrangements if necessary), would be rather more effective and more credible than the Community sanctions against "excessive budget deficits" envisaged by the draft treaty, for never in its history has the Community yet applied effective sanctions against any of its member states.⁴ In this area, then, there is definitely room for improvement in the contractual agreements.

A crucial prerequisite for entry into the final phase of EMU and securing a high degree of price stability in the period thereafter is the establishment of the necessary legal and institutional framework. This framework needs to be set up promptly, beginning at the national level. Its realization cannot wait until the end of the transitional phase as the state and the parties to collective bargaining must learn to live with an independent central bank. That means they will have to depart from traditional patterns of behaviour that are based on the experience that the central bank would sanction behaviour which is "wrong" from the point of view of stability by following an accommodating monetary policy, thus allowing such behaviour to go unpunished. This is a learning process which needs to be given time.

Of course, it is not enough simply to establish the legal and institutional framework. In countries which have traditionally had high rates of inflation, the inflationary mentality needs to be defeated on a lasting basis before EMU can bring price stability and full employment. If the inflationary mentality is allowed to live on, this will make itself felt in the voting habits of national central bank presidents in the ESCB Council (thus eroding the stability standard), in regional declines in production and employment (if wage settlements in those regions are too high) and/or in increased government spending and deficits which are liable to test to the extreme the solidarity

⁴ Cf. the observation by Andr  Sz sz, a member of the governing board of the Netherlands Bank, during the Finance Committee hearing: "It has been shown in the past that the Council shies away from political confrontation, and that will not be any different in future."

of other member states more firmly committed to the maintenance of stability. It is therefore essential, in order for member countries to "practise" economic behaviour appropriate to the stability objective, that a sufficiently long period of convergence to a comparable stability level should be allowed for.

The demand ought to be made that entry into the final phase of EMU, i. e. participation in the common monetary policy, should only be open to member states which have not only created the necessary institutional and legal framework but have also been converging for a sufficiently long period with the standard set by the country with the most stable prices to demonstrate that they are economically and socio-politically capable of participating in an EMU oriented towards the stability objective.

This approach runs completely counter to that which quite a number of other member states have so far favoured during the treaty negotiations, in which the maximum number of participants should be involved but with rather lax criteria on convergence. The model proposed here follows the successful example of the European Monetary System and assumes that the transition to monetary union will first be made (on a voluntary basis) by those countries which are already maintaining credible stability policies with firm exchange rates today, which have achieved close proximity in their inflation rates at low (medium-term) levels, and which are regarded by the markets as representing a "quasi-monetary union", having only slight differentials between their interest rates. In this way, the European currency will be able to establish itself as a stable currency from the outset, allowing the ESCB rapidly to attain the credibility it will especially need as a new monetary institution, i. e. credibility as seen by the parties to collective bargaining (stability-oriented wage policies), by savers and investors (interest rates), and by the rest of the world (exchange rate).

Elements of a Treaty Proposal

The contractual elements which will be needed by an approach based on the above principles include the following:

□ the establishment of a council of central bank governors at the beginning of the transitional phase, to act as a counterpart to the Ecofin Council. The task of that council will correspond to the functions defined in Art. 109D of the draft treaty. The council will be empowered to make stability policy recommendations to the Community and its member states and/or their monetary authorities. However, it will not yet have any decision-making or executive authority over monetary policy.

□ Ambitious legal and institutional as well as economic standards (i.e. sustained convergence with the performance of the country with the most stable prices) must be set as a condition for participation in the final phase of monetary union.

□ Voluntary participation in the system: any member state which fulfils the preconditions must make its own decision as to whether it wishes to enter. In view of the importance of such a step the decision ought to be subject to a parliamentary vote.

□ A low minimum number of participants (say, six) during the start-up period. Further member states should be admitted upon application, provided that they have fulfilled the legal, institutional and economic conditions.

□ The ESCB and the European Central Bank itself should not be established until the final phase has begun, and only those countries should participate in them which have surrendered their monetary sovereignty to the ESCB.

□ Even after the foundation of the ESCB, the council of central bank governors should continue to operate as an institutional link between the ESCB countries and the remaining member states. ESCB participant countries should be represented in that council by the President of the European Central Bank.

The Dutch proposal does greater justice to this position than the preceding draft treaty, and is therefore deserving of support. However, the proposed "trial period" for establishing convergence is rather short at just two years. If some countries feel the convergence criteria are too tough, they will have to face up to the question of whether they are really concerned with stability-policy objectives in wishing to participate in EMU, or whether they are not primarily seeking to soften the deutschmark-based stability standard which is already established. As far as Germany is concerned, at any rate, there can be no question of participating in an EMU which is built on weak foundations.

The European Community is now at the threshold of a new phase in its development. This phase will not only consist of the "deepening" which is about to be embarked upon but also of further widening. To say that the Community and the Economic and Monetary Union should be one and the same thing would appear extraordinarily problematic in view of the possibility that Community membership could double in the years to come. The admission criteria for participation in the monetary union should be demanding ones if EMU is to act to (further) cement members together, and not to blast them apart. Establishing the proper framework for monetary policy is not therefore a field which permits any political compromises.

Alfred Pfaller*

Economic Policy within a European Monetary Union

A European Monetary Union (EMU) and the complete transfer of the responsibility for monetary policy to a European central bank are no longer utopian ideas, but a politically highly relevant possibility. The question how economic policy goals can be achieved within such a monetary union is therefore gaining in importance.

Two questions are still at the forefront of the debate about European Monetary Union (EMU):

1. How far must member countries have achieved convergence in inflation rates and the policies responsible in this regard before binding commitment to a monetary union makes sense? Must far-reaching convergence be

achieved first, or is monetary union itself a means of accelerating convergence?

2. How can price stability be safeguarded within the monetary union? Put another way: how can the previous areas of stability (Germany, the Netherlands) protect themselves against imported inflation from other EMU countries if they are shackled to them by irrevocably fixed exchange rates?

These two questions epitomise the doubts that continue to stand in the way of the rapid implementation of

* European Research Associates, Brussels, Belgium. The original German version of this article appeared as No. 7 in the Eurokolleg series published by the Friedrich Ebert Foundation, Bonn. It has been revised in certain respects for publication in INTERECONOMICS.