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Norbert Berthold\*

## Europe after Maastricht – Have the Monetary Questions been Settled?

*The decisions taken at Maastricht seem to have finally removed the obstacles to European monetary union. So have the monetary questions really been settled? Is the process of monetary convergence irreversible?*

According to the decisions of the Intergovernmental Conference in Maastricht, it will not be determined until the end of 1996 which member states of the European Community meet the requirements for entry to a European monetary union, which relate to the permitted rate of inflation, net new government borrowing and the level of public debt. Only if at least seven countries are ready and able to set up the monetary union will a European central bank be established in 1997. If that does not happen, the European monetary union will come into force by the end of 1998 at the latest. Countries that then fulfil the criteria will automatically become members, unless they have secured an escape clause, as in the case of the United Kingdom.

Hence, it appears there can be no going back on the road to European monetary union, that the process of monetary convergence is irreversible. It remains to be seen whether this is really true, however. Europe has already witnessed many stage-by-stage plans that were not implemented, despite precise timetables. Even if this path is followed to the very end, the monetary decisions taken at Maastricht have not made the economic problems themselves disappear. Only if we come to grips with these problems dare we even hope that the European monetary union will be successful. It is therefore undoubtedly true that "There is an aura of unreality about the decisions taken in Maastricht", as one commentator wrote on the day after the conference.<sup>1</sup>

This view of things may be incomplete, given the narrow perception of the economist. It may even be too

pessimistic from the point of view of economics, because certain aspects have been ignored. A satisfactory answer to this is more likely to be found if one considers at least three questions:

- Why are the countries of the European Community striving for a monetary union in any case?
- What obstacles must be overcome on the road to an efficient monetary union in Europe?
- Where must one begin, in order truly to remove these obstacles?

A monetary union in Europe will always make sense if it helps reduce the cost of financial transactions.<sup>2</sup> These include in particular the cost of exchanging one currency for another or the costs caused by fluctuating nominal exchange rates or by inflation. Since the level of transaction costs depends very heavily on the degree of financial market integration<sup>3</sup> and the efficiency of macro-political action (monetary and fiscal measures),<sup>4</sup> the success of a monetary union in which exchange-rate induced transaction costs no longer play a role depends on the extent to which regulatory state intervention in the financial markets can be reduced and monetary and fiscal policy action disciplined so that inflationary problems are avoided.

<sup>1</sup> Cf. Frankfurter Allgemeine Zeitung, 11th December 1991, p. 15.

<sup>2</sup> Cf. R. Vaubel: Monetary Integration Theory, in: G. Zis et al. (eds.): International Economics, London 1988, p. 224.

<sup>3</sup> Cf. D. Gros: Paradigms for the Monetary Union of Europe, in: Journal of Common Market Studies, 27 (1989), pp. 219-230.

<sup>4</sup> Cf. N. Berthold: Monetäre Integration in Europa. Eine ordnungspolitische Analyse, Cologne 1990, pp. 7-17.

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The success of a monetary union can also be judged by whether it makes it easier to apply scarce resources to productive uses.<sup>5</sup> Allocation improves if it is possible to reduce the many changes in data (adjustment burdens) and to assimilate efficiently those changes that do occur in economic conditions (adjustment capacity). There would certainly be something to be said for a European monetary union if it not only succeeded in reducing the adjustment costs due to inefficient macro-political activities in member states but also increased the adjustment capacity of the often "sclerotic" European economies by making relative prices more flexible and factors of production more mobile.

Whether a European monetary union is ultimately successful therefore depends crucially on the extent to which it succeeds in disciplining the monetary and fiscal policy behaviour of monetary and governmental institutions and makes it possible to assimilate changes in parameters as efficiently as possible.

There are at least two obstacles that must be removed if a European monetary union is to be really successful. First, macro-political activities must be disciplined, and secondly country-specific shocks must be assimilated efficiently. With regard to macro-political activities, the question immediately arises whether it can make sense for individual members of a monetary union to support a monetary policy that is inconsistent with stability. The European economies differ not only in the economic objectives preferred by their policy-makers but also in the degree of imperfection of their markets in goods and factors of production. They therefore differ quite markedly in the extent to which they can exploit the trade-off between unemployment and inflation in the short term. The political decision-makers (politicians and bureaucrats) in countries with relatively high unemployment and a fairly low aversion to inflation therefore have an interest in pursuing a less stability-oriented, discretionary monetary policy.

These incentives are reinforced if there are differences in the cost of taxation, in terms of the waste of resources, and if countries bear markedly different burdens of debt. In such an imperfect world, inflation becomes a rational component of a "second best" tax structure,<sup>6</sup> because it not only distorts resource allocation but also increases government revenue and reduces the real value of the public debt. The more taxation contributes to the waste of scarce resources and the higher a country's debt ratio, the higher the optimum national inflation rate will be.

<sup>5</sup> *Ibid.*, pp. 30-32.

<sup>6</sup> Cf. N. G. Mankiw: The Optimal Collection of Seigniorage: Theory and Evidence, in: *Journal of Monetary Economics*, 20 (1987), pp. 327-341.

Since optimum national inflation rates in European countries are not identical, owing to structural differences and preferences for particular economic objectives, the members of a European monetary union will have to agree on a common inflation rate. It is probable they will settle for an average rate above the rate in the country with the lowest inflation.

### Inflationary Dangers

One monetary obstacle clearly lies in the fact that inflation problems are probable in a monetary union if it consists of economies whose preferences regarding economic objectives differ primarily in accordance with the degree of imperfection of their markets in goods and factors of production.

Even if countries could agree on a policy of price stabilisation, there is still a danger that such a policy would not be really credible. In that case, monetary policy would lack time consistency and the inflation rate in the monetary union would be sub-optimally high.<sup>7</sup> This hypothesis becomes understandable if one considers a country that wants to reduce inflation from a relatively high level and consequently announces that monetary policy will be more restrictive in future. Such a change of stance may not be credible, because the government has an incentive to revert to an inflationary policy once wage negotiators have agreed nominal wage increases based on faith in a policy of price stabilisation and capital market operators have set nominal interest rates at particular levels.

By so doing, the government could try to exploit the short-term Phillips curve trade-off for economic policy purposes by triggering a surprise surge in inflation, thereby also increasing revenue from "seigniorage".<sup>8</sup> If economic agents correctly anticipate this behaviour on the part of the government and take due account of it in their plans, they will not give credence to the announced monetary policy activities and will continue with their previous wage, interest rate and price behaviour. The inflation rate therefore remains sub-optimally high.

A second monetary obstacle to EMU therefore arises if monetary macro-policy is not really credible. This problem only arises, however, if monetary policy-makers aim to achieve real as well as monetary objectives,<sup>9</sup> since they have only one weapon in their monetary armoury, a conflict of economic objectives is unavoidable if they attempt to

<sup>7</sup> Cf. F. E. Kydland and E. C. Prescott: Rules Rather than Discretion: The Inconsistency of Optimal Plans, in: *Journal of Political Economy*, 85 (1977), pp. 473-491; and R. Barro and D. Gordon: A Positive Theory of Monetary Policy in a Natural Rate Model, in: *Journal of Political Economy*, 91 (1983), pp. 589-610.

<sup>8</sup> Cf. G. Calvo: On the Time Consistency of Optimal Policy in a Monetary Economy, in: *Econometrica*, 46 (1978), pp. 1411-1428.

pursue more than one aim. A policy of price stabilisation only stands a chance of success in a European monetary union if the countries ensure that common monetary activities are used to pursue only monetary and not real objectives.

The Delors Report and the current economic policy debate sometimes almost give the impression that the real threat to price stability in a European monetary union stems primarily from national fiscal policies that are inconsistent with stability.<sup>10</sup> Hence the call for fiscal measures to be restricted by state rules in order to curb undisciplined fiscal policy and limit the danger to price stability.

This demand is justified only if a European monetary union encourages undisciplined fiscal behaviour and expansionary fiscal policies actually have an inflationary effect. It is certainly true that the members of a European monetary union have an incentive to incur heavier debt if they can expect the other member countries to stand by them if they run into serious debt problems.<sup>11</sup> Such moral hazard will not jeopardise the price stability objective, provided the monetary institutions in a European monetary union are not prepared to finance fiscal policies by monetary means. It is therefore crucially important that national governments should not be able to borrow either directly or indirectly from a European central bank. If this cannot be satisfactorily excluded, however, there is a justified danger that undisciplined fiscal behaviour will have inflationary repercussions.

Hence, there are strong indications that fiscal policies in a European monetary union can be adequately disciplined only if a strict policy of price stability is adhered to. Consequently, the questions whether the European countries can agree on a stability-oriented monetary policy and whether such a policy is credible take on decisive importance. Put another way: will the monetary brakes in a European monetary union hold if national governments are pressing on the fiscal accelerator?

### Reactions to Asymmetrical Shocks

A second serious obstacle can arise if particular countries suffer real economic shocks. Changes in parameters generally have an asymmetrical effect on the

European economies. No matter what the monetary order, this presents no problems from the point of view of resource allocation if markets in goods and production factors are perfect. If they are imperfect, however, as they are in Europe, the allocative difficulties posed by such shocks could be eased by allowing nominal exchange rates to adjust. The question therefore arises whether, in a European monetary union in which nominal exchange rates are fixed or there is a single currency, country-specific shocks would not in fact become an obstacle to an efficient monetary union.

As a general principle, changes in nominal exchange rates can help countries to absorb asymmetrical shocks more efficiently. If relative prices are inflexible and production factors immobile, this is true not only of temporary but also permanent changes in parameters. Exchange rate adjustments bear part of the burden of adjustment, at least temporarily until relative prices react. In this way, it is possible to avoid a sub-optimal adjustment in quantities.

Although in the case of permanent changes in parameters efficient resource allocation is ultimately possible only if economies adjust to the new economic situation via relative price flexibility and factor mobility, a change in nominal exchange rates may save an economy not only from moving onto a detrimental adjustment path but also from ending up in an equilibrium in which economic agents are worse off than before.<sup>12</sup>

The belief of the Commission of the European Communities that country-specific shocks will be unimportant in the Europe of the future because of more intensive intra-industry trade is therefore questionable for that reason alone, because even in this case economic developments will not be symmetrical, since countries react quite differently even to symmetrical shocks;<sup>13</sup> they are often in very different economic situations, their goods and factor markets are imperfect to differing degrees and the many forms of state intervention and activity impair their adjustment capacity to differing extents.

If the terms of trade between member countries change, the only remaining option in a European monetary union where goods and factor markets are imperfect is sub-optimal adjustment in quantities. Here again, a monetary

<sup>9</sup> Cf. A. Cukierman: Discretion, Precommitments and the Prospects for a European Central Bank – Fixed Parities versus a Commonly Managed Currency, in: Z. Eckstein (ed.): Aspects of Central Bank Policy Making, Berlin 1991, p. 148.

<sup>10</sup> Cf. Delors Committee: Report on Economic and Monetary Union in the European Community, Luxembourg 1989; and M. Emerson et al.: Ein Markt – Eine Wahrung. Potentielle Nutzen und Kosten der Errichtung einer Wirtschafts- und Wahrungunion, Bonn 1991.

<sup>11</sup> Cf. M. Frenkel and M. Klein: Fiskalpolitischer Harmonisierungszwang durch die Europaische Wahrungunion?, in: Wirtschaftsdienst, Vol. 71 (1991), No. 3, p. 140; and J. von Hagen and M. Fratiani: Monetary and Fiscal Policy in a European Monetary Union: Some Public Choice Considerations, in: P. J. J. Welfens (ed.): European Monetary Integration, Berlin 1991, p. 242.

<sup>12</sup> Cf. M. Artis: One Market, One Money: An Evaluation of the Potential Benefits and Costs of Forming an Economic and Monetary Union, in: Open Economies Review, 2 (1991), p. 321.

union appears to make sense only if the imperfection of goods and factor markets is not too pronounced. In fact, this has been the position adopted by the "Economists" since the fifties in the monetary controversy in Europe.

### Call for Redistribution Measures

In such an imperfect world, however, the countries that are adversely affected by asymmetrical shocks or have long been economically backward in any case call for greater financial help from the other members of the monetary union. This was precisely what Spain requested in Maastricht as the mouthpiece of the less developed Southern European countries. Their demands are being met, because it is feared that otherwise a European monetary union would disintegrate sooner or later owing to regional imbalances.

As in national economies hitherto, the Community will no doubt try to reduce regional disparities in development by means of state measures, such as selective regional and structural policies and far-ranging financial equalisation measures. This will lead to a

comprehensive system of interregional transfers within Europe.

Such redistribution measures are problematic, however, for at least two reasons:

□ Since the political markets in Europe are also highly imperfect, political decision-makers have scope for discretionary action. Hence there is the danger that public expenditure will grow at a sub-optimally fast rate, as is usual in welfare states. It is also probable, however, that the European countries will agree on inefficient distribution measures and a less rigorous fiscal policy. In this way the politicians not only increase the burden of adjustment for the European economies, but also jeopardise a credible monetary policy by engaging in such fiscal activism.

□ Such redistribution measures at European level also create incentives for economic agents not to adjust immediately to changes in parameters but with a lag.<sup>14</sup> This is true of subsidised enterprises just as much as for

<sup>14</sup> Cf. J. Méhitz: Brussels on a Single Money, in: Open Economies Review, 2 (1991), p. 327.

## PUBLICATIONS OF THE HWWA-INSTITUT FÜR WIRTSCHAFTSFORSCHUNG-HAMBURG

Rasul Shams

### INTERESSEGRUPPEN UND ANPASSUNGSKONFLIKTE IN ENTWICKLUNGSLÄNDERN

#### Fallstudie III Jamaika

At the HWWA-Institute case studies are being conducted within the framework of a research project supported by the Deutsche Forschungsgemeinschaft (DFG), which are intended to enable statements based on empirical data to be made regarding the extent to which the conception and implementation of adjustment programmes tends to reduce or sharpen conflicts.

The studies are based on the assumption that the success or failure of the adjustment programmes is determined decisively by the activities of interest groups. This third case study deals with Jamaica, which as a small island economy is particularly suited for an exemplary examination of the usual arguments regarding the conflict potential of adjustment policies. (Only available in German.)

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workers receiving state transfer payments. The burden of adjustment is foisted onto others, namely European taxpayers. As a consequence, relative prices remain inflexible and production factors immobile. This reduction in the adjustment capacity of the European economies ultimately jeopardises the success of a European monetary union.

The conflict between resource allocation and distribution need not arise if economic markets are truly open. "We should therefore try to establish social justice by creating a functional all-embracing order, and especially by making income determination dependent on the strict rules of competition, risk and liability."<sup>15</sup>

The considerations outlined so far have shown that the obstacles to an efficient European monetary union arise because neither the economic nor the political markets are perfect. In the economic markets, inflexible relative prices and immobile production factors impede efficient resource allocation. The imperfections in the political markets give politicians scope for discretionary action and favour inefficient macro-policies and redistribution measures. However, as the resulting public expenditure cannot be financed without repercussions on resource allocation, there is an incentive to resort to monetary financing by printing money. The more imperfect the economic and political markets, the greater the incentive. Hence, a European monetary union will be successful only if it manages to reduce the imperfections in the economic and political markets.

It therefore seems logical that initially only countries whose economic and political markets have the least possible imperfections should come together in a monetary union. The monetary decisions taken in Maastricht could be interpreted in this way if one looked at the agreements on the first stage to the end of 1996. These state that countries will be admitted to the monetary union only if they meet certain convergence criteria—the inflation rate, net new government borrowing and the public debt. In this way, not only would the members differ less widely as regards economic interests, but they may be less tempted to be a monetary "free rider". Finally, they have less incentive to resort to inefficient monetary and fiscal measures, and the calls from individual member states for interregional redistribution are more moderate.

The economies converge considerably if they have similar inflation rates and do not display substantial

differences in either the level of their public sector budget deficit or public debt. Other European countries can join the club if they have managed to make their economic markets more efficient by pursuing a steadfast policy of deregulation in goods and factor markets and if they demonstrate, by adopting a strictly stability-oriented monetary macro-policy, that they are prepared to abstain from financing state expenditure by inflationary means.

### Need for Central Bank Independence

Even if a first clutch of countries form a European monetary union as early as 1997 or by the end of 1998 at the latest, the question remains as to how to ensure that the union will actually pursue a credible, stability-oriented monetary policy. Many economists and politicians think it is sufficient to create an adequate institutional framework that will make a European central bank immune to political pressure.<sup>16</sup> However, such a central monetary authority can only be really independent if at least three conditions are met:

□ Politicians must not be given the right, at either national or European level, to interfere in the monetary policy of a European central bank. This not only precludes both direct and indirect borrowing by the executive bodies from the European central bank but also implies that the latter has absolute sovereignty over exchange rate policy in relation to non-member countries. It is gratifying that the monetary decisions taken in Maastricht state clearly that governments may not borrow either directly or indirectly from the central bank. On the other hand, the exchange rate issue was not settled credibly. Most EC countries continue to hold the view that exchange rate objectives should be pursued in relation to third countries in order to limit the adverse effects of exchange rate fluctuations. In that case, however, European monetary policy might again depend on the exchange rate policies dictated by political authorities.

□ The central monetary authority in Europe must not be obliged to support the general economic policies of member governments. As an announced stability-oriented monetary policy is really credible only if monetary policy-makers do not pursue real economic objectives as well as monetary ones, there must be no general clauses that would oblige a European central bank to give monetary support to the macro-political activities of the European Community. This "assignment problem" was not really

<sup>14</sup> Cf. N. Berthold: Tariflöhne und Tariflohnrelationen – Flexibilitätsdefizite am Arbeitsmarkt?, in: H. Scherf (ed.): Beschäftigungsprobleme hochentwickelter Volkswirtschaften, Berlin 1989, pp. 233-250.

<sup>15</sup> W. Eucken: Grundsätze der Wirtschaftspolitik, 4th ed., Tübingen 1968, p. 317.

<sup>16</sup> Cf. J. von Hagen and M. Fratiani, op. cit., pp. 226-231; and M. J. M. Neumann: Precommitment by Central Bank Independence, in: Open Economies Review, 2 (1991), pp. 99-105.

resolved in Maastricht. The opinion almost everywhere in Europe is still that monetary policy should support governments' general economic policy. However, if such a general clause were inserted into the statute of a European central bank, the problem of the credibility of European monetary policy would remain, even if it were emphasised that the objective of price stability enjoyed first priority.

□ The staff of a European central bank must also be independent. For that reason, the contracts of employment of senior bank officials must be sufficiently long by comparison with the relatively short life-span of elected governments. Salaries should be on a par with those of senior managers in the private sector to avoid employment with the central monetary authority being used as a springboard for careers in private business. Finally, in order to limit the scope for political influence, the President of a European central bank should be elected from among prominent central bankers and not appointed from outside. On the last point, at least, no explicit agreement was reached in Maastricht, so that there is still the possibility for politicians to impose an outside candidate, a prospect some countries would probably prefer.

#### Restricting the Scope for Discretion

Even if a European central bank were independent in this sense, there is still no guarantee that Europe would pursue a steadfast policy of price stability. The independence of a central monetary institution obviously also enlarges the scope for discretionary action by central bank officials. However, the incentive to pursue a stability-oriented monetary policy decreases as discretionality increases.<sup>17</sup> Steps must therefore be taken to reduce the scope for discretionary action, "because experience has shown that a monetary order that gives monetary policy-makers a free hand places more faith in them than they generally deserve. Ignorance, weakness towards interest groups and public opinion, false theories—all of these have a tremendous influence on them, to the detriment of their appointed task".<sup>18</sup>

The scope for discretionary action can be limited in two ways: first, by introducing credible monetary policy rules, and secondly by a system of personal incentives for central bank officials to pursue a stability-oriented monetary

policy. The problem with rules is that they do not have the desired effect,<sup>19</sup> as economically efficient feedback rules are difficult to verify and hence are not themselves credible. As to personal incentives,<sup>20</sup> it has been suggested that salaries and pensions be linked to the success with which stability objectives are achieved. Another possibility would be for officials to resign automatically if they failed to achieve the stability objective within a given period of time. It is clear that these considerations were not in the frame at all in Maastricht, probably because it was felt sufficient to ensure that the European central bank was largely free from political influence.

#### Some Conclusions

If it is true that relatively perfect markets in goods and factors of production are an essential prerequisite for an efficient European monetary union, then the cart was put before the horse in Maastricht. Priority should be given instead to successfully completing the 1992 internal market initiative, for only if a determined policy of deregulation manages to establish competitive structures in economic markets can one also limit the politicians' scope for discretionary action and prevent macro-political and redistributive activities whose financing ceases to have no inflationary implications once they have reached a certain size and which would be so detrimental to a European monetary union.

However, this would be possible only if one opted for competition between systems and not for a strategy of harmonisation. "Competition between states for people (human capital) and capital was the best protection against state oppression and confiscatory taxation; the possibility to emigrate was the political foundation of freedom, intellectual plurality and material incentives, without which there would have been no 'European miracle'".<sup>21</sup> A look at the implementation of the provisions of the 1992 internal market project shows, however, that on really important issues such as fiscal, social and industrial policy, the Community has opted for harmonisation rather than competition and is probably no more prepared than in the past to pursue a truly consistent competition policy in Europe.

<sup>19</sup> Cf. M. J. M. Neumann, *op. cit.*, p. 107; and W. Kösters, *op. cit.*, p. 17.

<sup>20</sup> Cf. J. M. Buchanan: Can Policy Activism Succeed? A Public Choice Perspective, in: R. W. Hafer (ed.): *The Monetary versus Fiscal Policy Debate*, Totowa, N. J., 1986, p. 148; and R. Vaubel: *Currency Competition and European Monetary Integration*, in: *Economic Journal*, 100 (1990), p. 945.

<sup>21</sup> R. Vaubel: *Kommentar*, in: E. Kantzenbach (ed.): *Probleme der Internationalen Koordination der Wirtschaftspolitik*, Berlin 1990, p. 75.

<sup>17</sup> Cf. M. Friedman: *Monetary Policy: Theory and Practice*, in: *Journal of Money, Credit and Banking*, 14 (1982), pp. 98-118; and W. Kösters: *Zur theoretischen Integration der Stabilitätspolitik in die Konzeption des ökonomischen Liberalismus*, *Volkswirtschaftliche Diskussionsbeiträge der Westfälischen Wilhelms-Universität Münster*, 126, Münster 1990, p. 20.

<sup>18</sup> W. Eucken, *op. cit.*, p. 257.