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Hans-Helmut Kotz*

EMU After Two Years – Have Critics Been Confirmed?

Views on EMU have never been unequivocal. While European governments embarked rather enthusiastically on this venture, the general public, at least in the German case, has always been basically reluctant. Euro-sceptics forcefully made the case that Euroland was an artificial construct, sporting deep-seated flaws – substantial discrepancies in regional per capita incomes, rigid labor and product markets and, in particular, conflicting views about the remit of economic policy and, consequently, the design of institutions of policy-building – that would make for a fragile edifice and possibly even an eventual unraveling.

After two years, a preliminary, if partial, assessment seems possible. Looking at conventional indicators and judged against its own performance over the last decade, Euroland's constituent regions have evolved rather well (see Table 1). Growth picked up, accelerating towards double the pace that we were used to over the 1990s. To be sure, the German and Italian economies took quite a while to gather steam. Nonetheless, as regards for example Germany, last year's output growth at some 3 percent was substantially above the lackluster outcomes since the end of the unification boom and, fortunately, above the employment threshold. As a result, unemployment receded and employment increased – since 1997 and with unfamiliar rates. Performance was even more impressive at the – so to speak – periphery and with the small-open economies like Ireland, the Netherlands, Finland or Portugal. This growth has been within the limits of potential output, leaving Euroland's current account roughly in balance. Finally, and this being the fourth of the traditional objectives of economic policy, inflation has been well-behaved. While there was, to be sure, a pick-up in the price-level over the course of last year, exceeding the ECB's medium-run target, this was mainly the upshot of the sharp hike in oil prices – and the real-effective devaluation of the euro (to which we come presently). However, the increase in the price-level appears to be a mechanical once-and-for-all without inducing

additional second-round effects. This being a judgment in which markets invest as well – as inflation expectations embedded in French index-linked bonds show. Remarkably, this stands in stark contrast to the oil-price shocks of the early and late 1970s when wage claims did not account for the redistribution of income towards oil producers and hence squeezed corporate sector profits and, as a result, capital expenditures with further negative knock-on effects on growth and employment.

To be sure, alleging that all of this was but preordained by the euro's introduction would invite, correctly at that, substantial doubt. Nonetheless and sidelining some queries, economic policy in Euroland was conducted in a way compatible with an, on balance, healthy performance.¹ Still, in the German case the prevailing public judgment on the EMU experience seems to be sceptical. The main reason being the euro's trajectory over the last two years. In particular pundits who had confessed their dislike of the whole venture early on feel amply confirmed. For the wrong reasons, as is argued below, where the euro's recent course is put into historical and conceptual relief. Nevertheless, as will be briefly and selectively enumerated, EMU faces substantial challenges which have to be dealt with constructively over the coming years. By way of wrapping up, a suggestion on venues to explore in coping with these challenges will be offered.

The Euro's Course – Confirming EMU-Sceptics?

Since its launching on January 1, 1999, the euro almost constantly lost in value against the US-\$ until bottoming out in the fall of 2000 at some 83 cents to the dollar (see Figure 1). Looking at contemporaneous market indicators as well as consensus forecasts, this was a largely unexpected evolution. And, as an aside, even the most ferocious Eurosceptics, who tell us that they had always told us so, apparently haven't put their money where their mouth always was – i. e. in put positions on the euro. Sadly though, since, with

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¹ See for a rather similar evaluation Stefan Collignon: Two years into the Euro: the next step for Europe, mimeo, London School of Economics 2001.

Table 1
Macroeconomic Indicators for Euroland, 1992-2000

| | Real GDP growth in % | | | Employment growth, in % | | | Inflation (CPI/HCPI), in % | | | Yield, government bonds maturity 10 years | | | Current account balance in % of nominal GDP | | |
|-------------|----------------------|-----------|-------|-------------------------|-----------|-------|----------------------------|-----------|-------|---|-----------|-------|---|-----------|-------|
| | 1992-1995 | 1996-1999 | 2000* | 1992-1995 | 1996-1999 | 2000* | 1992-1995 | 1996-1999 | 2000* | 1992-1995 | 1996-1999 | 2000* | 1992-1995 | 1996-1999 | 2000* |
| Euroland | 1.3 | 2.2 | 3.5 | -0.8 | 1.0 | 2.1 | 2.0 | 1.2 | 2.4 | 8.6 | 5.6 | 5.4 | 0.18 | 0.68 | 0.0 |
| France | 1.0 | 2.4 | 3.3 | -0.3 | 0.9 | 2.1 | 2.0 | 1.2 | 1.8 | 7.5 | 5.3 | 5.4 | 0.60 | 2.40 | 2.30 |
| Germany | 1.3 | 1.5 | 3.0 | -0.8 | 0.4 | 1.6 | 3.5 | 1.0 | 2.1 | 7.1 | 5.5 | 5.4 | -0.80 | -0.40 | -0.90 |
| Italy | 1.3 | 1.5 | 2.8 | -1.8 | 0.8 | 1.3 | 4.7 | 2.4 | 2.6 | 11.9 | 6.5 | 5.6 | 0.48 | 2.09 | -0.90 |
| Ireland | 5.4 | 9.2 | 11.0 | 2.6 | 5.6 | 5.0 | 2.3 | 2.0 | 5.3 | 8.4 | 5.8 | 5.5 | 2.50 | 1.90 | 0.90 |
| Netherlands | 2.1 | 3.7 | 4.5 | 1.2 | 2.9 | 2.2 | 2.6 | 1.8 | 2.3 | 7.1 | 5.2 | 5.4 | 4.31 | 4.94 | 5.10 |

* For 2000: OECD Economic Outlook 68, December 2000.

Source: FERI.

hindsight, this obviously would have amounted to a money-making machine. But why is it that sceptics claim erroneously the depreciation of the euro for their position?

The rational, unexpected part. As a matter of fact, the engaged spectators on international financial markets consistently underrated the prospective performance of the US economy while, at the same time, being slightly too positive on Euroland's perspectives. Indeed, during the euro's second year of existence, the US economy, very late in an indeed long-lasting cycle, once more accelerated towards a year over year output growth of some 5 percent. This happened against major imbalances as seen from a conventional perspective, namely: a current-account deficit which was clearly on an unsustainable path.² And, even more palpably, developments on the stock markets and here, in particular, in the so-called high-tech sectors. There, price-earnings-ratios were, until March 2000, at simply unprecedented heights. Stock prices implied an abundance of investment opportunities as well as a corresponding profitability simply stretching credulity. Indeed, to justify existing market valuations one had to plug in franchise values – that is a wedge between the return on equity and the weighted average cost of capital – 2½ times above their historical average. Moreover, whereas standard theory tells us that return on equity should, at the end of the day, shrink towards cost of capital, the representative investor, by buying and holding shares, confessed her belief that this wedge would be permanent. As an up-shot, all sorts of claims, inconsistent with conventional ideas, were in the air. Ray Fair, for example, by applying the Gordon-growth formula, calculated that with the earnings growth implied in market valuations in early 2000 (some 14

percent over the next ten years), the ratio of after-tax profits to nominal GDP (assumed to grow by 6 percent on a nominal basis) should, with almost 12 percent, be double as high as the historical ratio.³ Moreover, returns on equity were boosted by substantial debt-financed share buyback programs, i.e. substituting debt for equity. Clearly, since economic profitability could not match return on equity demanded by shareholders, this increased leverage set the stage for a less resilient corporate sector when faced with an economic downturn.⁴ Admittedly, there would be more to address here like, for example, the wealth effect and its impact on private consumption. Be that as it may, in the meantime we have experienced that no amount of new economy reasoning could prevent markets from falling prey to the laws of (economic) gravity.⁵

Anyhow, a very instructive graph (Figure 2), which I borrow from the BIS Annual Report of 2000, palpably makes us aware of how market participants were surprised by actual developments in the USA. Even the most optimistic Wall-Street economist fell well short of the outlier which reality turned out to be in this case. In other words, after the fact the direction as

² See for an authoritative evaluation Maurice Obstfeld and Kenneth Rogoff: Perspectives on OECD economic Integration: Implications for US Current Account Adjustment, Paper presented at the Federal Reserve Bank of Kansas' Jackson Hole conference, August 2000.

³ See Ray Fair: Fed Policy and the Effects of a Stock Market Crash on the Economy, in: Business Economics, April 2000, pp. 7-14.

⁴ See Patrick Artus: Creation of Value with Excess Debt, Flash No. 99-179, CDC-Research Department, Paris 1999.

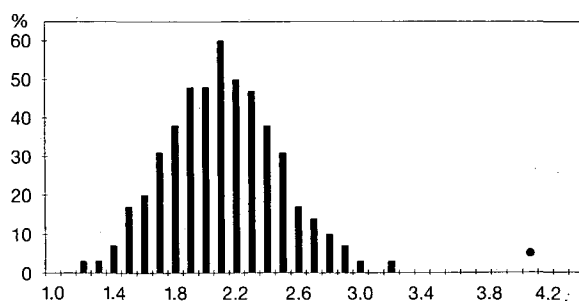
⁵ See for a comprehensive treatment Robert Shiller: Irrational Exuberance, Princeton 2000, Princeton University Press. A particularly instructive reasoning can be found in Sushil Wadhvani: The US Stock Market and the Global Economic Crisis, in: National Institute Economic Review, January 1999, pp. 86-105.

Figure 1
Euro-Dollar Exchange Rate –
the Short Term since 1999
(1 Euro = US-\$)



Source: Deutsche Bundesbank.

Figure 2
Dispersion of Forecasts for US Growth in 1999



Frequency distribution of forecasts (December 1998), point indicates actual outcome in 1999.

Source: BIS: 70th Annual Report, June 2000.

well as some of the way the euro-dollar exchange rate took is understandable with the most basic of economic models one uses, i. e. the Mundell-Fleming approach. Again, this lasting relative growth differential – as well as US interest rates therefore being constantly above Euroland levels and thus attracting capital quite naturally – came as a surprise.⁶ On the other hand, I am not aware that any of those who claim to have had the prescience on where the euro were to go, were making better predictions about the relative growth performance between the USA and Euroland, i.e. a proximate, underlying reason for the euro's performance.

The boundedly rational, overshooting part. To be sure, as regards exchange rates one is well-advised to beware of “one-reasoners”. Evidently, there is more to the plot than the open economy version of the IS-LM-approach allows us to grasp. And most probably, markets have overdone it again. This, alas, is not unusual on expectation-driven asset

exchanges. Indeed, a frequently used substitute for the MF-framework, the Dornbusch sticky-price model teaches us that with diverging speeds of adjustment between goods and asset markets, exchange rates should, as an equilibrium reaction, overshoot. Unfortunately, foreign exchange markets – like other asset markets as well – are at times inclined to go beyond even these limits.

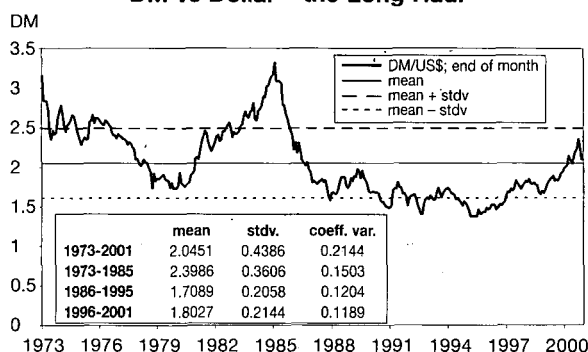
A graphical confirmation of this observation can be gleaned from Figure 3, which, for a recap, portrays the DM-US-\$ exchange rate over the floating-rate period. Incidentally, against this background arguments about the structural, inherent weakness of the euro as compared with the DM simply fall apart. Indeed, over the sample period the DM was valued, on average, at 2.04 to the US-\$; and two-thirds of the dispersion was within a 43 pfennigs band about that mean. There are, moreover, two obvious examples of significant overshooting. Beginning with the summer of 1984, the US-\$ decoupled from anything that might have served, even ex post, as a fundamental explanation. Then, in late February 1985, the Bundesbank intervened unilaterally and succeeded single-handedly in triggering a change in the US-\$'s course. The episode ushered in a period of explicit coordination (the Plaza and Louvre accords) and possibly an implicit target-zone. The other period which immediately falls to mind is the winter and spring season of 1995, when the US-\$ bottomed-out, on a daily basis, in mid-March at 1.36 to the DM. At that time, again, intervention has seemed to correct the course of events launching the dollar on a lasting upward trend.

Be that as it may, as evaluated from the vantage point of conventional wisdom, financial markets generate numerous anomalies, indeed so many, that standard finance texts devote at least one chapter for example to end-of-week, end-of-year, or excess-risk premia effects – among others.⁷ And foreign exchange markets are not above this. Indeed, Paul de Grauwe diligently gathered – in our eyes convincing – evidence of an instance of negative bubble-building with regard to the euro as well. While positive news on the Euroland economy, which should buoy on the euro (a variable endogenous to fundamental events) was usually left unaccounted for, the same held true for negative views concerning the USA. As a result, markets “systematically disregarded the observable

⁶ More precisely, the growth gap narrowed over the course of 1999 in order to open again during 2000. A further qualifier is called for: there was a constant outflow of long-term capital from Euroland towards the USA reflecting long-term relative return expectations which will be difficult to honor.

⁷ See for a concise and convincing overview Patrick Artus: *Anomalies des marchés*, Paris 1995, Economica.

Figure 3
DM vs Dollar – the Long Haul



Source: FERI.

fact that relative to Euroland's economy the news about the US economy was less favorable".⁸ Since, moreover, equilibrium values for exchange rates come with an uncomfortably large error margin – band of agnosticism as de Grauwe calls it – exchange rates can move quite substantially without being perceived as evidently out of kilter. Then, as de Grauwe argues, to rationalize current, if misaligned, levels analysts start a search for fitting news while at the same time carefully discounting evidence which does not confirm accepted beliefs. Of course, this is the cognitive dissonance reasoning which was suggested two decades ago by George Akerlof and William Dickens to explain various behavioral puzzles.⁹

Such a diagnosis, to make it clear, is not about disparaging market participants – which mainly behave compatibly with existing incentives or, so to speak, the logic of the situation. It is, however, about acknowledging how financial markets – aggregating over all the individual behavior – process and, in particular, select information. Moreover, against a background scenario of unevenly distributed knowledge about data and substantial economies of scale in passing judgment on them, simply following

other traders might become rational. Indeed, this behavior of others is an essential part of the information set of individual investors. Finally, if the canonical assumption held true according to which asset prices fully reflect all the possibly relevant information then, as Grossman and Stiglitz argued long ago, any individual incentive to gather as well as decipher data would disappear.¹⁰ Thus, with investors refining their calculations up to the point where marginal costs equal expected gross yields, again at the margin, prices might become essentially informationless.

All told, financial markets are prone to – rational – herding. Hence, asset prices can deviate significantly from what functionally efficient markets – appropriately reflecting underlying fundamentals (about which we are uncertain) – would call for.¹¹ As an upshot, significant consequences for the objectives people really care about – income, employment, prices – might result.

Anchoring devices: PPP, FEERs and BEERs. Therefore, whereas in academia a position of agnosticism is very much acceptable, in more mundane practical circles some pretense of knowledge about a roughly fitting value of the exchange rate is inevitable. It is here where purchasing power parity – belonging to the most cherished propositions of applied economics (identical goods must fetch an identical price) – comes in. While being almost buried until the mid 1980s, recent developments in econometrics fortunately gave it a further lease of life. Alas, however, movements towards PPP-levels are literally protracted, or, to use Kenneth Rogoffs appropriate metaphor, glacial.¹² From the empirical literature it emerges that it takes 3 to 5 years before half of a deviation from PPP is corrected for.¹³ Rather obviously, this is way – indeed: orders of magnitude – beyond the (apparently ever shrinking) time-horizon of those trading in (or commenting in public on) these markets.

As a consequence, when searching for criteria to evaluate the appropriateness of exchange-rate levels,

⁸ See Paul de Grauwe: *The Euro-Dollar Exchange Rate: In Search of Fundamentals*, mimeo, University of Leuven 2000; Hans-Helmut Kotz: *The Euro's Exchange Rate – A Problem for the ECB*, forthcoming in: Rolf Caesar and Hans-Eckart Scharrer (eds.): *European Economic and Monetary Union – a Preliminary Assessment*, Baden-Baden 2001, Nomos.

⁹ See George Akerlof: *An Economic Theorist's Book of Tales*, Cambridge 1984, pp. 123-44, CUP.

¹⁰ See for example Sanford Grossman and Joseph Stiglitz: *On the Impossibility of Informationally Efficient Markets*, in: *American Economic Review*, Vol. 70, 1980, pp. 393-408.

¹¹ The whole of this argument is, obviously, inspired by James Tobin: *On the Efficiency of the Financial System*, in: *Lloyds Bank Review*, No. 153, 1984, pp. 1-15; for a comprehensive overview see also Robert Shiller: *Human Behavior and the Efficiency of the Financial System*, in: *Handbook of Macroeconomics*, Vol. 1c, Amsterdam 1999, New Holland, pp. 1305-40.

¹² See for a very instructive review Kenneth Rogoff: *The Purchasing Power Parity Puzzle*, in: *Journal of Economic Literature*, June 1996, pp. 647-668.

¹³ A standard procedure, as developed in particular by Jeffrey Frankel (*International Capital Mobility and Crowding-out in the U.S. Economy: Imperfect Integration of Financial or Goods Markets?*, in: Ric Hafer (ed.): *How open is the U.S. Economy*, Lexington 1986, Lexington Books, pp. 33-67) regresses the real exchange rate on its lagged value and then uses the coefficient on the lagged endogenous variable – being 0.86 in this case – to calculate a half-life of 4.6 years for a deviation from PPP, more precisely: by applying the formula $1/(1 - \text{coefficient})$. No doubt, such auto-regression based tests of PPP have a notoriously low power in rejecting the null of a unit root – in which case there would be no mean reversion and the long run – being equal to the regression's constant divided by $(1 - \text{coefficient})$ – would not be defined. In other words, the real exchange rate might, if disturbed, wander all over the place.

one has to look for other devices.¹⁴ A first approach, as pioneered by John Williamson, figured out which exchange rate would be compatible with a sustainable position on the balance of payments account over the medium run. There were basically two ways explored to get at this fundamentally equilibrating rate, corresponding to internal as well as external balance. Either a structural model was solved, and thus the result was contingent on the model's spelling out how the world works, or more boldly, a medium-run tolerable position had to be posited normatively.

The second approach, to which Ronald MacDonald has been a decisive contributor, involves looking again for a position on the current account which is consistent over time, and lets the data speak. And the gap between actual and data-suggested exchange rates is perceived as misalignment. Again, these equilibrium values come with substantial margins of error.

However, at the end of the day, both approaches came to the conclusion that the euro was beyond – more precisely: below – bounds which could be reconciled with conventional arguments. Hence, inasmuch as this impacts on the final targets of economic policy, this was a situation which called for corrective action. As Michael Mussa, the IMF's departing chief economist said ahead of the ECB's interventions in the f/x markets: When, if not now?¹⁵

Challenges To Be Solved Constructively

Some have seen EMU as a – too risky – gamble. Others, in a more positive vein, conceive it as a challenge – to be met with constructive answers. Within the binding space limits given to me, I just want to touch upon three – all of them with a bearing on monetary policy and all of them dealing with externalities and hence coordination problems.

Underwriting financial market stability. The German Finance Ministry recently suggested a fundamental reorganization of financial market supervision. Starting from the observation that financial markets in the future will be dominated by institutions of the *bancassurance* variety – a view which can definitely claim to be original since it is neither shared by international institutions nor the bulk of the academic literature¹⁶ – it suggests creating an encompassing supervisory authority dealing with the universal banks – which, viewed from a US perspective, epitomize financial conglomerates – and securities markets, as well as the insurance industry.

Here is not the place to go into any detail. Still, what careful research has unearthed is that central banks,

as a result of confidential knowledge, are relatively better capable of evaluating the quite opaque positions of banks than markets or rating agencies.¹⁷ In addition, such knowledge generated while conducting hands-on supervision is conducive to the macro-duty of central banks, i.e. monetary policy: it allows for better forecasts of inflation as well as unemployment. Likewise, since EMU implies the effective expansion of the market arena, thereby creating deep and liquid markets, this will emphasize the *marchéisation* of external funding as opposed to the *bancarisation*.¹⁸ In such an environment, however, to counteract financial fragility, the provision of good money – the lender of last resort function – becomes ever more important. Rather obviously, monetary policy is deeply implied.

Moreover, and again a subject barely scratched at here, within the Basle deliberations on bank regulation, Euroland, without a blueprint of its own, is mainly reacting defensively to US proposals – on capital adequacy, on the supervisory review process or on market discipline. The patent holes in, for example, the models to control the trading book of banks need urgent attendance. Therefore, discharging central banks from conceptual obligations – as opposed to operational duties – appears to me to be highly debatable. Finally, the dominating partners in international rule-setting come from a finance or central bank inspired background. Hence, inasmuch as the new approach of the German Finance Ministry (leaving too much to desire) is apt to provide an example for our partners, the debate

¹⁴ See for a very fine overview Ronald MacDonald: Concepts to Calculate Equilibrium Exchange Rates: An Overview, paper prepared for a Bundesbank Workshop, Frankfurt, March 2000.

¹⁵ Views on interventions in f/x-markets – neutralized, to be sure, since otherwise they would not be an *additional* instrument of policy – have undergone a significant change since the early 1990s. Acknowledging the existence of risk-averse market participants, treating assets in different currency denominations as imperfect substitutes, the above-mentioned margins of error about fundamentally justified exchange-rate levels as well as the possibility of multiple-equilibria led to rethinking of the ineffectiveness-of-intervention position. The more positive evaluation started with Kathryn Dominguez and Jeffrey Frankel: Does Foreign Exchange Intervention Work? Consequences for the Dollar, Washington 1993, Institute for International Economics.

¹⁶ See for example Jean-Pierre Danthine et al.: European Financial Markets after EMU: A First Assessment, CEPR Discussion Paper No. 2413, 2000; or Ingo Walter and Roy Smith: High Finance in the Euro-Zone, Harlow 2000, Pearson.

¹⁷ See in particular Robert De Young et al.: The Informational Advantage of Specialized Monitors: The Case of Bank Examiners, mimeo, Office of the Comptroller of the Currency, 1998; as well as Joe Peek et al.: Is Bank Supervision Central to Central Banking, in: Quarterly Journal of Economics, 1999, Vol. 114, No. 2, pp. 629-53.

¹⁸ See on this Hans-Helmut Kotz: Capital Markets in Euroland: Filling Gaps and Piercing Veils, in: Rolf Caesar and Hans-Eckart Scharrer (eds.): Economic Policy Challenges in EMU, Baden-Baden 2000, Nomos.

merits to be conducted in a Euroland context. Hence, what is lacking in Europe is a constructive discourse on this subject of common interest.

Intra-Euroland price-level differentials. Starting with quite substantial differences in per capita income, Euroland was, to begin with, prone to sport diverging price-level developments. And in fact, regional inflation rates have been moving apart again of late. At the start of EMU national headline rates of inflation were between 0.25 and 3 percent, while core rates strayed between 1 and 2.75 percent. At the end of last year the inflation rate as measured by the HCPI was between 2.25 and 7 percent while the underlying rates were between 1 and 5 percent. Such discrepancies, if continued, could generate significant problems. After all, within a currency union a continuous loss of regional/national price-competitiveness implies quite naturally negative effects on employment and growth.¹⁹

To begin with, it is important to assess where price-level pressures emanate from. Economies, having embarked on a catching-up process, are usually characterized by significant changes in relative prices between tradable and non-tradable goods (in particular, services). This, being an upshot of differential productivity developments together with a mobility of labor existing within but not between regions of a currency union, is, so to speak, but an indicator of the catching-up process – an equilibrium response, hence negligible for monetary policy. On the other hand, however, if inflation differentials result from diverging developments of prices in the exposed sector, then, inevitably, a damper on price competitiveness would result.

For a unitary monetary policy this entails potentially nagging problems since in regions with higher inflation rates real interest rates are commensurately lower, possibly feeding local asset market bubbles (a point often made by Charles Goodhart during the debate about the costs and benefits of EMU). Here, again, we are confronted with a failure of capital markets, namely, that differentials between nominal interest-rate yields are substantially below regional inflation differentials – for which there is ample evidence. However, as has been frequently pointed out, the burden of adjustment falls on either relative prices, labor mobility or national fiscal policy. Moreover, inasmuch as the Euroland price index rises, on average, more rapidly than in the low-inflation regions of Euroland, this amounts to more ambitious inflation targets for the low-inflation regions, as Hans-Werner Sinn and Michael Reutter have pointed out.²⁰ Here, the US experience might serve as an appro-

priate counterfactual. As Stephen Cecchetti has shown, relative price levels between cities – i.e. intra-national real exchange rates – show a substantial divergence. And what is even more puzzling, they are characterized by strong persistence, that is mean-revert only very protractedly – with a half-life of convergence of some 9 years, thus roughly double the time we typically find for international real exchange rates.²¹

Macropolicy coordination. Euroland enhances the interaction of economic policy-formulating institutions, being autonomous and at the same time interdependent. What finally matters, the overall stance of macro-economic policy, will be the upshot of a three-level game between a Europeanized monetary policy, twelve national fiscal policies, coordinated via the Stability Pact, and a pretty heterogenous setup of wage- and price-setting behavior.²² Whatever its goals, monetary policy can realize them only by affecting aggregate demand – being, however, influenced by fiscal policies and wage policies as well. In other words, goal-achievement is inextricably linked to policies pursued by other actors in the plot.

In such a situation of strategic interaction with the attending externality problems, questions of coordination are at issue. However, evaluations are still rather far apart. Whereas, at one end of the spectrum, for the German *Council of Economic Experts* the debate about macropolicy seems to be of no avail, having been conclusively dealt with in the Maastricht Treaty of 1991, this is apparently not a view shared by, for example, the French *Conseil d'Analyse Économique*.²³ In other words, differences about the adequate policy mix and, in particular, how to accomplish it – by default or in a controlled fashion – are still looming quite large. And here a major bone of contention has been the means and ways of institu-

¹⁹ See for the following Olivier Blanchard: Country Adjustment within Euroland. Lessons after Two Years, mimeo, MIT 2001.

²⁰ See Hans-Werner Sinn and Michael Reutter: Die Mindestinflationssrate für die Euro-Länder, in: ifo-Schnelldienst, Nos. 35-36, 2000, pp. 23-26.

²¹ See Stephen Cecchetti et al.: Price Level Convergence Among United States Cities: Lessons for the European Central Bank, mimeo, Federal Reserve Bank of New York 1999; for Euroland evidence see the careful paper written by Guenter Beck and Axel Weber: How Wide are European Borders: New Evidence on the Integration Effects of Monetary Union, mimeo, Center for Financial Studies, Frankfurt 2001.

²² See on this Hans-Helmut Kotz und Wim Kösters: Perspectives on the Policy Mix in Europe, in: Rolf Caesar and Hans-Eckart Scharrer (eds.): Economic Policy Challenges in EMU, op. cit.

²³ See Sachverständigenrat: Jahresgutachten, Stuttgart 1998, Metzler-Poeschel; and Pierre Jacquet and Jean Pisani-Ferry: La coordination de la politique économique dans la zone euro: bilan et propositions, in: Conseil d'Analyse Économique, Questions européennes, Paris 2000, La Documentation Française, pp. 11-40.

tionalizing, if at all, fiscal policy coordination. In fact, proposals to develop the Euro Group towards a collective executive body, organizing the mutual exchange of information as well as being capable of defining and implementing common positions, are compelling in my eyes. Moreover, as suggested recently by Commissioner Solbes, the EU Commission here might serve in a supporting and coordinating capacity.²⁴

Concluding Remarks

With micro-benefits and macro-costs having always been embarrassingly balanced,²⁵ the economics of EMU has never been clinching. Hence, the decisive (and normative) arguments in favor of EMU have always been political.²⁶ At the same time, most of the queries reside here as well: a most urgent question thus is, how Euroland conceives of dealing with its structurally enhanced interdependence.

²⁴ This is a position argued in the paper by Pierre Jacquet and Jean Pisani-Ferry, *op. cit.*, as well as in Jürgen von Hagen: Co-ordination of Economic Policies and Employment, in: Alexandre Lamfalussy et al. (eds.): *The Euro-Zone: A New Economic Entity*, Brussels 1999, Bruylant.

²⁵ See on this Paul de Grauwe: *The Economics of Monetary Union*, Oxford 1996, OUP.

²⁶ See on this Klaus Gretschmann and Hans-Helmut Kotz: *The Politics of EMU: Problems in Creating Wahlverwandschaften*, in: *Kredit und Kapital*, 1997, Sonderheft 14, pp. 123-136.

While being critical of some aspects of suggestions by Pierre Jacquet and Jean Pisani-Ferry (for example on the ECB's two-pillared strategy or the external representation of Euroland), I largely sympathize with the bulk of their analysis, in particular that a debate about an economic policy charter – outlining principles and rules of the conduct of economic policy – should be launched. To arrive at a common position will be no mean feat. As a prerequisite, the respective positions should be acknowledged in a non-caricatural form. Of course, institutionalizing fiscal coordination must not impinge on the ECB's independence – as has, moreover, explicitly never been intended in the above-mentioned proposals. Indeed, according to the professed intentions, by creating a Euroland-level institution of fiscal policy and thus rectifying in the apt wording of Tommaso Padoa-Schioppa to some degree the "institutional solitude of the ECB at the Euroland level", criticism otherwise aimed directly at the ECB might be deflected.

All of this entails that we probably have to discard the convenient idea according to which the institutional setup as well as the guiding philosophy have been written in stone in Maastricht. Stating this is, indeed, ending on a positive note. Since it acknowledges that Euroland is capable of reacting to new challenges – as they come up. EMU is very much an open arrangement.

Pedro Solbes*

The European Union, EMU and Enlargement

Looking back over the last few years, we have seen historical changes. The fall of the Iron Curtain, German unification and democracy in central and eastern Europe have changed the political landscape of our continent.

To exploit the new opportunities and to repeat the success of western European integration with our eastern and some new Mediterranean neighbours we need to strengthen European integration.

We should not forget that even an enlarged European Union has to stand the test of international

competition and to guarantee economic growth and employment. Our companies must adapt to a new knowledge-based economy, to globalisation and world-wide financial markets and to increased structural changes.

We have to be able to defend our common interest in international trade negotiations and to safeguard the basic values of a European model of society, which is based on competitiveness and solidarity.

To meet the challenges of the world economy successfully, Europe needs an integrated well-functioning home market.

With the internal market programme, the European Union has successfully abolished national barriers to trade in goods and services, has started to set common standards and has helped to build a more

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