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**EVOLVING AMBITIONS
IN EUROPE'S MONETARY UNIFICATION**

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When I received the kind invitation of SUERF to give the Marjolin Lecture at the Frankfurt Colloquium of SUERF I became enthusiastic, because there is for me a close link between Economic and Monetary Union (EMU) in Europe and the name of Robert Marjolin. My introduction to the subject of Europe's monetary integration in fact goes back to my participation in a group headed by Robert Marjolin in 1974-75, exactly twenty-five years ago.

At that time the Werner plan, drawn up in 1970 by a group of high European officials, was in disarray. The eruption of high inflation following the oil price hike of 1973-74 and the transition to floating exchange rates had made the international environment for this ambitious undertaking too hostile. In the winter of 1973-74 the European Commission therefore decided to have a group of independent experts study whether EMU by 1980 as still possible.

Several prominent economists with highly sceptical views about EMU joined the group. Notable amongst them were Professor Herbert Giersch of Kiel and Sir Donald McDougall, then Chief Adviser to the Confederation of British Industries. There were also more positive voices such as Professor Hans Bosman, already then Secretary-General of SUERF, whose presence in this colloquium I deeply miss. Hans Bosman was a great European and contributed substantially to the debates in the Marjolin group. There was also Bernard Clappier, later to become Governor of the Banque de France and an architect of the European Monetary System (EMS). His view was that EMU might have been feasible if officials had been bolder in 1970 and had moved much more rapidly to locking up exchange rates. I also count myself among the optimistic members of the group in these dark moments of the 1970's. But in the end we were all persuaded to sign up to a sceptical report in April 1975, see Marjolin *et al.* (1975). Robert Marjolin himself has briefly and brutally summarized the conclusions from this report in his memoirs written shortly before his death in 1986, i.e. a decade later, see Marjolin (1986).

In his memoirs Marjolin does not devote many pages to his presidency of the EMU group named after him. This of course was to be expected for someone who had achieved much greater things in life than chairing a committee. Robert Marjolin came to the group with his rich experience, first as Secretary General of the OEEC from 1948 when he was only 37 and ten years later as the first Vice-President for Economic Affairs

of new European Commission. Marjolin also brought, particularly from the former of these experiences and from his many links to the United States, a global perspective on Europe's integration. He speaks in his memoirs of "the illusion of Economic and Monetary Union" and he criticizes politicians for seeing EMU as a substitute for political union. Marjolin further noted (in 1975) that "national economic and monetary policies have never in 25 years been more discordant". Indeed, 1975 when the report appeared was marked not only by double-digit inflation, but by inflation rates of 20-25% in Italy and the United Kingdom. Europe was about to enter a cycle of devaluation and inflation. While we worked in the group France was mostly outside the currency snake, the rudimentary exchange-rate arrangement that had been put in place in 1972 as the main legacy of the Werner report. The Marjolin Report pointed to an absence on the part of politicians on any real understanding of what was involved in EMU and it encouraged governments "to concentrate on the immediate problems of inflation, balance of payment deficits and unemployment".

With a certain pride Marjolin noted in 1986 that the report he presided over had its effect: "there was no more talk of EMU". He speculates whether the report may have contributed indirectly to the creation of the EMS three years later, but he also states that it would be absurd to speak of a practical arrangement such as the EMS as being a step towards full monetary union.

I wish Robert Marjolin would still be here to continue the argument. Some of the conclusions of his report have stood the test of time; others have not. The EMS did in the end turn out to be a step towards EMU, both in its long and successful survival and, more paradoxically, in its demise in 1992-93. And, in the long run, EMU may well turn out to be the best possible solution to preserving the priorities of low inflation and the containment of balance-of-payment imbalances and hence to meeting a precondition for addressing Europe's current main problem - unemployment.

In the following I want to trace the ambitions of European monetary integration as they evolved over the past twenty five years. I note five major ambitions and survey how they evolved, gradually gaining ground and overcoming the opposition, mostly from national policy makers, but also - and sadly from my point of view - from a majority of academic economists. The five evolving ambitions are the following:

- ▶ reducing, then eliminating nominal exchange-rate fluctuations;
- ▶ reducing, then eliminating inflation;
- ▶ developing rules for non-monetary national policies, then scope for coordinating them without undermining the rules;
- ▶ developing a potential role in the international monetary system, then adjusting it to the realities of today; and
- ▶ developing a European profile in financial regulation?

Truthfully only the first three, or may be more correctly two and a half, of these ambitions can be said to have been fulfilled with EMU as it has started on 1 January 1999. There are still unfulfilled ambitions. In any case, to start the discussion it is necessary to go back to the origins of the EMS or even further. In doing so I rely heavily on joint work with Daniel Gros, embodied in a book that we first published in 1992 and have published in a significantly revised second edition, Gros and Thygesen (1998).¹

Reducing, then eliminating nominal exchange rate fluctuations

The reduction - and finally elimination - of exchange-rate fluctuations must be said to have been the core achievement of the two decades since 1978. The European Monetary System evolved gradually from damage limitation via joint exchange-rate management to almost stable rates in the beginning of the 1990s. In the first four years of the system exchange-rate changes were still frequent; seven of them occurred in these four years. The system gradually firmed up over the next four years from March 1983, constraining exchange-rate fluctuations quite successfully, as countries tried to converge on Germany. From January 1987 a period of fully stabilized exchange rates followed and it lasted until September 1992. Towards the end of that period it even became fashionable to talk as if Europe was already in a quasi-monetary union.

A common currency was identified in the Delors Report (1989) as necessary for the final stage of Europe monetary unification. This was a remarkable development; in the

¹Some of the subsequent analysis has been developed in two earlier papers presenting our work on European monetary integration, see Thygesen (1998) and Thygesen (1999).

late 1980s the ambition talked about was initially just to have fully locked exchange rates. But it was recognized that it was very difficult to foresee that exchange rates could become “irrevocably” locked in the absence of a common monetary authority and indeed a common monetary unit. The evolution of the ambition to go all the way to a common currency implied that one moved from coordinating national policies and integrating financial markets to full-scale unification. That in turn implied a significant simplification of the task of monetary policy because one would then move to a more familiar “national” model.

In his remarkable book The Road to Monetary Union in Europe Tommaso Padoa-Schioppa (1994) notes that the utopian perspective of full currency union was confirmed as a realistic option by the 1992-93 crises in the EMS. With the degree of capital mobility achieved at the end of the 1980s, fixed-but-adjustable exchange-rates might have become impossible to maintain. Central bankers found it difficult to face this issue and claimed in most cases that the experience with the EMS was sufficiently promising to aim no further than a well-functioning EMS. It is more surprising that many, if not most, academic economists also found it extremely difficult to accept this ambition as reasonable in economic terms. I suggest that this is due to two important biases in much of the economic analysis of full monetary union. The first is that the alternative to EMU is viewed in too optimistic a perspective. The second is that the issue of asymmetric shocks affecting the participants in EMU in a differential way has been played up too much in the economic debate, confounding the possible with the probable. Finally most of the academic discussion seems to have underestimated the benefits of fully eliminating exchange-rate fluctuations.

The theory of optimum currency areas (OCA) has provided the economist with a useful check-list for the evaluation of whether an economy could derive net benefits from participating in a monetary union with one or more of its trading partners. Unfortunately the vagueness and the static character of the proposed criteria as well as their failure to give full attention to the alternative to monetary union has in my view imparted a certain bias against EMU in much of the academic literature on the subject. That in turn has left many economists and non-economists alike with the conclusion that EMU must be a project that can only be understood in political terms.

Nobody will deny that EMU has a political inspiration which may well have been dominant for some of the main actors in the process, such as Chancellor Kohl. But monetary union would not have come about if it did not have a stronger backing in economic arguments as perceived by large segments of business, trade unions and financial market participants than the bulk of the professional economics literature suggests. What are the causes of this gap in perceptions? And who is closer to reality?

May be the main weakness of the analytical framework of OCA theory lies in its inadequate attention to the alternative. It implicitly assumes that the alternative to a country's participation in a monetary union is either a well-functioning system of tightly managed exchange rates where rare realignments of parities are undertaken in situations of major country-specific or asymmetric disturbances without upsetting otherwise stable foreign-exchange markets, or a system of floating rates reminiscent of the ideal state of Friedman's classic 1953-case for flexible rates where markets smoothly provide a safety valve for the adjustment to residual differences between economic performances and/or policies in two areas. Both of these benchmark cases appear excessively optimistic when one considers a realistic overall alternative to EMU.

On important occasions the former of the two benchmarks received official status. The European Commission, usually not suspect of bias against monetary union, no doubt in its major report One Market, One Money of 1990 considerably underestimated the potential gains of realising EMU by comparing it to a continuation of the apparently successful tight EMS which existed at the time. The benefits of eliminating the small residual exchange-rate variability of the early 1990s were perceived to be small, though larger than the additional costs which had already been borne. In a surprising show of confidence some central bankers even said that should EMU fail to be implemented, the informal and pragmatic cooperation between central banks in the ERM had become sufficiently robust to largely reproduce the effect desired with EMU.

The foreign-exchange turmoil in 1992-93 demonstrated that any such confidence was misplaced. A system of fixed exchange rates where the possibility of realignments has not been excluded is very vulnerable in a state of high capital mobility which pushes countries beyond cooperation towards full-scale abolition of national monetary autonomy.

Without this final step, the ERM would remain prone to speculative attacks, as Padoa-Schioppa had already argued in 1988.

Models for such attacks had originally been inspired by observations of national monetary policies gradually leading to the exhaustion of international reserves required to defend the parity. Since financial market participants would be able to foresee the time of exhaustion they would attack earlier and precipitate a collapse. The crises for some currencies in 1992 - lira, peseta and Swedish krona - provide illustrations of this so-called “first-generation model” of speculative attacks. Many European officials were reluctant to admit the relevance of this model, because the EMS was in principle based on unlimited mandatory interventions, while at the same time the access to borrowing was growing rapidly for the participants. However, in September 1992 the Bundesbank reminded others that interventions could not in practice be unlimited as long as monetary policies were only imperfectly coordinated. The reminder has been repeated in the framework arrangement for cooperation between the euro area and non-participating EU currencies which has replaced the EMS at the start of EMU.

In the early months of 1993 and again over the summer there were new speculative attacks, this time on several currencies believed to have sufficiently sound fundamentals for the first-generation models to be inapplicable. These attacks can be illustrated by the so-called “second-generation models”: speculators gain if they have correctly anticipated reluctance among the officials responsible to continue to bear the costs of defending the parity by means of high domestic interest rates. As recession dragged on, France was seen to develop such reluctance and a growing temptation to follow the British example of exit from the system in the previous year.

These expectations proved unfounded in 1993 - there was no easing of monetary policy in France or in other EMS countries, even after governments and central banks in August 1993 took the unexpected, but in retrospect logical, step of widening the margins of fluctuation to $\pm 15\%$. That created “two-way risk” for speculators while the maintenance of the central rates indicated that fundamentals were unchanged. This lax system functioned well over more than five years when it became ever tighter, but one should not interpret this as evidence that the participants have finally found a robust compromise between fixed and flexible exchange rates: the disciplining force of approaching the final

deadline for monetary union had then become the major factor constraining behaviour.

If the calls from Britain and from Continental critics for postponing the start of EMU to await a longer period of convergence had been accommodated, the EMU-participants would no doubt have tried to hold on to central rates within wide margins for an extended transition. But it is unrealistic to expect that such a strategy could have continued to convince financial markets of its stability. Minor policy shifts in divergent directions would have become subject to over-interpretations; it is particularly doubtful if the system could have survived one or more realignments.

A system of managed exchange rates where changes are confined to relatively rare occasions of “fundamental disequilibrium” would for these reasons have been unable to provide an acceptable alternative to monetary union. Could the other benchmark of flexible exchange rates have done so, provided fluctuations were dampened by a commitment of the countries concerned to low and broadly parallel inflation rates? This is of particular interest to countries such as the United Kingdom and Sweden which have chosen initially to stand apart from EMU, but have introduced national inflation targets, apparently fully consistent with stable exchange rates vis-à-vis the euro.

Unfortunately the answer appears to be negative. The experience with inflation targets suggests that even when the policy delivers the main result intended - a low and stable inflation rate - it does not deliver a high degree of exchange-rate stability at the same time. Canada has had an impressive inflation record over a number of years, similar to or better than that of the United States. This has not prevented the Canadian dollar from fluctuating very significantly against the US dollar. More to the point: UK inflation broadly parallel to Continental European inflation has not prevented sterling from moving over a wide range between DEM 2.25 and 3.10 over the past three years. If one were to take the mid-point of this range as close to a longer-run equilibrium it is necessary to reflect on the cost both to the UK economy and to those of its trading partners of swings of $\pm 15\%$ in both directions. There is certainly no evidence to suggest that the movements observed in sterling since 1992 can be explained primarily by movements in relative fundamentals. Even the Bank of England described the strength of sterling in early 1998 as “erratic”.

If one presents the alternative to monetary union as either a system of managed exchange rates prone to recurrent speculative attacks or as a régime of flexible rates marked, even in relatively propitious circumstances, by excess volatility of rates the conclusion changes from that where EMU is compared either to a well-managed discretionary system where exchange-rate changes remain as a useful instrument of macroeconomic adjustment - or to a flexible system where the exchange rate functions as a safety valve. It should be a cause for soul-searching to economists why they emphasize the random and volatile nature of exchange rates when teaching international economics while adopting a very different posture when they review the pros and cons of EMU. A less biased question would be whether monetary union eliminates costly exchange-rate volatility to a degree which makes the lost opportunity of allowing the exchange rate to move in the rare cases when such changes could provide an important element in the macroeconomic adjustment appear acceptable. As you will have gathered my own answer to this question is yes.

Let me now turn to the second source of bias in the evaluation of the net benefits of EMU: the assumed prominence of asymmetric shocks affecting the participants in a differential way. Here again I refer to classical OCA theory. When are changes in the nominal exchange rate appropriate as part of macroeconomic adjustment? The celebrated asymmetric or country-specific shocks are seen by many as the essential argument for preserving national currencies and hence the possibility of adjusting their external value.

Mundell's pioneering article (1961) took as its starting point demand shifts between domestic and foreign products in a world of sticky prices and very limited factor (labour) mobility. Such shifts become more likely, the more specialized the economy is in its productive structure; Kenen (1969) extended Mundell's model, which had assumed full specialization, to diversified economies between which demand shifts are less likely and in which supply shocks have more similar effects. Whatever will pose a threat to the survival of EMU, it will hardly be significant demand shift from, say, German to Italian or Spanish goods - even less so after the start of EMU has unified monetary policy and imposed constraints on divergences between national budgetary policies. In EMU one will no doubt continue to observe non-policy disturbances which have a particularly strong impact on some sectors and industries and hence on regions in which these sectors or industries are strongly represented. But such regions are unlikely to correspond to national

states participating in EMU and their problems could not, as Mundell himself was the first to point out - and as he has recently repeated, see Mundell (1998) - be corrected by a realignment between national currencies; they should lead to changes in relative prices and in relative remunerations of the factors used in the production of the sector's output. The main question is therefore - in EMU as it was before the project was launched - whether these mechanisms work more or less well inside any particular country.

This puts the most used argument against EMU - the singling out of asymmetric shocks as the main obstacle to the single currency - into a more realistic perspective. It is not enough to demonstrate that over the past two or three decades the correlation between GDP growth rates or changes in unemployment in the EU countries has been much less than perfect. In order to evaluate the need for retaining the exchange rate as an adjustment mechanism it is necessary to isolate those disturbances which are truly external in nature, because it is with the purpose of softening the impact of the latter that OCA-theory advocates reliance on exchange-rate changes. Yet it is only rarely that this distinction is made. Some researchers adopt an indirect approach by distinguishing between supply shocks, which should in principle be independent of domestic macroeconomic policies and demand shocks which clearly are not, see notably Bayoumi and Eichengreen (1994). But this does not go far enough; some shocks to supply such as wage explosions have also been generated by divergent economic policies.

Gros and I use a crude method for identifying externally-generated shocks by looking at the difference between the growth rates of exports from an EU member state and from the whole of the EU and we report some rather striking examples of differential performance. Yet such a measure also exaggerates the problem that will be faced in EMU, as can be illustrated by the example most often quoted of an asymmetric external shock: the impact of the dissolution of the Soviet Union on the Finnish economy around 1991. The standard presentation of this case is that the virtual disappearance of an important trading partner was a decisive asymmetric shock requiring the major devaluations of the Finnish markka observed in 1991-92.

The facts are that Finnish export volumes overall fell by 6% in 1991; when compared to a growth rate of exports from EU as a whole of 4.8% this was indeed the largest single discrepancy in national export performance ever observed. However, the

main reason was less specific and less external than implied by the standard presentation: if the Soviet market had develop in line with all of Finland's other export markets, total exports would still have fallen by just over 5%. The dissolution of the USSR, however dramatic and unique, was not the main explanatory factor: a long inflationary boom in Finland, fuelled by expansionary policies, had weakened competitiveness and exposed Finnish industry as recession struck in 1991. Finnish policy-makers have obviously been content to endorse the OCA perspective of an asymmetric external shock, but this does not make the story more convincing. Even in this apparently unique case it is necessary to qualify the measure of the external asymmetric shock in order to make an assessment relevant to the challenges conceivable in EMU.

Have external, i.e. export, shocks, regardless of their origin, been important in shaping internal balance - as measured by the most politically sensitive indicator, the unemployment rate? Somewhat surprisingly, it is not straightforward to demonstrate such an impact. Among the EU countries the relationship was statistically significant only for Belgium. If one can not confirm the importance of export shocks for employment changes that must weaken the assertion that retaining the instrument of exchange-rate adjustments is essential to good macroeconomic management in the sense of maintaining broadly satisfactory employment levels.

The implication of this conclusion is, at a minimum, that external shocks would have to be very large before they have a significant impact on employment. The point can also be illustrated by the size of the real devaluation required to lower the unemployment rate by one percentage point in a typical medium-sized EU economy, where the share of exports in GDP, is about 30%. Over a 2-3 year horizon most macromodels estimate the elasticity of exports w.r.t. the real exchange rate at about 0.5. It would then take a 20% real devaluation to produce the increase of output of app. 3% which according to Okun's Law, is required to cut one percentage point off the unemployment rate. Although this back-of-the-envelope calculation disregards the impact on output and employment via imports, public finances and other indirect channels it does suggest that giving up the use of exchange-rate changes makes only a modest difference to the macroeconomic performance of the EU economies.

My final point in the rationalization of why many economists have been critical

of the move to full monetary union is that economic analysis has largely neglected the costs of short-term exchange-rate volatility. While the costs of longer-term swings into misalignments of currencies have generally been recognized, short-term volatility is mostly not seen as costly, simply because it is assumed that such disturbances can easily be hedged through the foreign-exchange market.

It should, however, be uncontroversial that there are transaction costs and other costs related to exchange-rate volatility which can only be eliminated by the emergence of the single currency. These costs depend on the degree of variability, since bid-ask spreads in the foreign-exchange market as well as hedging costs are directly related to the latter. The most recent research-based estimate in view of the experience of the early and mid-1990, is about 1% of EU GDP, see IFO (1997); European multinationals typically regard this as too low a figure. Even disregarding this latter view, the potential gain from the euro is not negligible - one to two years' benefits of this order would be enough to offset the once-and-for-all costs of introducing the euro - though it may not provide a decisive argument in favour of going all the way to monetary union. There is, however, an additional argument.

Economists have tended to dismiss further macroeconomic effects of the elimination of exchange-rate variability with reference to the difficulties experienced in documenting any major impact on trade flows. Even the least agnostic findings have suggested a boost to intra-European trade flows of only app. 1% as a result of reducing volatility, measured by, say, monthly variability of rates to zero. These modest effects have been rationalized primarily with reference to the ever-extending scope for hedging currency risks.

I have long had doubts as to whether the macroeconomic effects of exchange-rate variability were really as limited as these studies suggest. Inspired on the one hand by the work of Krugman (1989) on the implications of variability for the evolution of a wait-and-see attitude to international trade where firms follow a "pricing-to-market" strategy and hence experience major changes in profit margins when the exchange rate moves, and on the other hand by the recurrent German debate about the value to Germany of very stable exchange rates vis-a-vis important European trading partners, Daniel Gros and I tried to see if we could observe for Germany as well as for other EU member states a direct

linkage from monthly exchange-rate variability between the EMU-currencies to changes in the unemployment rate or in the percentage rate of change of employment in manufacturing. Somewhat to our surprise we initially found significant and quantitatively important effects on these important indicators of macroeconomic performance for Germany. As an illustration, the increase in the monthly variability of the DEM against an index of the other EMU currencies from 1994 to 1995, when European currency markets again experienced some tensions, may explain a rise of one percentage point in the overall German unemployment rate, say from 8 to 9%. Subsequently, broadly similar results have been found by Belke and Gros (1998) for the three other large countries in the first EMU-group (France, Italy and Spain), though not for the United Kingdom.

Obviously these results are preliminary and suggestive only. Some colleagues have found them implausible, not least when seen in conjunction with the relatively low estimates of price elasticities in the trade flows of the EMU-countries which we have also reported. But the paradox can be explained. It is entirely possible that trade flows could be more sensitive to changes in the volatility of exchange rates than to changes in their level; there may even be a trade-off between these two dimensions to the extent that an increase in volatility, by generating more uncertainty about the more permanent level of the exchange rate, will tend to reduce price elasticities. That is indeed the argument of Krugman in his analysis of inertia in observed trade flows when volatility in the dollar-yen exchange-rate shot up in the 1980's - admittedly more dramatically than anything witnessed in Europe. This line of reasoning may also help to understand the underlying support of German industry and trade unions for the participation of Germany in EMU, in contrast to the usually more vociferous skepticism voiced by German savers vis-a-vis the project.

It is accordingly not adequate to dismiss the macroeconomic benefits of the single currency by viewing them as arising only from some relatively modest savings in transaction and hedging costs. The latter may be the easiest to quantify, but not the most important.

My conclusion is that the case for fully eliminating exchange-rate fluctuations by forming a full monetary union is much stronger on purely economic grounds than has yet been generally accepted by economists. This does not imply one should overlook the

political motivations for creating Europe's common currency - only that these political motivations, strong as they may have been for some actors, can not explain why this objective achieved steady support in the business community as clearly has been the case. The first ambition of EMU has been fulfilled and there are good arguments for being satisfied with this outcome.

Let me now turn to the second ambition which is more generally accepted by economists as desirable, namely that of the reducing the inflation rate to a very low rate, may be even to zero.

Reducing, then eliminating inflation

When the discussion of EMU surfaced during the turbulent years of the 1970s, the ambition of using European monetary integration as a means of reinforcing anti-inflationary policies in the members states was initially appealing to liberal academic economists such as Herbert Giersch, Roland Vaubel, Pascal Salin and Paul de Grauwe - all of whom have subsequently been sceptical about EMU itself.

I had an early experience with discussions of an ambitious liberal approach to a European single currency through my participation in a group that drafted the so-called "All Saints Day Manifesto" which was published by The Economist on 1 November 1975, see Basevi *et al.* (1975). The group of nine European economists behind this statement based themselves on the Hayekian view that competition between different issuers of national currencies was the best way of reducing the scope for irresponsible and divergent policies such as those that marked the earlier period of the 1970s. European monetary integration could do that by offering citizens in inflation-prone countries the choice of an alternative currency of superior quality.

Hayek elaborated the idea of competition between different currency issuers in his little volume The Denationalization of Money published in 1976, and he endorsed the idea of competition between national currencies in Europe in a paper presented in 1980, see Salin (ed.) (1984). Briefly the idea was to expose nationally-issued currencies to competition from a new European unit - we called it the Europa - the purchasing power of which was to be guaranteed by the European authorities jointly. More precisely all

consumers and firms in Europe would be offered the opportunity of using a unit which appreciated against any individual European currency in step with its superior inflation performance as measured by national consumer price indices. This would have put enormous pressure on countries permitting high inflation rates whereas those with low inflation rates might have been able to successfully defend their national currency domain for quite some time. The proposal was arguably naive and excessively brutal; it seems unlikely that European governments could ever have agreed to the joint issue of a completely stable currency in competition with their own much weaker ones; that would no doubt have been perceived as too risky. The group had considerable difficulties in persuading The Economist to publish this radical idea, not least for this reason. There was also a major weakness in the scheme, soon pointed out in the subsequent debate: the plan was designed for the transition to the single currency rather than for managing the single currency subsequently. During the transition period the constant purchasing power of the new unit could be guaranteed in a technically easy way by the rule of appreciation against national currencies. However, once the new unit had replaced national currencies one was left with the problem of managing a single European currency according to the same principle of stable purchasing power. Once conversion rates could no longer be relied upon, the supply of the single currency would have to be tightly managed.

Anyway, a much more gradualist and managed approach was preferred by European officials when the EMS was started, notably after 1982-83 when inflation convergence was put high on the agenda. The emphasis was put on tightening central bank cooperation gradually to eliminate the inflation differential between the high inflation countries and those at the low end, particularly Germany. In other words, central bank collaboration was preferred to the competitive process inherent in the currency competition of the All Saints Day Manifesto. Most of my co-signatories of the latter disliked this alternative approach which they tended to label a central-bank cartel, unlikely to have the same beneficial effect of reducing inflation as unfettered currency competition. The suspicion was that there would be incentives for such a cartel to inflate together. The stability of exchange rates would then endanger the achievement of low inflation even in the prudent member states. Such a conflict could, in the view of the liberal economists, only be resolved by subordinating exchange-rate objectives to the overriding aim of price stability.

In retrospect, the liberal economists underestimated the capacity of the European policy-makers to strive simultaneously for external and internal stability, though it must be admitted that their concerns did not seem unfounded for an important part of the history of European monetary unification, arguably until the post-1992 period. Although Germany was obviously happy to see to other EMS countries trying to emulate their relatively better inflation performance through attachment to German monetary policy via a fixed rate for the DM, “borrowing the credibility of the Bundesbank” was not a complete solution to the potential conflict between the external and internal dimensions of price stability. Two outcomes could be envisaged: either inflation rates would converge at a low level - in which case German monetary leadership would inevitably be called into question by demands to share that leadership in a joint European framework - or some inflation differentials would remain and gradually undermine the credibility of fixed exchange rates. In the latter alternative countries with excess inflation might well succeed in temporarily taking over the leadership from Germany and other low-inflation countries, because the tendency of the former group to maintain higher nominal interest rates would keep their currencies strong inside the EMS; for a while in 1989-90 the Spanish and Italian currencies were typically trading at rates stronger than their central rate for the DM, despite continuing excess inflation in Southern Europe. Such a situation could endure for a while, but not indefinitely.

German unification from 1990 on gradually pushed up German inflation and obliged the Bundesbank to raise interest rates. Monetary leadership was, at least in part, restored, but the higher average inflation rate in the EMS removed some of the pressure to reduce inflation elsewhere in Europe and opened up a debate as to what rate to aim for. Was a rate of 4-5%, as observed in the early phase of the recession of 1991-93 about as far as one ought to raise ambitions, or would progress towards zero inflation be justified after weighing the output costs of reducing inflation against the benefits of a more stable monetary unit?

The political answer came first and most clearly; an academic rationalization had to wait a few more years. As recession spread there were few illusions that it could be contained by more expansionary macroeconomic policies. Budgetary policies were constrained by past excesses, notably the failure to consolidate significantly during the upswing of the late 1980s which had left little room for manoeuvre when it subsequently

became desirable to expand. Monetary policy was applied with great caution, may be in retrospect excessive caution, in 1993-94, out of fear of rekindling inflation. The countries that chose to abandon a fixed exchange rate for their currency, notably the United Kingdom, Italy and Sweden, all opted for maintaining or reducing inflation. These three countries adopted broadly similar anti-inflationary strategies with explicit inflation targets below any recent historical experience as the focus. The task for them, as for those countries which remained in the EMS, was much eased by the slack in their economies, by structural improvements in their labour markets and, not least, by a favourable international climate, marked by low prices of raw materials and increasing competition from low-cost producers of manufactured goods outside the industrial countries. In the most recent period inflation has fallen even below the rate of 2% which was long regarded as fully satisfactory by the Bundesbank and recently referred to as the upper threshold of a target range by the European Central Bank. We do not yet have in Europe any thorough study of the size of the likely upward bias in the measurement of inflation conveyed by national consumer price indices, or a fortiori by the harmonized index (HICP) calculated by the ECB, but surely measured inflation of about 1% is for practical purposes an indication of price stability². If anyone had suggested ten years ago, not to mention at even earlier stages of Europe's monetary integration, that such an objective should be set and maintained over a long horizon, such a proposal would have attracted derision, protests or both.

Why has political opinion and a large part of academic opinion endorsed a high priority for price stability - and how has monetary policy come to be seen almost solely as a means for maintaining a stable nominal framework - and regardless of the exchange rate régime? These are the fundamental questions for anyone wanting to evaluate the soundness of EMU as designed. Trying to provide answers would take me far beyond the limits of this lecture. Let me just offer a rationalization for the objective of price stability. It has not influenced the design of the Maastricht Treaty, yet it is not unreasonable to suggest that policy-makers in this as in some other cases - insistence on full elimination of exchange-rate uncertainty is another example discussed in the previous section - are capable of developing solutions to policy issues which only somewhat later find more

²In the United States a commission, chaired by Michael Boskin, reported in 1995 that in the United States the consumer price index may overstate the inflation rate to the extent of at least one percentage point.

complete justifications in the academic literature.

At least some recent efforts at evaluating the net benefits of reducing the inflation rate all the way to zero - corrected for possible inflation bias in the consumer price or other index being used - should offer food for thought. There is an older literature, mostly from three decades ago, on the optimal rate of inflation. The central contribution, see Friedman (1969), stressed that the optimal rate of inflation was slightly negative in view of the argument that if not the public would hold less than the optimum quantity of monetary base (which can be produced costlessly). Others, notably Phelps (1973), criticized this view by pointing out that in a second-best world inflation tax on money holdings might be less distortionary than the alternative taxes which might otherwise be imposed. But a comprehensive discussion of the costs and benefits of low inflation had to wait for the recent period.

In a pioneering article Martin Feldstein (1996), performed an elaborate evaluation of the net benefits of reducing inflation from 2% to zero, allowing for possible bias in the measure of inflation. The costs are the temporary loss of output as inflation falls; they depend crucially on the sluggishness of prices and wages. The benefits come from several sources, one of which, but less important than others, is the increased willingness of the public to hold a larger volume of non-interest bearing money at zero inflation. The most important benefit is that zero inflation minimizes the distortionary effects of a nominal tax system. Other benefits come from the impact on private saving and on demand for housing, the main long-term asset in private portfolios. Feldstein estimates the net benefit from zero rather than 2% inflation in a steady state to be equivalent to an increase in the level of GDP of app. 1% year after year.

Given the presumed high degree of price and wage flexibility in the US economy one would expect the costs of implementing such a policy strategy to be more modest than in Europe where sluggishness in nominal variables is undoubtedly greater than in the United States. This conclusion is borne out in studies of two European countries - Germany and Spain - but at the same time the benefits of zero inflation also seem to be larger, see Tödter and Ziebarth (1997) and Dolado *et al.* (1997) who follow the empirical methodology of Feldstein. In Germany and Spain the net benefits of eliminating the residual two percentage points of inflation therefore turn out to be very similar to, or a bit

larger than, those found for the United States. A third study for a European country has been carried out for the United Kingdom; here the net benefits are also found to be positive, but only marginally so. Yet the main conclusion from this set of studies is that there are indeed probable gains from going all the way to price stability in the full sense of the term.

It is necessary to repeat that this research remains preliminary despite all the work that has gone into it. If taken at face value it nevertheless suggests a net gain of an order of magnitude similar to that found from the complete elimination of exchange-rate variability inside Europe. In that case EMU presents a double gain to which external and internal stability have contributed about equally and the total effect - a level of GDP a couple of percentage points higher than would otherwise have been observed - is certainly considerable. The ambition of European policy-makers in making a monetary union with de facto zero inflation would then seem to be vindicated.

This double achievement is the core result of EMU with a stable currency. Achieving also the other ambitions to which I now turn is clearly subsidiary to the elimination of both exchange-rate variability and inflation. It is well-known, however, that in order to make these two main achievements sustainable, threats to them should be minimized. Such threats may come from three sources that could each potentially undermine EMU: from large imbalances in the main other type of macroeconomic policy, budget deficits, from large-scale interventions in the foreign-exchange market for the single currency against other currencies, and from efforts to prevent financial instability.

Developing rules for non-monetary policies, then scope for coordinating them

From the start of this past decade's debates on the design of EMU the role of budgetary policies was controversial. Some - and I readily admit to have been among them - thought that once exchange rates were locked definitively, the longer-term constraints on budgetary decision-makers would be sufficiently severe to make outright rules for budget deficits and debt superfluous. But I became convinced by the discussions in the Delors Committee that this view was too sanguine. The argument in favour of some form of "binding guidelines" for the upper limit to budget deficits in the member states participating in EMU was primarily based on the likelihood that national governments

when freed of the risk of higher interest rates and possibly a currency crisis would react by relaxing any effort to contain their public sector deficits. Any textbook analysis suggests that the efficiency of tax and expenditure policies increases with the degree of fixity of the exchange rate.

If only one or a few smaller member states succumb to this temptation there might not be any important distortion to the aggregate policy stance. But there is no mechanism to assure that the temptation will not be widespread in a monetary union. We may already have seen this mechanism at work towards the end of the 1990s when several member states failed to consolidate their budgets at a time of a relatively strong upswing. As the EMS firmed up and governments became confident of the stability of the exchange-rate framework, discretionary expansion largely offset the automatic improvements on the revenue side, as clearly illustrated in Buti and Sapir eds. (1998).³ This mechanism was not yet clearly perceived in the Delors Report, but the basic argument was presented as a plausible hypothesis by Lamfalussy (1989) in an Annex to the Report, and it convinced at least the central bankers that peer pressure based on clear rules of budgetary conduct to contain divergent national behaviour had to substitute for some of the market discipline imposed through higher premia in national interest rates. The idea was incorporated into the Maastricht Treaty and further elaborated in the Growth and Stability Pact (GSP or “Stability Pact”) proposed by Germany in 1995 and agreed at the Amsterdam European Council in 1997. This final elaboration clarified both the procedure to be followed in evaluating whether an excessive deficit had emerged in a country participating in EMU and the precise nature of the sanctions to be imposed on a deviant country - issues that had been left vague in the Treaty itself.

On balance, and having considered the alternatives, governments found it difficult to escape the conclusion that mandatory upper limits to budget deficits - except in well-defined “exceptional circumstances” - would be warranted in order to bolster the capacity of the ECB to conduct a monetary policy directed at price stability as a primary objective. Judging from the experience around the start of EMU it is easy to see that they were well justified in not relying solely on the remaining elements of market discipline to contain a plausible expansionary bias in budgetary policies; differentials between long-term

³See notably Figure 7.2, p.87.

government bond rates narrowed over the final months of 1998 to 20-30 basis points despite a remarkable decline in the benchmark rate of the German Bunds. In contrast to what some economists and market practitioners had argued, rising credit risk premia far from substituted for rapidly declining currency risk premia, hence vindicating the skepticism of central bankers that the former would constitute reliable discipline.

The main criticism of the admittedly somewhat arbitrary mechanism introduced by the adoption of the Stability Pact is, however, that macroeconomic stabilization policies may become too constrained if EMU participants, having lost their capacity to conduct monetary and exchange-rate policies independently, also become unable to protect themselves against the impact of asymmetric shocks through the working of automatic budgetary stabilizers, occasionally supplemented by discretionary action. Here it is necessary to distinguish between transitional problems and the longer-run properties of the Stability Pact. For the more immediate future the problem is that several countries, not least the two largest member states, have entered EMU with budget deficits which are perilously high relative to their output gaps. Even a modest worsening of the economic outlook in 1999-2000 could bring Germany and possibly France in conflict with the 3% limit to budget deficits.⁴ Hence the room for manoeuvre is extremely small and it would clearly be damaging to confidence if the budgetary limit were to be breached already within two years of the start of EMU. The ECB faces a difficult task in persuading governments that for it to maintain - or even further ease the stance of monetary policy - is contingent on more efforts at budget consolidation.

In a longer-term perspective the mechanism of the Stability Pact seems unobjectionable. Its central element is the declared intention of governments to aim for budget balance or a small surplus on average over the business cycle. This is a sensible objective which marks a clear improvement over past behaviour. If adhered to, it would leave considerable room for automatic stabilizers to work, particularly if countries where deficits are most sensitive to the cycle accept that they would have to aim for a small surplus as the normal state of affairs. Focussing on the average budget position over the cycle would bring the budgetary rule close to the concept most economists would prefer

⁴In the German case the major transfer from the Bundesbank to the government in 1998 reflecting the revaluation of gold reserves temporarily boosted the budgetary position by about 0.4% of GDP.

to see at centre stage: structural deficits. It would be far superior to sole focus on the measured deficit and to the balanced budget amendments in existence e.g. in US states, though such a rule can be justified in federations where the lower levels of government have little or no macroeconomic stabilization functions.

Large Federal states use a variety of methods for imposing discipline on sub-Federal levels of government, ranging from administrative controls in many developing and transition countries to monitoring by financial markets where the latter are most developed, e.g. Canada.⁵ Intermediate forms such as rules or a cooperative approach in annual negotiations are also observed. The Stability Pact clearly relies primarily on rules, at least in the initial stage.

On balance, the Stability Pact with its apparently rigid rules and procedures should help to put budgetary policies closer to the kind of medium-term stable path which is already the aim of the joint monetary policy. As such it deserves to be credited rather than just regarded as a side condition to monetary union which it became necessary to fulfil simply because the German government insisted on it in order to placate its own domestic opinion, still hostile to the single currency in the run-up to EMU. This latter interpretation, not implausible in view of the zeal with which the Stability Pact was presented by and in Germany, should not be the full story. The mandatory budgetary rules and procedures have improved the prospects for an appropriate policy mix. They offer some protection against erosion of the central achievement of very low and stable inflation outlined in the previous section - and ultimately against threats to a break-up of the single-currency area.

It is still questionable whether that in itself can be labelled as an achievement meeting a fundamental ambition of EMU. Whatever one may think of the imposition of constraints on national budgetary policies, this step does not qualify as coordination of macroeconomic policies in the traditional sense of that term. At first sight the Stability Pact appears to have superseded coordination of budgetary policies; the situation looks similar to the position of the ECB which is committed to price stability as a primary objective, leaving scope for output stabilization only when that objective is beyond danger. But the analogy runs deeper than that; both the ECB and the national budgetary

⁵ For a useful survey, see Ter-Minassian (1997).

authorities will need from time to time to decide upon the desirable speed at which economic disturbances that cause temporary departures from expected achievements - for budgetary policies with respect to the output gap and unemployment - should be eliminated. If, say, a negative output disturbance with potential inflationary consequence is observed for (most of) the EMU participants, the ECB will need to consider how rapidly future inflation can be brought back to its desired trajectory; analogously, the ECOFIN Council, while continuing to insist on national budgetary deficits staying below 3% of GDP, will need to apply judgment in evaluating departures from previously submitted Stability Programmes. In the opposite case where both inflation and budgetary targets are undershot there may be a case for initiatives to shift the policy stance in a less contractionary direction. Therefore, simple rule-bound budgetary policies prominent in the Maastricht Treaty and the Stability Pact, useful as they are, will hardly be the full story of economic policy-making in EMU, nor would they be accepted as such in the European policy debate. They will in reality be supplemented by efforts at coordination of a cooperative nature as outlined in the literature on fiscal federalism.

The ECOFIN Council has a natural mandate, in addition, to look at EMU-wide aggregates, as the ECB is already obliged to do. Important indicators here are the aggregate output gap and unemployment rate, the current account position of the euro area and movements in the euro vis-a-vis the major currencies (see also the following section). There have over the recent months been several signs that the ECOFIN Council, led by the Euro-11 Finance Ministers, will wish to rise to this challenge and not just confine its activities to the monitoring of compliance with the Stability Pact. This would make economic sense and should bring two types of benefit, the first economic - to improve macroeconomic policies - and the second political - to protect the ECB better against a backlash of frustration of public opinion, if central bankers were perceived to be virtually alone on the European policy stage. Some visible role for ECOFIN, or rather the Euro-11 Council, in the coordination of non-monetary policies may in fact protect rather than endanger the independence of the ECB.

Supplementing the Stability Pact by extended policy coordination with the double purpose of monitoring both individual budgetary behaviour inside the Stability Pact limits and the aggregate policy stance is to-day the unfulfilled second half of the third ambition for EMU which I have listed. It is of more recent vintage than the first two ambitions

already discussed. But it has surfaced in earlier discussions of EMU as well. The Werner Report of 1970 which presented the first outline of the final stage of EMU outlined an advanced form of centralization of budgetary authority at the EU level. That went beyond the politically feasible for a member of member states and the idea was explicitly rejected as superfluous in the Delors Report. An additional reason for the change, rooted in economic analysis, was that, over the twenty years between the publication of the two reports, the degree of optimism concerning the capacity of budgetary policy to fine-tune an economy had been significantly modified making the idea of vesting authority to try to manage the tax and expenditure policies of a number of countries at the European level look economically naive as well. When Roy Jenkins as Commission President in 1977 proposed to resume the debate on EMU his main concern was to develop a budgetary stabilization function at the European level through a much expanded EU budget to finance public goods and effect transfers between the participating states in analogy to what is found in many large Federal states. But the amounts required were regarded as far beyond the politically realistic and the debate on the Jenkins proposal soon ended. The present ambition is in this perspective more realistic, modest and constructive. The strong push now given to the recent version of the budgetary ambition, not least by France and Germany, suggests that the ambition is firmly on the agenda.

Developing a potential role in the international monetary system

This fourth ambition has been present in Europe's monetary unification at least since the start of the EMS in 1978-79. To the fathers of that project, Chancellor Helmut Schmidt and President Valéry Giscard d'Estaing, tighter monetary integration was initially a defensive move made necessary by unstable policies in the United States, in the long-term a means of enhancing Europe's role in the global monetary system. The first part of that ambition has been fulfilled; as the EMS firmed up gradually, intra-EMS exchange rates became less sensitive to movements in the US dollar than had been the case with particular virulence in 1977-78; now that EMU is formed the last traces of the capacity of USD-swings to push European cross rates apart have by definition disappeared. This is in itself a major achievement; with only a small part of the foreign trade of the EMU participants with the United States and countries that link their currency to the USD, the potential harm to the EMU participants from global instability has been sharply reduced, though certainly not eliminated.

The second part of the international ambition remains unfulfilled, but the potential to do so is now available. Some of the initial EMU participants, notably France, have always regarded EMU as a stepping stone to global monetary reform; the emergence of a single European currency could finally make a more managed international monetary system feasible. This view was until recently - with the exception of Helmut Schmidt - not shared by German leaders, but with the change of government in September 1998 German attitudes have converged much more closely towards French views, and both governments have indicated an interest in examining the case for a target zone for the euro's exchange rate vis-a-vis the USD and possibly the yen; in the case of the latter the Japanese authorities have voiced sympathy for the initiative, whereas the attitude of the US authorities remains negative. The ECB has also poured cold water on the idea, fearing that any obligation to maintain the euro within intervention margins against other international currencies could prove incompatible with the ECB's primary objective of maintaining price stability.

The formal procedures governing any initiative by the EMU-participants with respect to exchange rates are outlined in Art.109 of the Maastricht Treaty, which distinguishes between "formal arrangements" and other situations. In the former case the ECOFIN Council can unanimously decide to enter into them, having sought the view of the ECB as to the consistency of the proposed arrangement with price stability. Once the formal arrangements are in place, the ECOFIN Council can decide to "adopt, adjust or abandon" the central rate of the euro by qualified majority. In the absence of an exchange-rate system in relation to one or more non-EU currencies, the ECOFIN Council may by qualified majority "formulate general orientations for exchange rate policy", again following consultations with the ECB. The Council has recently indicated that it will discuss general orientations - the latter term was chosen in preference to "guidelines" used elsewhere in the Treaty - in cases where the euro's exchange rate is beginning to look misaligned. Given the reluctance of both the ECB and the US authorities to engage in exchange-rate stabilization it is highly doubtful whether these provision will lead to anything really new. A unilaterally declared target zone for the euro could hardly qualify as "formal arrangements" and would therefore imply only "general orientations" from the ECOFIN Council. Even the Louvre Accord of 1987 which is the closest the main industrial countries have come to agreeing on a target zone would presumably have to be

a lot more specific and transparent before it could be regarded as formal. If the euro were to appreciate sharply against other important currencies, mainly because it is taking market share from the USD in private world financial portfolios, that may obviously sway the attitude of the ECB and make it more receptive to “general orientations” from the ECOFIN Council.

Europe’s role in the international monetary system does not, however, stand and fall with its capacity to negotiate a target-zone like arrangement with the US authorities, although the avoidance of major unwarranted swings in the exchange rate between the world’s two major currencies remains an important test. Fortunately the days when European policy-makers could rightly lament about major imbalances in the US economy - the sharp weakening of the USD in 1977-78 and the gyrations of the USD in the 1980s, closely linked first to the emergence of the massive budget deficits under President Reagan and subsequently to the market perceptions that the position was unsustainable and the USD grossly overvalued, are the main examples - have been over for some time. Europeans have much less to criticize at a time when the US Federal budget has swung into substantial (and appropriate) surplus and the Fed’s monetary policy has succeeded in keeping US output and employment performance much better than Europe’s and without signs of a pick-up in inflation. Old confrontational attitudes die hard, but it may well be that the past attractions of being able to challenge the United States through the emergence of a strong European currency to compete with the dollar are no longer relevant. This would certainly be true if the growth rate of output in the euro area were to begin to match more closely that of the United States and the dollar were to weaken moderately - both factors would then reduce the US current account deficit and the European external surplus. These two factors will no doubt be seen to operate over the next couple of years. But even the glaring current imbalance between the two regions is difficult for the Europeans to criticize at a time when the US economy must be credited with imparting the bulk of the remaining growth in world demand.

What is then the main challenge in the next few years, may be a decade, for Europe to meet in reinforcing the international monetary system? It is to cooperate more efficiently with the United States to contain international financial instability and improve the much talked-about international financial architecture. Most urgently, it is to contribute constructively to the containment of financial crises outside the industrial countries

- of which a number of examples have been provided since the currency and banking problems in Asia came to the attention of the international community in mid-1997.

The euro area needs to meet three conditions in order to become an effective player in the present difficult phase for the international monetary system. It has clearly met the first by creating a unified currency area. It is beginning to meet the second: to develop a tight rules-based system of regional surveillance, comprising also budgetary policies - and hence the policy mix. Together these two first elements already have a positive impact, simply by showing to other regions in the world the value of tight regional integration comprising fully fixed exchange rates, non-zero inflation and a certain degree of macroeconomic policy coordination. There will be a long way for other regions to go in even beginning to emulate some of these achievements, yet the example will be important. But Europe has hardly begun to meet the third condition for exercising an influence commensurate with its economic and financial weight. The euro area needs to develop an effective representation of its views in global fora.

Put crudely, there are currently far too many Europeans in the traditional international fora: the G7 (or 8, as it has recently become with the inclusion of Russia), the G10 and the Executive Board and the Interim Committee of the International Monetary Fund (IMF). The fragmentation of the European presence paradoxically implies a loss of influence despite the European capacity to outnumber other.

With the set-up of the ECB things are beginning to change, but very slowly. Central bankers from the four large European countries apparently still intend to participate in G7 meetings and other meetings with central bank input. On the side of the budgetary authorities, European representation will even be enlarged; the four large countries' Finance Ministers will be accompanied by the President of ECOFIN (if he is not from one of the four large countries) and a representative of the European Commission. This is the arrangement laboriously worked out and announced at the European Council in Austria in December 1998. To American and other non-EU officials this makes matters worse rather than better; from an outsider's point of view the President of the ECB and the President of ECOFIN would suffice, even though the short tenure of six months of the latter does not exactly assure the kind of continuity in personal relations which is important in international policy coordination.

Irritation among US officials over the numerically strong EU presence in the G7 and the G10 no doubt contributed in 1998 to the set up of a new informal framework for discussing some of the issues most central to reform of the international monetary system. The US Secretary of the Treasury convened, at the time of the spring Meeting of the IMF Interim Committee, three working parties consisting of representatives from the G7 countries and 15 emerging market countries to consider three sets of issues from the agenda of the IMF (transparency, financial reforms, and private sector participation in financial support packages). That structure squeezed out all the smaller EU member states (and Spain); four of them have subsequently fought their way back into the caucus, the future of which is reportedly uncertain at the present stage. Finally, the EU constituencies in the IMF bodies do not reflect present realities after the start of EMU; some constituencies mix EU and non-EU member states, while one EU-country (Ireland) is in the Canadian constituency.

Some of these deficiencies - at least from the viewpoint of effective EU representation - are clearly less serious than others and will anyway take some time to remedy. Others could be addressed with some urgency. The excessive central bank representation in the G7 reflects the highly decentralized way in which the ECB has initially been implemented, operationally as well as in its analytic and policy-formulating role. That may gradually be rectified, as will the surprising continuation of the representation of the national central banks of the euro area in the Economic and Financial Committee (formerly the Monetary Committee) which prepares issues on the agenda of the ECOFIN Council. In view of the likely international agenda with emphasis on containing international financial crises the composition of these bodies and their international representation is of some considerable interest to the outside world.

The US Treasury is usually able to act quickly and decisively in international crises because it has a unified political leadership; the present office holders, Secretary Robert Rubin and his Deputy, Larry Summers, are necessarily at the centre of international economic efforts. The Europeans may be jealous - and sometimes critical - of their efforts in which would like to have more of a role rather than being informed subsequently when events and financial rescue packages have already taken shape. If the European Finance Ministers can not for sometime designate an external representation which is both

effective and acceptable to all member states, is it too much to hope that they could at least designate someone just below their level to coordinate European views? There has been much discussion in recent month about the now imminent designation of a high-level representative for the common foreign and security policy where national attitudes are typically further apart than in the international economic area. There seems to be a strong case for a similar figure in international economic affairs. A natural candidate for such a “State Secretary for International Economic Affairs” could be the Chairman of the Economic and Financial Committee; that might be preferable to a representative of the European Commission (in analogy to the role of the Commission the trade policy field), since the Commission’s authority in economic policy is not strongly developed. Of course, such a European counterpart to Mr. Larry Summers would have some congenital weaknesses relative to the latter until the euro area has advanced further in its non-monetary integration and coordination. But the point is that the process could be advanced significantly by such a procedural step.

In short, it takes more than establishing a solid single currency to develop Europe’s potential role in to-day’s international monetary system. Given the institutional complexities of external representation the euro area - and even more the EU as a whole - is still far from “speaking with one voice” in international fora. May be it will take a major international crisis to being about.

Developing a European profile in financial supervision

One may discuss whether this final ambition should have been included at all. Not only is it largely unrealized, it is not even an ambition widely shared by European officials. Rather, it is a task which financial instability is likely to thrust upon financial supervisors and the ECB. Therefore I would argue that it should be an ambition.

When the Maastricht Treaty and the ECB Statute annexed thereto were negotiated nearly a decade ago the majority view was that the ECB should not be considered directly responsible for financial stability. Prudential control of financial institutions and markets was to remain in the hands of national authorities. The reasons for this design were complex. As in the area of budgetary policy the general principle of subsidiarity appeared to suggest leaving responsibility for financial stability in the hands of those closest to the problems. Two additional reasons were also given: some central banks were not in charge of financial supervision in their domain, hence making it institutionally more difficult to envisage vesting this authority in the ECB after the start of EMU. Some important central banks, notably the Bundesbank, and several political authorities felt that responsibility for monetary stability - the main task of the ECB - could be undermined by widening the list of objectives. Anyway, the issue of who is in charge of financial supervision - central banks or separate agencies - is subsidiary to whether the task is sufficiently well coordinated at the European level in view of the higher level of financial integration after the start of EMU.⁶

Coordination between national supervisors in the EU is to-day based on bilateral memoranda of understanding. It seems important in EMU to intensify cooperation between supervisors and central banks and to underpin it by clear EU-wide agreement on a code of conduct covering supervisory responsibilities and standards in order to avoid misunderstandings, institutional rivalry, and excessive forbearance by national supervisors and to ensure that all financial institutions are adequately supervised by a lead regulator. The ECB could play a role as a clearing house for such a cooperative arrangement which should, in particular, make clear provisions for the allocation of responsibilities in times

⁶The following is largely based on Statement No.2 by the European Shadow Regulatory Committee of which I am a member.

of crises. Such coordination at the EU level would represent an important contribution to global financial stability.

There is a surprising degree of ambiguity in the framework of the ECB and the national central banks participating in EMU with respect to lender-of-last-resort operations. Financial stability may occasionally require the capacity to conduct such operations.

The decentralized framework with operational activities carried out through the national central banks implies that conflicts may arise between the provision of liquidity to national institutions and the ECB's responsibility for determining liquidity in the euro area as a whole. An interest-rate subsidy to a local problem bank may in the end be paid for by banks in other EMU countries and by their costumers. For these reasons, and because of the need to preserve competitive equity, procedures for lender-of-last-resort operations should be clearly allocated between the ECB and national central banks. These agreed procedures should include adequate collateral, penal interest rates and prior authorization rather than simple monitoring by the ECB for the injection of liquidity by a participating national central bank.

Conclusions

There is to-day a much clearer perception of what EMU implies than Robert Marjolin foresaw in his critical review of 1975 and in his Memoirs a decade later.

I listed five ambitions which have gradually evolved as the project progressed towards realization. There is a logical order in them, as we look back over the past two decades since the start of the EMS. Increasingly rigid exchange rates - an important benefit in themselves - required convergence of national inflation rates, hence raising the issue of who should exercise the n-th degree of freedom in an increasingly joint monetary policy. Basically, such a policy required an explicit stand on the principal objective of monetary policy - to provide a stable nominal framework for the area as a whole. With the inflationary experience of the 1970s and early 1980s still fresh un the minds of policy-makers, this issue was settled in a clear and forceful way in the Maastricht Treaty and recent research has confirmed that the gains of near-zero inflation are likely to be

substantial and must not be put at undue risk.

Even the most virtuous central bank is not, however, fully in charge of the factors that may cause inflation. A monetary policy aiming at price stability can be undermined by large-scale public sector deficits, intervention obligations vis-a-vis other important currencies and financial crises which appear to require significant injections of liquidity. A purist might say that, in order to preserve to the maximum the capacity of the ECB to meet its primary objective, monetary policy should be protected fully against these three factors. The tools for assuring that are, respectively, rules for maximum public sector deficits, no obligations to intervene in foreign-exchange markets, and no role for the ECB in solving financial crises.

The Maastricht Treaty is imbued with this spirit. It emphasizes constraints on deviant national budgetary policies, subsequently reinforced by the Stability Pact, it makes an exchange-rate policy for the euro area very difficult to envisage, and it gives no important role to the ECB in financial supervision. The degree to which these purist side conditions for EMU was imposed was impressive - and surprising given the ambitions which were also present, though less prominently, to improve the coordination of non-monetary policies among the EMU-participants, to allow the euro area to fill its potential role in the international monetary system and to assure a high degree of financial stability.

We are now entering an interesting phase where these three remaining ambitions reassert themselves. The Euro-11 Finance Ministers will push the ECOFIN Council towards additional budgetary coordination and towards a more aggregate view of the EMU policy mix, particularly in a more global context. With a less conflictual international agenda there is scope for a constructive contribution from the euro area to the resolution of global economic problems, notably financial crises, but the issue of more effective external representation remains to be resolved. Finally, there is increasing awareness (though still only moderate) that financial supervision needs to be better coordinated after the arrival of the euro and that the role of the lender-of-last-resort function needs to be more clearly specified and allocated.

The re-emergence of these three ambitions - or at least of the first two of them - is natural now that the two major and most important achievements of eliminating all

exchange-rate variability and, for practical purposes, all inflation in the euro area have been obtained. There is some scope for realising the remaining three ambitions while still assuring that the first two are always kept in mind.

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