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The Euro: A Dozen Do's and Don't's

by Horst Siebert

1. Make the national labor markets more flexible in order to avoid additional unemployment.
2. Do not Europeanize wage formation.
3. Leave employment a national responsibility.
4. Do not push for a social union.
5. Resist the political demand for transfers.
6. Accept the 'one-size-fits-all' monetary policy and improve efforts to stabilize the national economy.
7. Tie down national fiscal and budget policy to avoid political pressure on the European Central Bank.
8. Do not belittle the entry criteria of sustainability.
9. Do not get seduced by the fallacy of the short-run Phillips curve.
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The Euro: A Dozen Do's and Don't's

Introducing the euro is a project of great historical importance. It is intended, as a common currency, to bring the peoples of Europe closer together. It is also intended to render impossible a recurrence of a Yugoslavian-type scenario of disintegration and conflict in Western Europe, and eventually in the whole of Europe. From this point of view, the monetary union is politically motivated. Placing the project in a historical perspective and looking a hundred years ahead — presupposing a successful European integration — the people of Europe will think it is quite normal to have a common currency. For instance, in Germany today no one mourns for the south German “Gulden” or the “Kurant” of Lübeck, which existed prior to 1875. Nevertheless, a monetary union is in itself no guarantee against political disintegration. Both the Yugoslavian experience and the breaking apart of the Austrian-Hungarian Empire after World War I clearly point this out.

In addition to being politically motivated, monetary union also requires economic legitimization: by abolishing the cost of exchanging currencies, the transaction costs for the trade of goods, the exchange of services, the movement of people and the flow of capital — for the four freedoms — will be reduced; the Common Market will be completed from the monetary side. Thus, the process of European integration will receive a new impetus. These two reasons — the political motivation of linking people together and the economic objective of completing the monetary side of European integration — will have to legitimize the European Monetary Union.

Political expectations concerning the stimulative impact of European Monetary Union are high, but quite a few internationally renowned economists have voiced severe concerns (Blanchard 1997; Feldstein 1992, 1993, 1997; Friedman 1997; Krugman 1993a, 1993b). There are not many precedents for a common currency among nation-states that remained sovereign. And those that we have, such as the “Latin Currency Union” of the 19th century and the “Scandinavian Currency Area,” are not too convincing; actually, they were abandoned. Thus, we must take refuge in speculating on how the monetary union will function in the long run. Will it work the way politicians imagine? Under which conditions will it do so? Which prerequisites have to be fulfilled for a monetary union to function? These prerequisites — twelve do's and/or don't's — will be elaborated in the following. They relate to more flexibility of the wage rate as a substitute for the exchange rate, to a strict discipline of national economic policy, especially fiscal policy, and to the relationship between a common monetary authority and sovereign nation-states.

I appreciate comments and suggestions from Christian Fehlker, Harmen Lehment, Joachim Scheide and Markus Schlie.

I.

1. **Make the National Labor Markets More Flexible in order to Avoid Additional Unemployment**

In a monetary union, exchange rate adjustments can no longer be used as an equilibrating measure if economic development between countries diverges.

The role of diverging development. An important case of diverging development is when a shock affects countries asymmetrically. Consider the case when a member country is struck by a negative exogenous shock more intensively than other countries in the currency union. Prior to the monetary union, the country could have devalued its currency to regain competitiveness. Within a monetary union, a member country fully experiences the asymmetric shock: In the case of a negative disturbance, production falls, the utilization of the production potential decreases and unemployment rises. The economy now has to adjust by using mechanisms other than the exchange rate (Siebert 1996b, 1998a).

Moreover, the exchange rate can no longer be used in other instances: when some countries have weaker growth than others, when the business cycle in the European Union is out of synchronization and a country is in recession, when homemade problems evolve in some countries, when some countries respond more flexibly to a shock that is symmetric to the European Union as a whole and when the unemployment rates diverge strongly between countries.

How relevant diverging economic development between the countries of the monetary union will be, depends on a number of conditions. The economic structure may differ, so that external shocks have a different impact. Empirical studies indicate that there is some homogeneity between some European countries (especially Germany, Austria, Benelux and to some extent France) in the sense that these countries experience shocks that are correlated to shocks of Germany, which means there is interdependence (albeit to a smaller degree than between the regions of a country, for instance Germany, Funke 1997). But there is heterogeneity in a larger monetary union, which means weaker linkages (von Hagen and Neumann 1994; Funke et al. 1997); for instance, shocks in the UK show a stronger correlation with shocks in North America than with continental countries. It is an open question whether a common currency area will lead to greater specialization in space (Krugman 1993a) or whether the economic structure will become more homogenous. The example of the US suggests that spatial differentiation can play an important role in a large geographical area. Moreover, convergence in per capita output does not rule out a strong differentiation in space, for instance, in economic structure. In addition, the fundamentals of economic growth may differ between countries.

Three substitution mechanisms for the exchange rate. A first mechanism of adjustment which can be taken into account as a substitute for the exchange rate is the migration of labor. If workers leave a country which has been struck by a crisis and move to more prospering countries, unemployment decreases in the crisis area. The per capita income of the country in question will rise again. Never-

theless, this is a “passive” cure. Moreover, under European conditions, one can assume that this form of adjustment will not be accepted by the countries to which workers would have to emigrate. The willingness to absorb workers from abroad will generally be low. Evidence for this is given by the German discussion on the “Entsendegesetz,” which is an attempt at keeping foreign EU workers out of the German labor market by making minimum wages mandatory in the construction industry. Moreover, language barriers and cultural diversity will limit the mobility of people. Even though the free movement of labor is one of the four freedoms of the Common Market, it seems realistic that labor migration will play a minor role as an equilibrating instrument in the divergent structural development in Europe. Unlike the United States, where labor mobility is generally high and where migration between regions as a reaction to an economic shock plays a central role (Blanchard and Katz 1992), labor mobility in Europe cannot be expected to solve problems between countries.¹

If labor migration is ruled out as an alternative to exchange rate adjustment, relative prices will have to do the job. In the case of a negative shock, a real depreciation will bring about improved competitiveness. This means that the relative price of nontradables must fall, in order to stimulate the production of tradables. In bringing about this change in relative prices, wages, as the price of the immobile production factor, will have to bear most of the burden of adjustment. Under static conditions, a decline in national wages makes a country regain its competitiveness. Under conditions of a growing economy, which is more realistic, wages do not rise as much as before. The decline in wages, or their reduced increase, stimulates the economy the same as a devaluation would. There is one difference, however: a devaluation re-establishes competitiveness for all goods, a fall in wages favors labor-intensive production and thus re-establishes the competitiveness of jobs.

If wages do not react flexibly, differences in unemployment between the countries of the currency union are likely to develop. Then transfers are the only remaining mechanism in order to help nations in adjusting to a crisis (see below).

Thus, a cascade of equilibrating mechanisms exists which can be used to replace an exchange rate adjustment. First, the migration of labor can take the place of a devaluation of the home currency. If this is not possible, prices of the immobile production factor, predominantly wages, can adjust. Alternatively, if this is also not possible, financial transfers have to take over the shock-absorbing role of a devaluation. The hierarchy of adjustment mechanisms may be interpreted as criteria for an optimal currency area (Mundell 1961). The question of how relevant the adjustment mechanisms will become in the future is analogous to whether the Mundell criteria are satisfied when founding the monetary union. If “... the case for Europe as an optimal currency area is lukewarm at best” (Wyplosz 1997: 8), this means that the adjustments in the monetary union will be severe and that we move down the cascade of adjustment mechanisms.

¹ Compare Decressin and Fatás (1995), who apply the Blanchard-Katz approach to Europe. Note that spatial mobility of labor, if existing in Europe, is a phenomenon between regions of a nation and not so much a phenomenon between nations (Wyplosz 1997).

More pressure on the labor market. Since wages have to take over the equilibrating function of the exchange rate, it is necessary that wages are differentiated in the economic space of the monetary union; it needs highly flexible wages. This prerequisite is not satisfied in most of the continental European countries, especially in Germany and France. Obstacles to institutional changes which exist already today will become greater, since employees will compare their wages in a common currency; this will render it more difficult to differentiate wages between countries. Nevertheless, it should be quite clear that the founding of the monetary union mandates a change in the institutional settings for the labor markets.

The necessary adjustment is not only a matter of nominal or effective wages. Restrictions existing on the employment of labor are implicit labor costs. Formally, such restrictions represent negative shadow prices of labor to firms and reduce their demand for labor. The labor markets of Europe are marked by such restrictions, which cause high unemployment to a significant extent (Siebert 1997b). If the rigidities on the labor markets in Europe are not removed, if policy cannot change the institutional setting — as, for instance, the minimum wage in France — and if wage flexibility is not increased, differences in unemployment will result and an increase in overall unemployment in Europe is inevitable.

2. Do Not Europeanize Wage Formation

A differentiation of wages and labor markets can only be brought about by decentralizing the wage formation process, that is, by putting it at the level of individual firms, or, in other words, by assigning a larger role to the market. To Europeanize wage formation is in complete contradiction with the requirement of decentralization. Attempts to centralize wage bargaining on a European level run counter to what is needed in order to reduce unemployment in a currency union. Some countries have strengthened the bargaining partners, i.e., trade unions and employers' associations, and the wage cartel by passing laws that, for instance, extend wage bargaining results from one region to another region, that make wage negotiation results binding per se or that make them binding pursuant to other laws which rule out exemptions even in the case of economic crisis. Supporting wage cartels in this manner should not be allowed on the European level. Moreover, a process of institutional competition is needed to find the best national solutions for unemployment.

It is essential that unions and employers' associations of the individual countries continue to be responsible for employment. As well, the responsibility for the institutional framework of the labor market in the individual nations should continue to rest with the nations.

3. Leave Employment a National Responsibility

Policy should not make itself a victim of the illusion that the problem of unemployment can be solved on a European level by an employment program or an employment pact. This would be a misjudgment of the economic mechanisms operating in a market economy, especially in a monetary union. Since a

further differentiation of labor costs is necessary, the responsibility for unemployment should not be shifted to the European level. Moreover, the unemployment rates differ considerably between the countries of the European Union; in 1997, from 3.3 percent in Luxembourg and 6.2 percent in the Netherlands to 22.1 percent in Spain. This suggests that different national approaches to the labor market will have to be used.

The employment chapter added to the EU Treaty at the Amsterdam Summit should not camouflage the necessity of decentralizing wage formation. It cannot mean that employment policies such as governmental schemes should be Europeanized. Such an approach would blur the national responsibilities. What can be done on a European level is to strengthen national governments against vested interest groups in the individual countries which prevent the necessary institutional changes.

4. Do Not Push for a Social Union

A monetary union assigns increased importance to the labor costs in the individual countries during an adjustment process after a disturbance. Labor costs also include the costs of social security, which are politically determined. In some countries, these costs — the *second wage* — amount to nearly the level of regular wages; Germany is an example.

Thus, countries can also keep their jobs competitive if they have a social security system which is more efficient, for instance, because it is shaped differently for historical reasons or because it is less complete. A harmonization of the social security systems in Europe would run counter to the differentiation of labor costs and would raise unemployment. Therefore, a harmonization of social security systems cannot be put on the agenda. In any case, these systems are now organized nationally in Europe; payments are only provided by the social security system to which the recipient has made his contribution (principle of territory). Thus, one realistically has to assume that a European social security system stretching from Portugal to Sweden is not feasible. Therefore, no attempt should be made to set up such a system (Donges et al. 1996).

The institutionalized regulations concerning working time, protection against wrongful dismissal, social closing plans and comparable issues should also not be harmonized without further consideration, since they present implicit labor costs from the employer's perspective. Their implementation will also vary according to the legal environment in European nations.

One should clearly point out to the peoples of Europe that everything which hinders the differentiation of labor cost will also hinder the monetary union. From this perspective, the monetary union and the social union are at odds. In any case, it is more difficult to establish a social union in a monetary union. Converging levels of social security can only result in the very long run — in a historical perspective.

5. Resist the Political Demand for Transfers

Large economic regional units are usually characterized by some type of transfer mechanism.

Transfers as a substitute for flexible wages. Transfers have to replace the exchange rate adjustment mechanism when labor is not sufficiently mobile and wages are not sufficiently divergent between countries. Taking the US as an example — an area with a common currency — transfers are made between different regions via the allocation of revenue between federal and state authorities and via the social security system. Additionally, the assignment of competencies for expenditure and taxation to the various regional administrative bodies — the different hierarchical levels of the state — play an important role in regional adjustment processes. In principle, a political union will be accompanied by higher transfers. As a rule, competencies for expenditure and taxation will be assigned in a way that financial transfers between the different regions only have to net out major discrepancies in revenue.

One must therefore be aware that the monetary union will necessarily be associated with a strong political demand for an additional transfer mechanism and for more tax revenue competencies at the central level unless labor markets become more flexible. The demand for transfers may lead to a severe political clash in the monetary union in the future. However, such a transfer mechanism may be acceptable in a political union but it is hardly conceivable among still sovereign nation-states. Thus, since the European Monetary Union will not be accompanied by a political union, the willingness at the European level to agree on transfers and on a centralization of tax income should be lower than it is in the nation-states. The territorial principle has to be applied to social security systems anyhow. In addition, an increase in the budget of the European Commission is limited, since decisions on tax policy have to be passed unanimously. Furthermore, the assignment of the right to tax to a central level requires democratic legitimization. Finally, transfers eat away some of the efficiency gains that can be expected from an intensified European integration.

Determining factors for the extent of transfer payments. The extent of transfer payments depends on the heterogeneity of the member countries. It will be greater, the more asymmetric shocks occur when economic structures are divergent, the greater the differences in economic performances and growth of the member countries and the higher the national rates of unemployment. Thus, the volume of transfers will vary with the size of the monetary union. In the case of a small monetary union, similar economic structure and performance should keep the political demand for transfers low. In the case of a large monetary union, where exogenous disturbances have heterogeneous effects, transfers will play a more important role. Finally, the extent of transfer payments is a function of the willingness to integrate politically; in a political union transfers become more acceptable.

A considerable increase in transfers has to be expected over time — even within a ten- or fifteen-year horizon — after the start of the euro. The political process needs enormous strength to resist this development.

II.

6. **Accept the 'One-Size-Fits-All' Monetary Policy and Improve Efforts to Stabilize the National Economy**

Politicians should have no illusions about what monetary policy means for national stabilization policy. Common monetary policy must be oriented towards price level stability in the monetary union as a whole. Consequently, it cannot take into consideration specific national conditions. In a monetary union, the monetary "suit" is no longer custom-tailored for each nation, the one size must fit all. Thus, if nations are in a different position in the business cycle, one being in a boom and the other one in a recession, they both must cope with the same monetary policy. National politics must accept this. High interest rates are hard on the country in recession; the country in recession is required quite a bit of a political discipline to accept a monetary policy that is oriented towards European price level stability. If, however, the country in recession could have its way in getting an easy money policy adopted, inflation in Europe would result.

A first test of this will come in the founding stage of the Monetary Union, when short-term interest rates in Italy, Spain and Portugal will be reduced to a common level, leading to excessive aggregate demand and a boom in these countries. If this is to be prevented, the short-term rate has to be raised, resulting in a negative impact on economic activity in some of the other countries, including the major economies.

According to textbooks, fiscal policy should gain a more important role in stabilizing the economy if past experience did not suggest that fiscal policy has been unable to satisfy this role. Rarely or never has fiscal policy been used to squeeze excessive aggregate demand in order to dampen the boom. Rarely has the political process been capable of balancing the budget over the business cycle: the stimulation of demand in a recession has usually been associated with an increase in public debt over time. Thus, heroically rational behavior of politicians is required if fiscal policy were to play a role in stabilizing national economies where the monetary suit does not fit. The politician undertaking restrictive fiscal policy in a boom when tax revenues are spouting has been compared to a pug dog guarding a pile of sausages. For an anticyclical fiscal policy, the vegetarian pug has yet to be invented.

In practice, fiscal policy often has been volatile due to the political economy of expenditure and taxation, thus generating a cycle itself or aggravating a cycle.² Such a stop-and-go policy or an ad hoc approach is to be prevented in the monetary union. Steadiness of fiscal policy is required to smooth aggregate demand and expectations of the private sector. Moreover, each country will have to increase its efforts to improve the elasticity of its economy so that fluctuations in GDP and employment can be reduced. In this context, asynchronous business cycle situations between countries add a new dimension to wage policy in a monetary union. Wage policy must help to tone down demand pressure in a boom;

² Compare, for instance, fiscal policy of Japan in the last 10 years.

at least wage policy should not break the boom by demanding excessive wages. In a recession, wage policy has to assist in bringing about an upswing, i.e., it must take into account the low (often negative) productivity growth in a recession in order to allow more employment to come about. More flexible wages, including a profit-related element, can help to make jobs more stable over the business cycle.

7. Tie Down National Fiscal and Budget Policy to Avoid Political Pressure on the European Central Bank

A major issue is the relationship between fiscal and budget policy of sovereign nation-states and the common monetary institution on the European level.

Experience concerning the relation between financial and monetary stability. Historical experience shows that untenable public finances can ruin a currency. Moreover, in the past stable exchange rates between countries could only be maintained in the long run if the participating nations gave up part of their sovereignty on fiscal policy. One example is the gold standard, which brought about stable exchange rate relations for a long time, but this was only made possible by nations giving up autonomous national business cycle policy. The gold standard broke apart in the turmoil of World War I, when European countries ran into higher deficits to finance military expenditure. The Bretton Woods system was linked to the premise that the United States provided monetary stability: it failed when the burden of the Vietnam War — with the resulting high public absorption on GDP — became overwhelming and when the United States could not sustain a stability-oriented policy any longer. Thus, without sovereign states renouncing some of their fiscal autonomy or accepting some restraints, a monetary union cannot be sustained.

Shielding the Central Bank from political pressure. Central banks are always exposed to political pressure. Political pressure on the European Central Bank may originate if countries face severe economic problems. This holds particularly true for countries with excessive deficits and high indebtedness. Such countries are interested in low interest rates, a rather lax monetary policy and a slightly higher inflation rate than the one anticipated by financial markets because all this would ease their budgetary situation, especially because debts would melt away in real terms. Such a policy becomes even more attractive when political maneuvering space in the future is restricted by a high interest burden. Political pressure on the European Central Bank will be further increased if the economy of a highly indebted state is taken by recession and if it faces severe financial difficulties. The issue is not that a country will deliberately follow a policy of excessive deficits in order to eventually force the European Central Bank to step in as lender of last resort. The problem is that a long-run process of accumulating debt may occur as a result of political decisions so that eventually the European Central Bank has no other option than to monetize the public debt. Consequently, the criterion of a sustainable public budget within the monetary union is well-suited to shielding the central bank from political pressure.

According to Article 104b Section 1 of the EU Treaty, the EU is not liable for the financial difficulties of any member state with a budget deficit, nor are other member states liable for this state's difficulties. Nevertheless, the political pressure for transfers granted by the European Union or by member countries will become perceptible in the future. Thus, if transfers have to be made in the end — in spite of liability being excluded — the donor of transfers, as well as the recipient, may develop an interest to keep these transfers as low as possible, replacing them by a rather lax monetary policy. Notice that Article 103a Section 2 suggesting financial support in extraordinary situations should not be used to circumvent the no-bail-out provision of Article 104b Section 2.

Control of unreliable fiscal policy with the stability pact. The arguments in favor of sustainable public finances motivate the stability pact, by which the fiscal policy of the member countries is made subject to certain constraints. The intention is to limit political pressure on the European Central Bank. Such a constraint on fiscal policy becomes especially necessary if countries have institutional arrangements which are not conducive to solid governmental finances. A case in point is a constitutional weakness as in Italy. Attempts to improve the budget situation shown in the last years may not be continued once the powerful sanction of being excluded from the monetary union is gone; the situation in the bargaining game is asymmetric prior and after May 1998. The intention is to control this situation with the stability pact which, in a way, serves as a substitute for a political union.

The general rule now is that a budget deficit surpassing three percent of GDP is considered excessive. This only holds if GDP falls by less than 0.75 percent. In other cases, there are exceptions: A real decrease of GDP on a yearly basis of at least 2 percent is viewed without any further argument as an exception. In the intermediate range between 0.75 and 2 percent, a set of discretionary decisions of the ECOFIN council will have to be made. The determination of an excessive budget deficit remains undecided if a member state, after being put into delay by a formal resolution, indeed takes appropriate measures. Whether measures taken are appropriate is also decided by the ECOFIN council. It should also be noted that initially only a non-interest-bearing deposit is required. This will be converted into a fine after two years if the budget deficit remains excessive. These discretionary steps raise the question whether the stability pact will be effective. Moreover, there is a conflict of roles, since those who are responsible for the excessive budgetary deficit will also be the ones to define it.

Thus, self-confinement of the countries to a quasi automatism has only been reached in case of GDP declining less than 0.75. Proposals have failed according to which a budgetary deficit would be confirmed automatically, for instance if 3 percent of GDP is surpassed, as attested by the Statistical Office of the European Union. After all, automatic mechanisms of surveillance of excessive budgetary deficits, which would by themselves have enhanced the control function of the financial markets, have not been implemented (Scheide, Solveen 1997).

The prescriptions for fiscal policy given here seem to be asymmetric. On the one hand, national fiscal policy may have to play a larger role in stabilizing national economies; on the other hand, it has to have its hands tied in order to avoid political pressure being put on monetary stability. This is no contradiction. The overriding restraint is to prevent political pressure on the central bank: in no case should the stabilization role of fiscal policy lead to debt levels that will jeopardize price level stability.

8. Do Not Belittle the Entry Criteria of Sustainability

The Maastricht Treaty requires a “high degree of lasting convergence” as a precondition for a monetary union according to Article 109j. Sustainability of the governmental financial condition is an important aspect. The overriding target is that the government remains solvent; usually this is interpreted as requiring stationarity of the debt. This means that the debt/GDP ratio has to remain constant. In the Maastricht Treaty, a limit for an excessive deficit of 3 percent of GDP is associated with a 60 percent debt/GDP ratio if nominal GDP growth is 5 percent. If the level of debt surpasses 60 percent of GDP, the level of indebtedness has to be sufficiently diminishing, say to a considerable extent, and has to approach the reference value with a satisfactory pace, say within several years. If the level of indebtedness remains more or less unchanged, this condition is not met. The condition is also not satisfied if an excessive deficit is prevented by once-and-for-all measures.

In choosing the members for the monetary union in May 1998, policymakers will be tempted to compromise on the criterion of sustainability of government financial positions, but they had better be aware that they will then only shift problems into the monetary union and postpone them. The more compromises are made while founding the currency union, the higher the conflict potential will be in the course of the currency union. It will be difficult to convince the public that compromises can be made with respect to sustainability when founding the monetary union, but that later on the criterion of sustainability will be strictly applied even if constitutional weaknesses are not corrected. This would be a bad start. It would then be harder for the European Central Bank to establish its reputation. If the requirement of sustainable public finances is watered down by political compromise, one should also not be surprised if exchange rates in the interim period become vulnerable and are tested by the financial markets. Policymakers should be aware of the lesson to be had from the recent Asian crisis with respect to exchange rates: what is not sustainable is vulnerable.

III.

9. Do Not Get Seduced by the Fallacy of the Short-Run Phillips Curve

For monetary policy to be successful one has to presuppose that the European Central Bank is predominantly oriented towards price level stability. In this regard, the problem emerges of how members of the Central Bank Council will evaluate — according to their preferences — possible conflicts between the objective of monetary stability and other objectives of economic policy such as unemployment, that is, whether they will be averse to inflation or not. Furthermore, different approaches of explanation may exist — for instance, with respect to the validity of a Phillips curve between the rate of inflation and unemployment.

Politicians should not have the illusion that an excessive increase in the money supply can stimulate employment in the medium run. This would be a severe misjudgment. Economic agents would

anticipate the inflation rate and require higher nominal interest rates, the value of money would deteriorate and the European Central Bank would lose its reputation. Eventually, the European Central Bank would be forced to put on the brakes, and a "stabilization recession" would be the result.

National governments may be tempted to nominate members for the Council of the European Central Bank who lean more towards the employment target instead of price level stability. A central bank which — when filled with Keynesians — would interpret its objective in a way that it would move up and down the Phillips curve between the inflation rate and unemployment in the short run, would lead to a failure of the project, concerning monetary stability.

10. Do Not Play Around with the External Value of the Euro

Opinions differ with respect to the role of the external value of the common currency.

Strategic external value versus stable internal value of a currency. In some countries and in some circles, the opinion seems to prevail that the exchange rate of the euro against other currencies of the world — like the dollar or the Japanese yen — can be used strategically in the interest of the European export industry by driving down its external value in order to stimulate European exports. This is a misleading idea. Disruptions and quarrels in the international division of labor, turmoil in the financial markets and reactions of other players in the world economy would ensue. What is more important, a lower external value of a currency can only be brought about if this currency is supplied more generously than other currencies. That is, the expansion of the aggregate money supply exceeds by far the growth of the production potential. This, consequently, causes the internal value of the currency to fall. It would be disastrous for the European Monetary Union if it were dominated by those who favor a weak external value. External value and internal value of a currency are two sides of the same coin. Both a weak external value and a weak internal value signify that citizens can buy fewer goods for one unit of currency. In the first case, fewer goods can be bought from abroad. In the second case, fewer goods can be bought on the whole, independent of their origin. Whoever pleads in favor of a weaker external value of the currency pleads for a weaker internal value. In other words, he accepts a reduced value of money, that is higher inflation. Hoping for a weak euro as representatives of industry tend to do is rather short-sighted. Price level stability has been one of the pillars of the social market economy; giving this up would be a serious mistake.

Exchange rate responsibility. It is the subject of debate whether the European Central Bank should be obliged to intervene in favor of weak European currencies which will remain out of the currency union in the case of an incomplete monetary union, i.e., whether the European Central Bank should stabilize the currencies of nonmembers vis-à-vis the euro. In addition, the exchange rate of the euro vis-à-vis international currencies is also the subject of debate. The fundamental decision on the form of the exchange rate regime — for instance, if there should be a system of fixed or flexible exchange rates — may be left to policy. All the remaining issues, though, belong to the competence of the European Central Bank. This also holds for the competence to intervene in the exchange rate, particularly in the present regime of flexible exchange rates. The EU Treaty, Article 109 Section 1,

requires a qualified majority in the European Council for it to fix or change the central parities of the euro within the international exchange rate system. Nevertheless, an explicit competence on the part of politicians to intervene in currency markets is not compatible with an independent central bank. If the central bank is forced to maintain a predetermined exchange rate vis-à-vis other currencies, this would mean an exchange-rate-oriented monetary policy. In this case, the central bank would not be free to determine its monetary policy. Hopefully, this conflict between policymakers and the central bank is softened by Article 3a Section 2 of the EU Treaty, which states that the exchange rate policy has to pursue predominantly the objective of price level stability. The European Council should never announce orientations for exchange rates which are not sustainable and not compatible with price level stability.

No overloading of monetary policy with international exchange rate targets. Politicians — including those in Germany — occasionally give the impression that a common European currency could bring about stable currency relations in the world economy. This desire for stable currency relations is quite understandable. Nevertheless, there is ample evidence from the past that the much-conjured international cooperation — G-7 meetings and accords — has not been able to bring about stable exchange rates. The proposals to strive for exchange rate targets have not proven feasible. Stable exchange rates in the world can only be established if monetary policy provides for a stable internal value of the currency and if all other aspects of economic policy, and fiscal policy in particular, do not give rise to negative expectations about currency stability. For this reason, one can only warn against overloading the monetary policy of the European Central Bank with the objective of pursuing exchange rate targets for the euro against leading world currencies.

11. Denationalize the Common Money

Monetary policy affects countries who participate in a monetary union roughly in the same way because of uniform short-term interest rates in every country. Nevertheless, monetary policy is still judged in national political decision making processes, since a political union does not come into existence simultaneously with a monetary union. Thus, a potential for conflicts inevitably arises between a communal monetary policy and national economic interests.

Let us run an experiment imagining a perfectly independent European Central Bank, which steers the money supply automatically like a machine, expanding the aggregate money supply according to the growth rate of production potential. Similarly, in case of inflation targeting, it would stick to its preannounced target. In neither case would it take into account the business cycle nor the election schedules in individual countries or any other variable. Then, no one would need to shield such a machine against political pressure. But if one assumes more realistically that a central bank does not operate in an institutional vacuum, the question arises of how to fend off political pressure put on the European Central Bank. This question is all the more pertinent, since the European Central Bank may experience less support from its audience in Europe than it does in Germany (Lohmann 1996).

In a historical perspective, a monetary union — in the sense of the coronation theory — is the natural supplement of political unions: in the last century, the “Zollverein” in Germany (1834) preceded the political union (1871), which was then followed by the currency union (1875). In a currency union, monetary policy is judged by a national decision-making process as long as a political union does not exist. Consequently, one has to take into account the possibility that an asymmetry between the uniform incidence of a common monetary policy and the political evaluation of monetary policy by national decision-makers might arise. This holds especially true in the case of diverging economic scenarios in the member states — for instance in case of slackening growth, asymmetrical economic crisis or high unemployment in individual countries. As a result, the European Central Bank might come under political pressure. It may be argued that in a monetary union a single country has little influence and that it generally has to accept jointly determined decisions. Nevertheless, if the European Central Bank faces resistance from a major country because EU monetary policy conflicts with its national economic policy, the potential of conflicts can be aggravated. Furthermore, a scenario can emerge in which several countries do not accept the European monetary policy.

Thus, EMU requires a tremendous amount of discipline on the part of national policymakers. With the common currency, politicians in the member states must be prepared to accept that the money supply process has been handed over to a common institution on the European level, i.e., that money has been denationalized.

12. Depoliticize the Common Money

The EU Treaty has gone one step further: By entrusting an independent European Central Bank with the authority to steer the money supply, i.e., to set the interest rates and determine other monetary policy instruments, it has taken monetary affairs out of the hands of politics altogether, it has depoliticized the process of money creation. Politicians in the member states have to accept this. They should not interfere with the decision making of the European Central Bank.

European countries have had different historical experiences with institutional arrangements for steering the money supply and for the relationship of monetary policy to the political process. Two opposing concepts still seem to exist in this regard. One concept focuses on the independence of a European Central Bank and is based on the German experience — both the negative experience during two periods of great inflation in this century and the political instrumentalization of the central bank after 1933, and the positive experience with the Bundesbank during about the last fifty years. In principle, the Maastricht Treaty provides for independence of the central bank, that is analogous to that of the Bundesbank.³ The other concept, which still seems to predominate in the public discussion

³ A more stringent form of depoliticization — a set of binding rules for monetary policy or a legally prescribed upper limit for the admissible inflation rate — has not been discussed in the negotiation process on the EU Treaty.

in France, still appears unprepared to depoliticize the European currency. According to that perspective, the central bank should be responsible to politics, possibly the Euro council.

Thus, both concepts are indeed opposing concepts. This gives rise to a lack of clarity on the substantial content of the monetary constitution. The assignment problem of economic policy remains unsolved. Which priority will be assigned to monetary stability in relation to other economic policy targets is still in question. Strictly speaking, consensus does not yet seem to exist on the independence of the European Central Bank, which will lead to conflicts within the monetary union. The possibility that countries who attribute a lower priority to monetary stability will start these conflicts once the monetary union is irrevocably established cannot, *a priori*, be excluded.⁴ If fundamental divergences of this kind exist, there is no guarantee that a common currency can fulfill its peace-maintaining objective. It is even likely that a monetary union will lead to conflicts over economic policy if there is a great social crisis in one member country. In this case, opposing interests may be separated along the old national lines because of national decision making. If these evaluations are strongly divergent between individual states, they will not be able to be institutionally channeled within the European Central Bank Council.

Without a common philosophy on the depoliticization of the currency, especially a consensus between France and Germany, the European Monetary Union will rest on unstable ground. It is an imperative requirement for the monetary union to establish a long-lasting consensus on the very essence of the European Monetary Union, namely on the depoliticization of the common currency. Thus, policymakers have to respect the decisions of the European Central Bank, prior to all, in situations where these decisions are unfavorable for a single country or its government — for instance, in times preceding an important governmental election or when a country is facing unfavorable economic conditions.

IV.

Establishing the European Monetary Union is a noble objective. For it to succeed, central prerequisites have to be fulfilled. These prerequisites require making national labor markets more flexible; decentralizing wage formation and not Europeanizing it; leaving employment a national responsibility; not pushing for a social union; resisting transfers; accepting national discipline vis-à-vis the common

⁴ Here lies the greatest risk of failure for the euro, namely that the preference functions with respect to price level stability and other economic policy targets are too divergent in Europe and cannot be institutionally channeled into a common decision. If the European Central Bank fails to provide a stable money, disappointment with European integration, at least in Germany, will develop with repercussions for the integration process. It is understandable that the *de facto* dominance of the Bundesbank no longer was acceptable to our European partners; it would be not acceptable, however, if the dominance of price level stability is given up.

currency; tying down fiscal and budget policy in order to prevent an unsustainable accumulation of public debt, not belittling the aspect of sustainability, when founding the currency union, not playing around with the Phillips curve and the external value of the currency, de-nationalizing the common money and depoliticizing it. If these prerequisites are not fulfilled, the common money will lack a sound economic basis.

Politics should do everything possible to lay the ground for the solid economic foundation necessary for this historic project. Compromises while founding the currency union would lead to an erosion of the economic basis. Problems would be postponed into the monetary union. The common money should not be the bone of contention — the *pomme de discorde*, the *Zankapfel* — in the future of Europe.

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