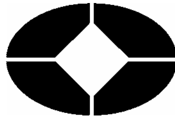
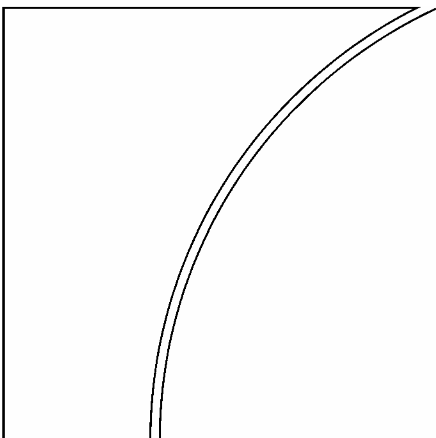


BANK FOR INTERNATIONAL SETTLEMENTS

BIS Working Papers

No 201



Central banks, governments and the European monetary unification process

by Alexandre Lamfalussy

Monetary and Economic Department

February 2006

JEL Classification Numbers: E42, E52, E58, F33, N14

Keywords: central bank, government, cooperation, European Monetary Union, European Central Bank, monetary and financial stability

BIS Working Papers are written by members of the Monetary and Economic Department of the Bank for International Settlements, and from time to time by other economists, and are published by the Bank. The views expressed in them are those of their authors and not necessarily the views of the BIS.

Copies of publications are available from:

Bank for International Settlements
Press & Communications
CH-4002 Basel, Switzerland

E-mail: publications@bis.org

Fax: +41 61 280 9100 and +41 61 280 8100

This publication is available on the BIS website (www.bis.org).

© *Bank for International Settlements 2006. All rights reserved. Brief excerpts may be reproduced or translated provided the source is cited.*

ISSN 1020-0959 (print)

ISSN 1682-7678 (online)

Foreword

On 27-29 June 2005, the BIS held its Fourth Annual Research Conference on “Past and Future of Central Bank Cooperation”. This event brought together some 80 senior officials from central banks, academic institutions and the private sector to exchange views on this topic (see the programme attached). This paper was presented at the conference. The conference was part of the BIS 75th Anniversary programme. The views expressed are those of the author(s) and not those of the BIS

Abstract

This paper explores the evolving relationship between central banks and governments in the European monetary unification process. In particular, it focuses on the institution-building phase (setting up of the ECB) and the monetary and macro-economic policy mix within EMU. I attribute the undeniable success of the institution-building phase to an exceptional convergence of favourable facts and influences. Most importantly: the strong political commitment of the governments concerned; the trust placed in central bank experts in preparing the Maastricht Treaty; the incremental momentum resulting from the tight timetable; and, last but not least, the prevailing macro-economic conditions. As for the monetary and macro-economic policy mix, it is argued that in the run-up to achieving EMU the convergence criteria spelled out by the Maastricht Treaty proved a very effective tool in aligning national policies and in consolidating central bank independence (which became, in fact, the “sixth” convergence criterion, conditioning access to EMU). However, since the late 1990s, this delicate balance seems to have become rather less secure for mainly three reasons: the weakening restraint of politicians with regards to monetary policymaking; the worsening performance of the economy in the euro area; and the fact that economic union continues to lag monetary union, particularly with respect to micro or supply side reforms.

Fourth BIS Annual Conference

Past and Future of Central Bank Cooperation

Basel, Switzerland, 27-29 June 2005

celebrating 75 years of the Bank for International Settlements, 1930-2005

Monday, 27 June 2005

Keynote dinner address

Tommaso Padoa-Schioppa, former member of the Executive Board, ECB

Tuesday, 28 June 2005

Opening remarks

William White, BIS

Chairman: Herman Baron Van Der Wee, Katholieke Universiteit Leuven

Session 1

One hundred and thirty years of central bank cooperation: a BIS perspective
Claudio Borio, BIS and Gianni Toniolo, University of Rome Tor Vergata, Duke University & CEPR

Discussants: Marc Flandreau, Institut d'Etudes Politiques, Paris
Miles Kahler, University of California, San Diego

Session 2

Almost a century of central bank cooperation
Richard Cooper, Harvard University

Discussants: Barry Eichengreen, University of California, Berkeley
Albrecht Ritschl, Humboldt-Universität zu Berlin

Chairman: Harold James, Princeton University

Session 3

Architects of stability? International cooperation among financial supervisors
Ethan Kapstein, INSEAD

Discussants: Charles Goodhart, London School of Economics
Peter Praet, National Bank of Belgium

Session 4

The future of central bank cooperation
Beth Simmons, Harvard University

Discussants: Michael Bordo, Rutgers University, New Brunswick
Edwin Truman, Institute for International Economics, Washington DC

Wednesday, 29 June 2005

Chairman: Paul De Grauwe, Katholieke Universiteit Leuven

Session 5

Central banks, governments and the European monetary unification process
Alexandre Lamfalussy

Discussants: Peter Kenen, Princeton University
Yung Chul Park, University of Korea

Policy panel discussion

Chairman: Malcolm D Knight, BIS

Reflections on the future of central bank cooperation

Participants: Andrew Crockett, J P Morgan Chase
Jacques de Larosière, Paribas
Allan Meltzer, Carnegie Mellon University
Paul Volcker, International Accounting Standards Committee
Yutaka Yamaguchi, former Deputy Governor, Bank of Japan

Contents

Foreword iii

Abstract v

Conference programme vii

Central banks, governments and the European monetary unification process
(by Alexandre Lamfalussy)

Preliminary remarks 1

Institution-building 2

The policy mix.. 5

Concluding remarks 8

Comments on Alexandre Lamfalussy's paper, "Central banks, governments and the European monetary unification process" (by Peter B Kenen).. 10

Comments on "Central banks, governments and the European monetary unification process"
(by Yung Chul Park) 12

Central banks, governments and the European monetary unification process

Alexandre Lamfalussy[1]

Preliminary remarks

It is not without hesitation that I have accepted the challenge of sharing some thoughts with you on the evolving relationship between central banks and governments in the European monetary unification process. For one thing, I am not a historian - and the formal, narrowly defined beginning of this process goes back to the Hague Summit in 1969, when the heads of state or of government "agreed that on the basis of the memorandum presented by the Commission on 12 February 1969 and in close collaboration with the Commission a plan by stages should be drawn up by the Council during 1970 with a view to the creation of an Economic and Monetary Union". Anything that was conceived more than 30 years ago deserves careful scholarly treatment calling on all the virtues of a reliable historian - even if the scholar is not a professional historian. This is the more so since European monetary cooperation in a broader sense began with the establishment of the European Payments Union in 1950, well before the emergence of the Common Market and of the European Community. It is arguable that neither the decision taken in The Hague, nor the subsequent Werner Report, nor indeed the long history of the monetary unification process which has led us to where we are today, can be fully comprehended without referring back to the early 1950s. Much of this scholarly work has already been accomplished, and accomplished well. Let me just refer to the collection of papers edited by Alfred Steinherr (*Thirty Years of European Monetary Integration: From the Werner Plan to EMU*, London, Longman, 1994), to Daniel Gros and Niels Thygesen (*European Monetary Integration*, New York, St Martin's, 1992) and to André Szàsz (*The Road to European Monetary Union*, London, Macmillan, 1999). I have neither the intention nor the ability to compete with them. But I could try to rely on my personal experience and attempt to draw some lessons from my participation in the monetary unification process - if only to stimulate an exchange of views on our current problems in EMU.

But what are my credentials for doing this? Here I have encountered some other reasons for being modest: my direct participation in the European monetary unification process was neither continuous nor of the same "quality" all the time. True, I was a member of the Delors Committee, where I could and did play a role, but this took up less than one year; true, first as Economic Adviser of the BIS and later as its General Manager, I was in a good position to observe what was going on within the Committee of the Governors of the Central Banks of the Member States of the EEC, which was meeting in Basel, and whose secretariat was provided by the BIS - but this was observation rather than action; true, the fact that the BIS is a bank allowed me to gain a privileged insight into the crisis mechanics of the critical years of 1992-93, but I did not participate in crisis management meetings. More importantly, I did not take part in the negotiations leading to the Maastricht Treaty, although of course the Treaty took over a very substantial part of the recommendations of the Delors Report. As opposed to all these "buts", however, I do not have to be unduly modest about my role as the first President of the European Monetary Institute. Whatever was achieved by the EMI was of course the result of the teamwork of the Council and of the staff of the member central banks and of the Institute; but as President I had ample opportunities to wreck, or at least substantially slow down, the realisation of the institution-building project. Which I chose not to do. Moreover, during these three and a half years I was directly exposed to a rich variety of political influences and gained a first-hand experience of dealing with high-level civil servants as well as with their political masters - which entitles me to hold some views on the relationship between governments and central banks. This is the reason why most of the remarks which follow are strongly influenced by the experience gained during my EMI years.

---

[1] Catholic University of Louvain. Former General Manager of the BIS and former President of the European Monetary Institute.

I propose to group my remarks on the relationship between central banks and governments under two headings: institution-building and policy mix.

Institution-building

A major part of the European monetary unification process has had to do with institution-building. This observation is valid for the whole process, but it applies especially to periods of accelerating change; and there is little doubt that the quantum jump implied by the introduction of the single currency and the establishment of the European Central Bank *was* such a period.

One would think a priori (and so I had thought myself) that a period of this kind would provide a propitious environment for bitter conflicts. Specifically, for conflicts between the central banks operating within the EMI structure (which had been put in charge of setting up the ECB, defining the operational infrastructure of the single monetary policy and preparing the future monetary policy strategy), on the one hand, and the member governments of the EU, on the other. But also for conflicts within the central banking community as well as among governments, and for conflicts with the Commission, guardian of the treaties. So many vested interests were at stake. Countries had to give up their monetary sovereignty (even though most of them had already lost it in practice). The national central banks were invited to cooperate in a sort of merger process as a result of which they swapped their ability to carry out "their" monetary policy for their Governors having one vote in the future ECB's decision-making body. They might have considered this a net loss, even though most of them had already tied their currency to the DM without having any say in the Bundesbank's decisions. Even the Commission was about to lose a bit of its power: there would no longer be a Commissioner in charge of monetary affairs. Last but not least, you could not expect generalised popular support for losing your country's national currency (even though the citizens of a great number of European countries could hardly derive great pride from the past performance of their national currencies).

These forebodings proved unfounded. The road leading to 1 January 1999 - the beginning of Stage III - was on occasion somewhat bumpy, but there were no major conflicts of the kind that could have fatally jeopardised the implementation of the single currency: neither between the EMI Council and the governments, nor among governments, nor inside the EMI, nor indeed between any of these and the Commission. I myself was not excessively optimistic about the outcome when I was appointed President of the EMI, but I became gradually more and more confident, and by the winter of 1995-96 I had acquired the conviction that we were on the right track. Market sentiment was also beginning to change at that time: witness the downward convergence of long-term interest rates. This was not the case for the majority of our American friends, who argued, first, that it had been foolish to conceive the single currency project; at a second stage, when they could no longer ignore the determination of our politicians to go ahead, they predicted that implementation would fail; and when implementation was about to be achieved, they were beginning to foretell that the system would shortly be blown apart by market forces.

There can be little doubt that the institution-building phase of the single currency project has been successful - this much, I would guess, has by now been accepted even by those who dislike(d) the project or those who (not without reason) harbour some misgivings about current developments. And by institution-building phase I do not refer only to the period ending on 1 January 1999, but also to the one which ended during the early weeks of 2002 with the exchange of banknotes. But the absence of disruptive conflicts, however important it was, does not fully explain this success story. First, because the absence of these conflicts itself requires an explanation. Second, because the enterprise was a unique event, for which there had been no genuine historical precedent: it amounted to the merging of the monetary policy functions of 11 central banks, all of which had a long history behind them and were operating in highly complex monetary and financial systems. A lot of things could have gone wrong in this process, even without the disruptive influence of vested interests. How is it that they did not go wrong?

My explanation is that we have been well served by the exceptional convergence of several facts and influences. In what follows, I will try to list them, but not in their order of importance, because I have no clue what this order is.

First, the initiators of the project were the governments themselves - and at the highest level: the heads of state or of government (as it should be). This was the case when, in The Hague, they started

the process; this was again the case when, in Hanover in June 1988, they recalled that "in adopting the Single Act, the Member States of the Community confirmed the objective of progressive realisation of economic and monetary union" and therefore decided to set up the Delors Committee, which was given the "task of studying and proposing concrete stages leading towards this union". Finally, at the Maastricht Summit (December 1991) they adopted the Treaty on European Union, which, among many other provisions, decided the creation of the European System of Central Banks, of its central institution, the ECB, and of a new currency, the ECU, to replace the national currencies of the member countries. The ratification process took almost two years but, after granting an opt-out clause to the United Kingdom and an opt-in clause to Denmark, the Treaty entered into force in November 1993. So the initiative was clearly a political one; not simply because the initiators were heads of government, but also because, at decisive moments, the political motivation played a major role. This had already been the case in the earlier years, but it became quite decisive at the time of the negotiations preceding the Maastricht Treaty, as we all know. With such a political commitment, our highest political authorities acquired a vested interest in a successful implementation process.

Second, it is worth noting that the political leaders entrusted the central bankers right from the beginning with a major role in the preparation of the Maastricht Treaty, starting when they decided to set up the Delors Committee, the membership of which was overwhelmingly of central banking extraction. Jacques Delors was not only a good chairman, but he also possessed the political wisdom to accept that the majority of the meetings, and practically all the preparatory work for the meetings, would take place at the BIS, with both rapporteurs being central bankers. Subsequently, the Dublin Summit (June 1990) mandated the Committee of EC Governors to draft a statute for the ESCB to be submitted to the Intergovernmental Conference on EMU.

Third, the institution-building process was governed by the Maastricht Treaty, which set out a roadmap in great detail, described reasonably clearly what should be the division of labour between the Council, the Commission and the central bankers of the EMI and of the ECB, and, most importantly, set 1 January 1999 as the latest date on which the single monetary policy should start operating. Time constraint, as I and Wim Duisenberg had the privilege to learn, turned out to be a barbarian but most effective instrument for finding compromises in matters which were not regulated by the Treaty (I propose to give a major example). Finally, while the Treaty left open a number of issues, it was (almost) clear on two subjects which could have created serious conflicts between governments and central bankers. The independence of the ECB - and before that of the EMI - was well defined; and so were the convergence criteria for accession to EMU. Among these criteria, the fiscal ones, and naturally the inflation criterion, were of crucial importance for sparing us major conflicts between governments and central banks.

Fourth, let me make a few remarks on how it was possible to avoid major disruptive conflicts *among* the central banks. There was, of course, the time constraint just mentioned. At the EMI in 1994 we devised a somewhat pompously entitled "master plan", which set out for each of the monthly Council meetings the topics on which decisions *had* to be taken in order to ensure that the single monetary policy would become operationally feasible on 1 January 1999. Given the long, but variable, lead times necessary for implementing measures, and the interactions between them, this was a highly complex procedure, which, moreover, required appropriate deadlines for the various subcommittees which prepared the Council decisions. We included, of course, precautionary safety margins and made appropriate adjustments, but this technique served as a useful monthly reminder of the Treaty obligations imposed on the EMI. In addition, the discussions, and the search for constructive compromises, received increasingly powerful support from the EMI staff, which grew from about two dozen members taken over from the secretariat of the Committee of EC Governors to more than 400 by the time I relinquished my position as President in mid-1997. Most of the staff, and all those in key positions, came from the member central banks, but within months they had acquired the "multilateral" frame of mind so indispensable for making realistic proposals to reconcile conflicting views held by member central banks - and do not forget: most of the Council decisions had to be unanimous. Achieving progress would have been impossible if, instead of a solid institutional structure, the work had had to be carried out within a cooperative framework. Finally, I have to pay tribute to all Council members. They were given an institution-building mandate, and they fulfilled their obligation, even when some of them had misgivings about the feasibility, or even the desirability, of the project.

At the same time, the absence of major conflicts and the relatively smooth development of the institution-building process owe quite a lot both to the facts and figures relating to the economic situation prevailing at that time in Europe, and to the changing perception of how macroeconomic policy should operate. As regards the first factor, these facts and figures concern mainly the

deterioration of the fiscal indicators. As noted in the first annual report of the EMI (April 1995): "The early 1990s marked a sharp reversal of trends in general government deficits in the Union. Following a prolonged period of decreasing deficits, fiscal balances deteriorated significantly from 1989 onwards. After standing at 5% of GDP in 1992, deficits in the Union reached 6% of GDP in 1993, the highest level on record since the foundation of the European Community". The deficits began to decline in 1994, but in 1996 still stood at 4.4% of GDP. As a result, general government gross debt, which had stood at 56% of GDP in 1991, reached 73.5% in 1996. This was such an obviously unsustainable development that in all likelihood it would have triggered policy reactions, though perhaps not with sufficient vigour. The constraint of the convergence criteria emerged at the right time.

As for macroeconomic policy, Keynesian demand management went out of fashion after the stagflation experience of the 1970s - and not only in Europe - many years before the revival of the EMU initiative. This resulted in a dramatic decline in the rate of inflation in Europe, which started after the observation of very high inflation rates, which peaked in 1974 at slightly above 14%. As observed in the second annual report of the EMI (April 1996): "Average EU inflation has declined successively from 10.5% in 1980-84, to 4.4% in 1985-89, to 4.1% in 1990-95, and to 3% in the past two years". Even more significantly, the (unweighted) standard deviation of national CPI inflation, which had been 6.5% on average during 1972-82, had fallen to 2% by 1995. This goes a long way towards explaining the relatively serene atmosphere prevailing in the ECOFIN Council meetings which I attended. To which one has to add the fact that the regained respect for both inflation-fighting and the inflation-fighting capability of monetary policy has been accompanied by a gradual, but general, move towards granting policymaking independence to central banks - and this, too, began well before Maastricht. It is of course true that the Federal Republic of Germany played a major role in shaping the definition of the ECB's independence (which in fact was defined more strictly than that of the Bundesbank, although not more strictly than what had become over time the German practice), but these requests fell on receptive ears in the case of the majority of member countries. The time was ripe for moving collectively in this direction.

Let me conclude these remarks by recalling the story of the scenario of the changeover to the single currency. This is a good illustration of how it was possible to achieve decisive progress in an area which the Treaty left undecided, without unnecessarily spectacular conflicts between the Council, the Commission and the EMI, which all had their part to play. Indeed, while it was quite clear that the irrevocable pegging of exchange rates vis-à-vis each other and vis-à-vis the ECU and the implementation of a single monetary policy had to start at the latest on 1 January 1999, as regards the introduction of the single currency the Treaty simply said that the "Council shall, acting according to the same procedure [which meant "on a proposal from the Commission and after consulting the ECB"], also take the other measures necessary for the rapid introduction of the ECU as the single currency of those Member States" (the "those" refers to the member states which passed the hurdle of the convergence criteria).

By early 1995 it had gradually become clear that unless agreement was reached on a precise changeover scenario, the credibility of the whole undertaking would suffer. How could market participants prepare themselves for the changeover in a timely manner, unless they knew what was going to happen and when? Or perhaps nothing would happen anyhow? (A question I heard often from quite a few market participants, and not only Americans.)

The Commission took up the challenge first, by publishing on 31 May 1995 a Green Paper on "The practical arrangements for the introduction of the single currency". The EMI, which was supposed to be consulted instead of the not yet existent ECB, was somewhat behind. During the spring it undertook an extensive EU-wide survey of the banking community, covering nearly 400 credit institutions, on the detailed technical implications of the changeover. This was indispensable for drawing operational conclusions, of which we prepared a preliminary version for the informal autumn meeting of ECOFIN, scheduled to take place in Valencia under Spanish presidency. (The final, formal EMI report, entitled "The changeover to the single currency", was published on 14 November.)

The Valencia meeting was a crucial one. A number of informal decisions were reached, possible compromises were outlined - to be submitted for formal decisions to the November ECOFIN meeting and to the December Madrid Summit. The main objection to the Commission's Green Paper, coming principally from Germany but supported also by other countries, was that it wanted to achieve at a very early stage a volume of transactions denominated in the single currency which would reach a "critical mass" (thereby ensuring "no return") and, if necessary, to do so through regulation. At a time when public opinion was barely familiar with the whole process, it was deemed dangerously counterproductive to signal four to five years ahead the list of transactions which would have to be

denominated in the single currency, announcing only too clearly the ultimate disappearance of the national currency units. The alternatives therefore seemed to be *either* an early announcement of a number of mandatory changeovers, which would have enhanced credibility at the risk of creating a political backlash, *or* leaving practically all the changeovers to the very end of a three-year period, which would have appeased those who feared this backlash but at the same time could have undermined the credibility of the whole process. In other words, the choice appeared to be between an early "big bang" and one that would occur more or less simultaneously with the exchange of banknotes. We therefore tried to extricate ourselves from this unappealing choice.

In discussions within the EMI I began to argue that all monetary policy operations by the future ESCB should be carried out from the very first day in ECU - which meant that all accounts held by counterparties with the ESCB would have to be denominated in ECU, yet the banks and all private market participants would retain their right to undertake their changeover at the time of their liking, but naturally at the latest at the beginning of the banknote exchange. I thought (and after some discussion it turned out that I was right) that even the most hesitant members of my Council would realise that *not* doing this would have made monetary policy operations remarkably cumbersome (although not impossible technically) and would have exposed the central bankers to the criticism that they themselves had some doubt about the final outcome of the process. I also thought that any such decision implied that the entire interbank market would start operating instantaneously in ECU - not by decree, but for obvious practical reasons.

The second initial change which I considered essential was that, right at the beginning, governments should denominate in ECU new tradable debt issues by the public sector, for the same credibility reason which applied to monetary policy decisions - knowing of course full well that any such decision would have to be accompanied by the conversion of the outstanding stock of public debt into ECU. Once we had agreed among ourselves on the decision to be taken by the Governing Council of the future ECB, all of us saw that this was a practical necessity for conducting a smooth monetary policy (it would not have been impossible, just ridiculously unpractical, to operate with repos otherwise). At the same time, it was obvious that we should keep a low profile on an issue which, ultimately, had to be decided by the governments. But this did not prevent me from outlining the argument to a number of ministers.

Interestingly, the final decision in favour of denominating all new tradable government debt issues in the single currency was triggered, as so often happens in intergovernmental negotiations, by a deal which would seem strange to any distant, outside observer. The Germans did not like the idea (even though they acknowledged the logic of the argument), but accepted it in the end in exchange for the French agreeing to swap the name ECU for euro.

The changeover scenario contained a large number of less controversial but quite important decisions: the formal acceptance of dates, the carefully worded legal definition of the euro (as a result of which the national currency units would on 1 January 1999 become the non-decimal components of the euro), the commitment by the national central banks to provide conversion facilities during a three-year period to those financial institutions which had not been able to equip themselves with such facilities, a timetable for the changeover of the public administrations, and so on. Combined with the two key decisions, they formed a coherent whole, which radically enhanced the credibility of implementing the single currency project, without, however, imposing an early changeover on private market participants by decree. In the spring of 1996, I concluded one of my presentations to a group of European banking CEOs thus: "You may still have some doubts, but you would be well advised to insure yourself against the risk that the single monetary policy will effectively start operating on 1 January 1999". A year before, they would have taken this remark as a joke; this time they did not smile, but looked genuinely interested.

The package which was finally adopted by the Madrid Summit, on the recommendation of the (formal) ECOFIN meeting of 27 November 1995, was fully compatible with the detailed report issued by the EMI on 14 November. Little mention was made of the earlier Green Paper drafted by the Commission. This, in a sense, was unfair. It was the Commission which had got the ball rolling, and for this initiative it deserved praise. Moreover, the "critical mass" concept was far from being a silly one. But the EMI played a decisive role by formally proposing one key measure, suggesting a second and putting in place a number of practical ones, which crucially contributed to the fact that, for the financial markets, the euro became an early reality - without having to resort to administrative regulations.

The policy mix

During my EMI years, not only institution-building, but also macropolicy decisions were characterised by the absence of major, disruptive conflicts between the central banks and the governments involved. This applied certainly to the relationship between the EMI Council and ECOFIN, but also to the relationship between most of the NCBs and their respective governments, although in the latter case there *were* instances or periods of conflict (one significant example was provided by France). For the central banks there were two main reasons for not being unduly worried by actual, or prospective, policy misbehaviour by governments. One was the declining trend of inflation. The other was the existence of the fiscal convergence criteria, which governments *did* try to respect. Yet even in a period which by today's standards could be regarded as having been relatively peaceful, we were beginning to perceive causes for concern. Both in the 1996 Convergence Report published by the EMI (in November 1996) and in the Institute's 1996 Annual Report (published in April 1997) you may find numerous examples of concern expressed regarding several developments: the slowness of the pace of reduction of fiscal deficits; the recourse to one-off measures; the temptation to raise taxes rather than reducing expenditure; and, most importantly, the little attention paid to the sustainability of the deficit reduction measures. (The Convergence Report contains a detailed analysis of a development which received far less attention at that time than it does today: the growing fiscal burden of old-age pensions.)

As regards governments, their traditional inclination to blame central banks for poor economic performance was also tempered by two factors: on the one hand, by the declining trend of long-term interest rates (which had started at the beginning of the 1990s and was interrupted only in 1994 for a short period); and, on the other, by their formal commitment, as a result of the ratification of the Maastricht Treaty, to respect central bank independence. It would have been strange if they had chosen to ignore this commitment so quickly - especially since this was in fact the "sixth" convergence criterion, compliance with which conditioned access to EMU, and could therefore not be taken lightly.

More than six years have now elapsed since the beginning of the end of the institution-building process on 1 January 1999 and more than three years since its unquestionable end. These are short periods when compared to the more than 35 years which have elapsed since the Hague Summit, and even shorter if you trace back the origins of European monetary cooperation to the establishment of the EPU in 1950. Yet we have been watching significant changes in the relationship between central banks and governments during these periods; and these changes have not been for the better. Hardly a week passes without one or the other head of state or of government publicly questioning the appropriateness of the monetary policy stance decided by the Governing Council of the ECB, and suggesting that the ECB should take as its model the Federal Reserve of the United States - thereby flatly disregarding Article 107 of the Treaty, which unequivocally states that: "The Community institutions and bodies and the governments of the Member States undertake not to seek to influence the members of the decision-making bodies of the ECB or of the national central banks in the performance of their tasks". Similarly, the cavalier way in which an increasing number of member states have dealt with the constraints of the Stability and Growth Pact suggests that they have conveniently forgotten that this pact was explicitly designed (not in prehistoric times, but in 1997) to preserve the constraining elements of the fiscal convergence criteria *after* accession to EMU, precisely because uncontrolled fiscal laxity could severely undermine the ECB's ability to fulfil its prime responsibility of maintaining price stability. No wonder this triggered reactions not only from the President of the ECB, but also from practically all the NCBs - reactions that were not to the liking of the governments concerned. No wonder either that when the head of government of one of the large countries attributes all the hardships of his country simultaneously to the introduction of the euro and the high level of the ECB's interest rates, central bankers feel it appropriate to argue that his country's problems have nothing to do with monetary policy. This hardly amounts to an environment which would favour a balanced and constructive exchange of views on optimal policy mixes (note the plural).

What has gone wrong since the second half of the 1990s?

It is easy to see with hindsight that, after the completion of the "heroic" institution-building phase, some deterioration in the political environment should not have come as a surprise. Managing the successful implementation of the single currency required considerable efforts on the part of politicians - efforts that could not be expected to be sustained. The success may have given the impression that the difficult part of the process was behind us, whilst it simply implied that the nature of the challenges had changed: we now had to "live" with EMU. On top of this, within a few years there has been a generational change in the political elite in the majority of countries and, most importantly, in three of

the largest countries (but not only there). This stands in stark contrast both to what had been happening in the political world during the decade following the signing of the Maastricht Treaty *and* to the continuity still prevailing in the world of central banking. A personal note: when today I meet members of the ESCB (at various levels), I expect to know at least two thirds of them, whilst when I meet politicians, or even high-ranking civil servants, the proportion is below one quarter - and even this is to be attributed to my recent activity relating to the reform of the regulatory process in the European securities markets rather than to my more distant EMI experience.

A much heavier responsibility for the deteriorating relationship between European governments and European central bankers lies with the worsening performance of the economy in the euro area, especially in comparison with the United States. The single most important fact in this respect has been the decline in Europe of the rate of growth of labour productivity (as measured by output per hour). For the EU 15 the deterioration has been dramatic, in comparison both with the European past and with the performance of the United States. Between 1985 and 1995 the average annual rate of growth was 2.2%, which allowed a sizeable catching-up with the United States, where productivity rose at that time at an average rate barely exceeding 1%. Since the middle of the 1990s, however, this relationship has been radically reversed; and during the years 2000-04 the US figure came close to 3%, while its European counterpart declined to 1% (and this figure would be even lower if the UK was excluded from the total). As estimated by the BIS (*74th Annual Report*, p 20), more sophisticated calculations of total factor productivity developments confirm this dismal story. I find convincing the arguments put forward in the Report that this discrepancy cannot be solely attributed to greater use of IT equipment in the US: "much of the acceleration in the trend TFP in the United States could well have come from the previous deregulation of markets for goods and services" (p 21). Central bankers, looking at these figures, have come to the conclusion (which I share) that there is precious little that monetary policy can do to alleviate these supply side inefficiencies. Supply side reforms are the responsibility of governments.

But this is arguably not the full story. That in the medium to long run these productivity developments are bound to put a brake on European growth is beyond doubt. But it is true that other factors are also at work; and in a shorter perspective they seem to play a more important role. One is the relatively low rate of participation of the European population in the labour force; another is the high rate of unemployment; and the third is that Europeans tend to work fewer hours per year than their American counterparts. These three facts can be summed up in one sentence: fewer Europeans work fewer hours than the Americans, which explains to a large extent why European income per head of population is lagging behind the American equivalent. No wonder that governments, and quite a few academics, argue that even if you define potential output in a quite restrictive way, there is a negative output gap which could be reduced by an acceleration in the very modest rate of growth of European domestic demand. And, so runs the argument, since central bankers are so vocal in opposing fiscal laxity, they should engineer this acceleration by pursuing a more aggressive monetary policy. By doing this, they would also help alleviate the danger that the so strongly anticipated US policy adjustment measures - cutting the country's fiscal deficit and raising the propensity to save of its households - will end up creating a slump in the world economy (which, incidentally, is about the last thing that Europe needs).

This is a serious debate which *has* to be pursued, but how can this be done within the framework of our current institutional arrangements?

It is at this point that I turn to the third group of reasons which bear a responsibility for it not being possible to pursue this debate in an environment conducive to constructive solutions. The major weakness of our current institutional arrangements can be summed up in a few words: that while the M-leg of EMU is solidly established, its E-leg is not. Let me remind you that I had misgivings about (what one might summarily call) the "missing federal finance minister issue" from the very beginning of my active participation in the monetary unification process. You may find the expression of my misgivings in a paper (for the preparation of which I received Claudio Borio's active assistance) submitted to the Delors Committee and published in an annex to the Report itself ("Macro-coordination of fiscal policies in an economic and monetary union in Europe", January 1989).

Let me briefly elaborate on how I see this problem today.

One problem would not necessarily be solved by having a large federal budget and a powerful federal finance minister: the destabilising emergence of a "globally" excessive fiscal deficit. No doubt, there is a powerful Secretary of the Treasury and a large federal budget in the United States, yet few of us would argue that the current and prospective American public sector deficit is an optimal one. Nor

would I argue that such a situation would by itself prevent the emergence of differences, even of major differences, between national (or "state") fiscal balances. To avoid this happening, you need additional arrangements: you cannot dispense with something akin to our poorly managed Stability and Growth Pact. A large federal budget would, however, represent one major advantage. It would provide a framework for more or less automatic transfer mechanisms which could help alleviate the politically and socially disruptive impact of differences between the growth performances of the member countries. Whether this would be a good or a bad thing would, however, depend on the origin of these differences: probably a good thing if we had to deal with country-specific external shocks - but a rather bad thing if the differences are of the countries' own making. And since my suspicion is that the emerging differences between the growth performances within Euroland can to a large extent be attributed to policy decisions (or the lack of them) by individual countries, I come to the conclusion that we should not expect much help from any move towards macroeconomic fiscal federalism - which in any case is highly unlikely to happen.

I would therefore today put less exclusive stress on the need for macropolicy coordination than I did 16 years ago, but would rather emphasise the desperate need to accelerate - and collectively accelerate - the micro or supply side reforms, of which we have so far seen only timid, and very uneven, beginnings. It is in this particular area that the E-leg should be strengthened.

Concluding remarks

It would be disingenuous on my part not to briefly outline, by way of conclusion, where I stand in my "stylised" summary of the current debate between European central bankers and their governments.

Let me start by saying that I share the concern of those who would like to see a pickup in the lacklustre rate of growth of domestic demand in Euroland. But what are the policy means of achieving this?

Forget about monetary policy - however tempting it might be to ask for "more responsive" policy reactions by the ECB. Anyone who cares to take a glance at the monetary statistics published by the ECB is bound to notice the currently relatively high rate of growth of broad money. You also have to bear in mind that this is not a new development: between mid-2001 and late 2003, M3 had been growing at a yearly rate of around 8%. As a result, Euroland now enjoys a comfortable "money gap" - even if allowance is made for the earlier portfolio shifts from equity into money. By calling attention to these figures, I do not want to imply that I see a danger of such "excess" liquidity putting upward pressure on consumer prices in the foreseeable future - although I would not rule out that it could have an undesirable impact on asset prices, at least in some countries. All I am trying to say is that, with such a high degree of liquidity and with the currently prevailing very low nominal and real interest rates throughout the whole yield curve, it would require a generous dose of imagination to believe that a relaxation of monetary policy could significantly stimulate domestic investment and consumption. I do not possess such imagination. Moreover, in a world flooded by dollar liquidity, a liquidity-generating European monetary policy would surely not contribute to global financial stability.

What about fiscal policy? It would seem difficult to argue that a relaxation of the fiscal policy stance could provide no stimulus whatsoever to domestic demand in Euroland. Initially, and for a short period, it possibly could - but at a price. Public opinion is no longer ignorant to the point of not realising that any such relaxation would come on top of the irresponsible handling, by the largest member countries, of their commitment to the Stability and Growth Pact. This has seriously undermined the credibility of future fiscal policy commitments. It is easy to lose credibility, but very hard to regain it. And this has happened at a time when the same public opinion has become acutely aware of the need to reform our health care and social security systems and to draw the appropriate conclusions for our pension systems from the ageing prospects of our populations. With the level of taxation well exceeding any reasonable level, it would seem difficult not to expect an increase in the burden of public debt. No wonder that the citizens of Euroland are not very keen to abandon their high propensity to save.

The upshot of all this is that the use of the two traditional macropolicy tools for stimulating domestic demand would be unlikely to yield sizeable and lasting results, but would surely pile up trouble for the future. So what to do? The short answer is: try to exert an influence on investment and consumption by other means.

As regards investment, two objectives should be simultaneously pursued. First, to nurture an "investment-friendly" climate across the full range of the enterprise sector, but with special attention to small and medium-sized firms, which as a group are the only ones likely to create jobs. The core concern in this field (in addition to the obvious need to reduce the administrative, fiscal and regulatory impediments which hinder entrepreneurial initiatives) is to encourage risk-taking, which in plain language means increasing the rewards in case of success in comparison with the penalties in case of failure. The second objective is to raise not only the level of, but also the return on, investment, ie the reverse incremental capital/output ratio. This is what I regard as one of the major lessons to be drawn from the US experience.

As regards consumption, the key word is "confidence", or rather the lack of it. Many of our citizens are worried about their future because, on the one hand, they are fully aware that our "European model" (the solidarity features of which they are deeply attached to) badly needs repair, but, on the other hand, they either do not see the beginning of a credible reform process, or they fear its outcome. Our politicians face the historical challenge of having to relieve these often conflicting anxieties. They will not succeed in their endeavours unless the reform programmes enjoy wide popular support, which, in turn, requires broadly based consultation of all stakeholders. The bulk of the reforms will have to be conceived, agreed upon and carried out within national borders - but, Euroland being a politically motivated collective endeavour, confidence-building would gain much through agreement on broad principles at the European level. Quite a challenge for the policymakers of EMU's E-leg.

Comments on Alexandre Lamfalussy's paper, "Central banks, governments and the European monetary unification process"

Peter B Kenen[1]

Allow me to begin on a personal note. I was *not* a member of the skeptical American majority that Alexandre mentions in his paper, partly because I had acquired a vested interest in the successful construction of EMU, as well as its subsequent functioning. I wrote my first paper on this subject in 1969, and it is still frequently cited, even by economists who have never read it. In the autumn of 1991, moreover, I held the Houblon-Norman Fellowship at the Bank of England and, thanks to Andrew Crockett, I was invited to read and comment on successive drafts of the Maastricht Treaty and ECB Statute. Thereafter, moreover, I turned my notes and comments into a monograph, *EMU After Maastricht*, that was published initially by the Group of Thirty and, in revised form, as a full-fledged book. Although the book did not appear until 1995, it was, I believe, the first comprehensive commentary on the Maastricht Treaty by an academic economist, and it was EMU friendly, although it raised questions about the fiscal provisions of the treaty and some other matters. I should perhaps add that some of my suggestions concerning the unresolved issues were, fortunately, ignored by Alexandre and his colleagues at the European Monetary Institute.

I also visited the EMI soon after it came into being, and I was fascinated by what Alexandre describes in his paper as the "master plan" for the work of the Institute. If memory serves me correctly, it was more than a list of issues that had to be resolved by the EMI Council. It was an elaborate work plan for the staff as well, including a detailed plan to bring TARGET into being - something that had to be done on time in order for the ECB to implement a single monetary policy from the start of the third stage of monetary union. Rather than exploiting what he describes in his paper as "opportunities to wreck, or at least substantially slow down the realisation of the institution-building project," Alexandre made it happen.

Turning to the body of his paper, let me comment on something that impressed me hugely when I was burrowing through the documentation that piled up in the months before the Intergovernmental Conference (IGC). There were significant differences between the various drafts of the Treaty itself, but the similarities were more striking. And this itself testifies to the crucial role played by the Committee of Central Bank Governors. Their first draft of the Statute of the ESCB and ECB was circulated a full year before the IGC, and a revised draft was distributed in April 1991, several months before that meeting. And when you compare the April draft with the text of the Treaty and the final version of the Statute, you cannot help but be impressed with the influence it had. I've just compared them again, and I've found very few significant differences.

The Treaty reduced the role of the ECB in prudential supervision (while leaving the door open to a larger role in the future), but given the cross-country differences in supervisory regimes within the European Union, it would have been hard to assign a bigger role to the ECB. And Article 111 of the Treaty, on exchange-rate policy, went through several drafts before and even during the IGC. It is still, to my mind, the most cumbersome article of the Treaty, and it poses a latent risk of conflict between finance ministries and the ECB.[2]

There was, I recall, sharp disagreement concerning the role of the EMI in the making of monetary policy during Stage II of EMU, but that tracked back to the Delors Report, not to the Draft Statute.

---

[1] Senior Fellow, Council on Foreign Relations, Professor of Economics and International Finance Emeritus, Princeton University.

[2] I noted in my book, however, that the cumbersome language of Article 111 reflects the cumbersome language of Article IV of the Articles of Agreement of the IMF, which speaks of the "monetary system" and the exchange rate "arrangements" of member countries (and then speaks of a "system of exchange arrangements").

Before turning to the second part of Alexandre's paper, let me note one way in which the IGC improved on the Draft Statute. Article 15.3 of the April 1991 draft said that "the ECB shall draw up an annual report, and the President shall present the report to the European Council, the Council of Ministers, and the European Parliament." Full stop. But Article 113 of the Treaty goes on to say that the Parliament "may hold a general debate" on the ECB's report. Furthermore, the Draft Statute said that the President and members of the Executive Board "may attend meetings of the European Parliament's specialized committees, if circumstances justify." But Article 113 of the Treaty says instead that "The President of the ECB and the other members of the Executive Board may, *at the request of the European Parliament* (emphasis added) or on their own initiative, be heard by the competent committees of the European Parliament." These are, I submit, important improvements in accountability.

This brings me, however, to one of my few disagreements with Alexandre. "Hardly a week passes," he writes, "without one or the other head of state or of government publicly questioning the appropriateness of the monetary policy stance decided by the Governing Council of the ECB … thereby flatly disregarding Article 107 of the Treaty, which unequivocally states that: 'The Community institutions and bodies and the governments of the Member States undertake not to seek to influence the members of the decision-making bodies of the ECB or of the national central banks in the performance of their tasks.'" Does Article 107 really mean a head of state or government cannot criticize the policies of the ECB? If so, how do we reconcile that provision with the clearly stated right of the European Parliament to "hold a general debate" on the ECB's annual report? Some of you may disagree with me, but I'm inclined to regard Article 107 as a safeguard against coercion rather than mere criticism of the ECB.

Having started by mentioning my 1969 paper, let me conclude with a comment on one of the main points made in that paper - one that Alexandre also makes without incriminating me: a large federal budget for the euro zone "would provide a framework for more or less automatic transfer mechanisms which could help alleviate the politically and socially disruptive impact of differences between the growth performances of the member countries." While I agree with him that such an arrangement might have the unfortunate effect of sheltering national governments from the growth-depressing effects of their own national policies, there is something more to be said. I have come to realize that the main difference between a federal fiscal system and a set of state (or national) systems is the difference in their impact on debt stocks.

When endogenous fiscal transfers occur within a federal system, they have little effect on the debt of the federal government. The endogenous transfers to slow-growing regions are offset by the endogenous transfers from fast-growing regions. When state governments run deficits, however, to cushion the impact of slow growth, they incur additional debt, and the risk of growth in debt is, in my view, the underlying rationale for the fiscal constraints in the Maastricht Treaty and the Stability and Growth Pact. If Italy runs a budget deficit of, say, 4 per cent of GDP, it does not gravely undermine the monetary policy of the ECB. If Italy's debt grows steadily, however, because of its 4 per cent deficit, and the country approaches a debt crisis, it threatens the policy independence of the ECB. There is the risk of political pressure on the ECB. More importantly, there is the risk that it may have to intervene in order to ward off a banking crisis resulting from an incipient debt crisis. In other words, a federal fiscal system, by consolidating deficits and stocks of debt, permits more fiscal flexibility and more insulation for monetary policy.

I concede the possibility that a federal fiscal policy can go badly awry. I come from a country where that has happened. I likewise agree with Alexandre that worries about debt levels and trends may help to explain why the citizens of Euroland have a high propensity to save. But I did want to explain what I now see to be the potential contribution of a federal fiscal system. It has more to do with holding down debt levels than with the endogeneity of fiscal transfers.

Comments on “Central banks, governments and the European monetary unification process”

Yung Chul Park[1]

Mr. Lamfalussy has written a very interesting and incisive paper on recent developments in EU monetary integration, focusing on the institution building phase of the single currency project and the problems of coordinating and harmonizing the monetary policy of the ECB and the fiscal policies of the EMU member governments.

Like many other East Asian policymakers and academics working on economic integration, I have been studying the evolutionary process of EU monetary integration for some time, but I am hardly qualified to discuss Lamfalussy’s paper. Thus, instead of commenting directly on his paper, I shall discuss recent developments in financial and monetary integration in East Asia since the 1997-98 financial crisis and what East Asian economies can learn from Europe’s experience in their efforts to integrate their markets and coordinate their policies.

The 1997-98 Asian financial crisis set in motion two interrelated financial developments in East Asia. One is that most of the region’s countries, including the crisis-hit ones, have increased the pace and scope of domestic financial reform to liberalize and open their financial markets and also to improve soundness, corporate governance, and risk management in financial institutions. The other development is the regional movement for financial cooperation and integration that has culminated in the Chiang Mai Initiative (CMI) and the Asian Bond Market Development Initiative (ABMI).

Before the Asian financial crisis broke out in 1997, few would have seriously argued for the creation of a system of regional financial cooperation in East Asia. To many, a market-led integration process was desirable and in fact was taking root in East Asia already at the time. The crisis, however, shook the region’s confidence in such a process and in consequence gave a strong impetus to the search for a regional mechanism that could forestall future crises. This search has been gathering momentum and opening the door to possibly significant policy-led integration in East Asia. Indeed, the region might be on the brink of a historic evolution, as Europe was half a century ago.

Since the crisis, there has been a rising sense of East Asian identity. When the proposal to create an Asian Monetary Fund (AMF) was shot down in 1997, the leaders of ASEAN responded by inviting China, Korea and Japan to join in an effort to seek economic cooperation in the region. The ASEAN+3 summit in November 1999 released a “Joint Statement on East Asian Cooperation” that covers a wide range of possible areas for regional cooperation. Recognizing the need to establish regional financial arrangements to supplement the existing international facilities, at their meeting in Chiang Mai, Thailand, in May 2000 the finance ministers of ASEAN+3 agreed to strengthen the existing cooperative frameworks in the region through the Chiang Mai Initiative (CMI). This initiative has since been followed by another regional initiative for developing and integrating the bond markets of the region’s individual countries into a large unified regional market; this is known as the Asian Bond Market Development Initiative (ABMI).

As a regional vehicle for financial cooperation, the CMI has been able to build a foundation for monetary unification in the long run. If they are committed, East Asian countries will now have to lay out a plan for building the requisite institutions, developing procedures for policy coordination and surveillance, and managing liquidity support over periods of time divided into several stages before actually adopting a common currency. The plan will also need to include the choice of a common currency and a collective exchange rate regime during the transition period that could facilitate monetary integration in the region. For a common currency, there are two choices: use of one of the

[1] Seoul National University.

major existing currencies such as the dollar, euro, or yen; or creation of a new currency as in the case of the EU.

As the European experience suggests, monetary integration is essentially a political process. Whatever the economic merits of using an "external" currency as the East Asian monetary anchor, few countries, in particular Japan and China, will be able to accept the US dollar as their currency. If joining the dollar bloc, or for that matter any other currency bloc, is not a realistic option, then East Asia may emulate the European experience of creating a regional common currency. Since the preparation period for introducing such a currency is likely to stretch over many years, East Asian planners may begin implementation of their plan by searching for a region-wide collective exchange rate system that could facilitate and accelerate monetary integration in the region.

Monetary integration in East Asia is expected to be an evolutionary process, beginning with a system of policy dialogues and review, while maintaining a variety of exchange rate systems in the region and then gradually moving into deeper stages of integration. Over time, these non-binding policy reviews and dialogues could develop trust and help establish working relationships for policy coordination and financial support among CMI members, eventually creating a political and economic environment conducive to introducing a collective exchange rate system. After five years of discussion and negotiation on financial cooperation, CMI members may believe that the time has come for them begin their search for a common exchange rate system for the region, as a transitional system before making the ultimate leap to a common currency.

As far as collective exchange rate systems are concerned, there appear to be three alternative mechanisms East Asia could consider for adoption. The region could replicate the European experience by introducing an East Asian version of the EMS that includes Japan as a member. Another alternative is pegging to a variety of baskets of currencies. If neither alternative is practical, then the region may choose to move to a free floating regime, although this option appears to be highly unlikely.

ASEAN+3 is a group of heterogeneous countries which have different political and cultural backgrounds and are at different stages of development. It includes the second largest economy in the world, a rapidly growing military power with a huge market, a number of emerging market economies, and poor developing economies. As a result of this diversity, economic integration in East Asia - in trade, finance, and monetary terms - has taken on the characteristics of vertical integration, whereas in the EU the similarity of the members has led to horizontal unification. As is well known, in East Asia's integration process, China may well become the final factory of the region, producing and exporting all sorts of manufactures using inputs imported from other East Asian countries.

Because of this fundamental difference, East Asia could learn much from the EU's early period of institution building, policy coordination, and development of political leadership that facilitated economic integration in Europe, but not so much from its experiences in the 1990s. In recent years, however, the EU has accepted a relatively large number of countries with different economic and political backgrounds. It will therefore be searching for ways to deal with a new phase of unification that is vertical, as East Asia's integration has been. East Asia will try to learn from Europe's experience with integration in the 1960s and 1970s. At the same time, it will closely follow the EU's recent enlargement, which has brought into the union a number of new members which do not share many economic and social features in common with its older members. The EU and ASEAN+3 may then enter a new phase of cooperation, exchanging views and experiences on the problems involved and perhaps establishing a more realistic approach to vertical integration.