



**THE EUROPEAN ECONOMIC AND MONETARY UNION:  
AN EXPERIMENT WHOSE TIME HAS COME --  
OR HAS IT?**

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(Abstract)

*One market, one money, one central bank -- what price euro?*

The countdown for establishing economic and monetary union (Emu) in Europe has started and the countries of the European Union are practically on automatic pilot. Nevertheless, some nagging questions still have to be addressed concerning the design of the project and the possibility that, if not detrimental, the benefits might not be as big as expected or as quick in arriving, as some had hoped. In addition there have been some developments recently that have been disconcerting since they violate if not the letter, then at least the intentions of the Maastricht Treaty -- and in some cases even the letter.

A particular point of disagreement has crept in among EU members concerning the strictness of meeting the Maastricht convergence criteria for Emu eligibility. Not less significant is the reinterpretation or outright potential violation -- the unambiguity of the Maastricht Treaty to the contrary -- of the independence of the European central bank which will succeed the European Monetary Institute and replace the autonomy of the individual central banks, combining them in the European System of Central Banks.

Another point not to be overlooked is the exaggerated expectation put into Emu as an engine of growth and thus a creator of employment. Unemployment in Europe is more structural than cyclical in nature and requires restructuring of the domestic economies which macroeconomic policies are not equipped to achieve. Unfortunately, some EU countries have been moving in the wrong direction, rejecting the Anglo-Saxon model and refusing to accept the requirements of market forces and the trend toward globalization of production. Lack of required flexibility will become even more disruptive in the absence of flexible fiscal policy and the loss of the exchange rate adjustments.

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*One market, one money, one central bank -- what price euro?*

*The Maastricht treaty -- an act of "historical stupidity"*  
Philippe Séguin<sup>1</sup>

**I. INTRODUCTION**

Popular definition has it that an economist is one who wonders when something works in practice, whether it also works in theory. Emu might become a prime example of why some economists may come to doubt the wisdom of European Monetary Union (Emu) -- and especially its timing -- even in the face of the stride of history. Today we may be tempted to observe that it may not even work in practice.

Germany's 'golden episode' of mid-May 1997,<sup>2</sup> was the pistol shot launching the countdown to Emu. With less than 500 days left till lift-off, we are now on automatic pilot.<sup>3</sup> But since there is no absolute certainty, 'minor' problems should continue to be addressed, even though the hour is late. NOT to pay attention to some nagging questions would be a serious sin of omission:

- ◆ what is the purpose of the space flight;
- ◆ at what cost does the space flight take place -- do not ignore and/or downplay preparatory costs;
- ◆ what is the probability that it accomplishes -- or can be expected to realize -- its mission; and even if the probability is greater than 0.5
- ◆ is it really needed, or could its goals, perhaps, be attained at lower political and economic cost?
- ◆ how large and safe is the space ship? did the lowest bidder get the contract -- not violating "Europe 1992's" procurement directives?
- ◆ who will be the navigator? the European Central Bank (ECB) based on central bank independence

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<sup>1</sup>President of the French National Assembly; The New York Times, May 27, 1997, A8.

<sup>2</sup>See below for a discussion.

<sup>3</sup>As it happened, there has been pack-peddling and Waigel declared that he will desist from moving forward with his plan. More on that most important infringement on Bundesbank independence, later in this paper.

(CBI)? governments? what will be the nationality of the ECB president -- the primus inter pares?

not an insignificant concern to the chief Emu proponents;

- ◆ who will be in the space ship on launch day? -- to be decided by May 1998, though the most likely composition of the membership could be determined as early as by end-1997;
- ◆ are the invites truly ready for the trip; have their entry tickets -- of course to be paid for in euros -- been properly checked for possible counterfeit, or, in Eurospeak, "fudging"?
- ◆ how harmonious and/or converging are the mind and philosophical outlooks of the prospective occupants of the space ship, and, more important,
- ◆ what are the chances they will get along, after take-off, when Emu leaves them "no way out"? No "Stop-the-World-I-Want-to-Get-Off" clause there;
- ◆ what is going to happen with those left behind, though members of the European Monetary System (EMS) and, perhaps, even its exchange rate mechanism (ERM); what is to become of them of the "Outs" also known, more politely, as the "Not-ins" or even more politely the "Pre-Ins" -- those milling around at Cape Frankfurt and waiting for a better day? Lo and behold, some "Not-even-yet-pre-ins" have started to prepare themselves for boarding Emu -- via a "link to Frankfurt";<sup>4</sup>
- ◆ how credible is the mantra "One market needs One money", when you have left behind members of the EU -- all participating in the Project 1992, thus, 'single marketers'?
- ◆ what about the 'widening' of EU, which, so the saying goes is not to be at the expense of 'deepening' but part of it?
- ◆ what would be the costs/benefits of scrapping the project?
- ◆ and finally, CUI BONO?

These are some of the questions that come to mind when trying to assess the probability of success of the

<sup>4</sup>On May 26, 1997, Czech National Bank governor Josef Tosovsky announced that henceforth the koruna would be linked to the D-Mark instead of to the dollar and D-mark basket and the trading band -- which within 10 days cost the central bank \$3bn in a futile attempt to keep it there, abandoned. Financial Times, May 27, 1997, p. 2.

experiment in which European Union members are about to engage. Not addressed in this paper is the effect Emu might have on the rest of the world, nor whether it will bring greater stability to the international economic relations.

## II. THE SPACE MISSION

### A. The politics and economics of Emu

While it is generally agreed that there are many objectives -- and objections -- to Emu on economic grounds, Emu is essentially a political decision -- though with major economic repercussions.<sup>5</sup> I emphasize economic considerations fully recognizing that economics and politics are closely intertwined.<sup>6</sup>

#### 1. The short run and the long

Emu brings with it economic and political benefits as well as costs. Both must, in turn, be subdivided into short- and long-run aspects: short-run versus long-run economic benefits and costs must be weighed against each other as do short and long run political benefits and costs. Just to make things more complicated, comparing economic (political) costs with economic (political) benefits will not suffice, however.

One also has to cross the disciplines weighing short-run political (economic) benefits against long-run economic (political) costs, and short-run economic (political) costs against long-run political (economic) benefits. Moreover, conceptual differences between short and long run divide economists and politicians. A politician's notion of the long-run is shorter -- generally measured in terms of the run to the next election -- than an economist's. Economists and politicians base their considerations on a different risk-reward calculus. Small surprise then that their respective preferences for and assessment of costs and benefits of various policies, tactics, strategies and even systemic arrangements tend to differ if not conflict.

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<sup>5</sup>Thus also, among many observers, former Bundesbank President Helmut Schlesinger. See The Economist (London), September 21, 1996, p. 25. More about this below.

<sup>6</sup>See Stephen Overturf, Money and the European Union. Forthcoming.

Furthermore, politicians, for obvious reasons, will invariably tend to understate costs of projects and policies, while overstating their benefits. Case in point: estimates of Germany's burden -- both in magnitude and duration -- of unification shortly before the historic event took place with Chancellor Kohl's famous imitation of President Bush's lip-reading; "no new taxes". History has amply demonstrated that economic forces cannot be violated with impunity -- certainly not in the long run. A good example along those lines is the battle over stability and growth, the proposed employment chapter and the lack of interest in or courage required for the much-needed microeconomic reform requiring restructuring of the labor market -- even if in the short run it would, as well it might, increase unemployment. Alas, France has chosen to **increase** the minimum wage, reduce the workweek, and not diminish wages for reduced labor input.

Relate the earlier discussed political/economic cost-benefit calculus to the rejection of possible postponement of the launching of Emu: the short-run political benefit (cost) -- maintaining (losing) credibility that Emu will take place -- ought to be measured against the long-run political cost of Emu being derailed for good, but also against the potential long-run economic cost, in case the preconditions -- those anchored in and those mistakenly left out of the Maastricht treaty -- have not been realized.

In addition, the economic benefits of observing the Maastricht conditions have to be weighed against the economic costs (to be reflected in higher interest rates on public debt and thereby increasing the difficulty of reducing their debts and deficits) and political cost (declaring them de facto second-class citizens) by excluding EU members -- even EEC founding members -- from Emu founding membership.

Our best, but probably futile, hope is that the designers of and policy makers in any system will have the courage to observe the Hippocratic oath: do no harm. Alas, they are predominantly trained in political short-run expediency and not in medicine and thus have neither commitment nor incentive to pay heed to the above admonishment.

#### B. Purpose of the space mission -- the rationale for Emu

There are purportedly many direct and indirect benefits to be reaped from Emu and membership in it --



some obvious ones while others might be less obvious but not less important.

1. Elimination of transaction costs

The most obvious of the benefits to be reaped from a single currency is that the currency-conversion costs have been eliminated. This benefits both the export-import businesses and the intra-EU traveling consumers. Of course, the financial sector loses income it derived in the past from currency conversion, and employment in its foreign exchange department will thus shrink.

2. Enhancing transparency, thus international competition

With only one currency and thus a single unit of account, prices of goods and services in different countries can easily be compared, which significantly enhances transparency and thus competition.

3. Elimination of exchange rate volatility

exchange rate volatility and uncertainty producing associated benefits: trade and investment is generally and widely seen as one of the major benefits of stable/fixed exchange rate, and perforce, of a single currency.

While this is true, the extent to which this matters is still debated. A study, by none less than the Commission of the European Community has arrived at the conclusion that volatility introduced since 1992 has not substantially reduced intra-European trade from what the growth rate would have been without the heightened volatility.

4. Completing the harmonization of financial regulation

The ECB and the single currency will complete the harmonization of financial regulations and liberalization, since the denomination of securities in different currencies prevents them from being 'perfect' substitutes.<sup>7</sup> On the other hand, the greatest costs will be borne by Germany and its Bundesbank since in a pegged-rate system it is the producer of the n-th currency, the Bundesbank, which has the freedom of action. This will be lost by the Bundesbank and replaced by the ECB and its euro.

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<sup>7</sup>Malcolm Crawford, One Money for Europe. The Economics and Politics of EMU. New York: St. Martin's Press, 1996. Second edition, p. 6.

#### 5. Enlarging and deepening financial markets

Single currency is expected by its very nature to enhance international competitiveness and attractiveness and thus would lead to large capital markets with all the advantages connected with deep markets with "pan-Emu bond and equity trading" <sup>8</sup> One should, however, remember that exchange controls -- in defense of stable exchange rates -- were a greater impediment to the development of a truly European market than the existence of different currencies. Of course, with a single currency you have eliminated the need to defend stable intra-EU exchange rates.

#### 6. Establishing a political alibi

Establishing a political excuse for introducing unpopular measures is a double-edged sword. Countries that on their own would not be able to instal much needed tight(er) economic policies might find a convenient excuse to adopt painful adjustment policies that would have been needed in any case but were difficult to get through the legislature and/or the trade unions, but might be less opposed being part of a greater goal with promised large benefits. An earlier example can be found in the decision of Mitterrand, **not** to leave the ERM in March 1983 but to accept the Bundesbank's monetary policy, which, without ERM, though prudent, would not have been politically and ideologically possible. Recent labor demonstrations in France and the rapid caving in of the government to labor's demand substantially weaken the currency of this argument. Augmenting the problems is that by blaming Emu for those painful measures for a greater collective good could turn popular sentiment (even more) against the project.

#### 7. Reduction of inflation rates

Lower inflation rates would have a beneficial impact on interest rates and, possibly, investments. Emu countries are expected to benefit from tying their economies to low-inflation countries; indeed, one of the convergence criteria is to enhance credibility of the seriousness of 'tying one's hands'; this would credibly lower inflation and interest rates, thus reducing the cost of borrowing, both private and public -- the country would, as some did, benefit from a "credibility bonus". Obviously, the weaker the country -- but

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<sup>8</sup>Andrew Fisher, "Bourses: Euro could be second most important currency." Financial Times, April 15, 1997.

with expectations that it will be a founding member of Emu -- the greater the credibility bonus.

The bond and foreign exchange markets, like a seismograph, have been tracing all the undulations of entry expectations -- as one would presume of efficient markets. For instance, on a day, when Italy -- the most important of the questionable founder members -- is likely to join Emu from the beginning, the D-Mark depreciates, while it appreciated when a delay of Italian membership seemed more likely.

Lower interest rates, in turn, would stimulate investment, and thus economic growth. Though the statement is correct, remember that the level of interest rates is not the only, not even necessarily the most important, determinant of investment. Investments are also closely linked to domestic economic outlook, capacity utilization and international competitiveness.

Another, often un-pronounced anticipated benefit of a project like Emu is that it gives politicians the excuse (and backbone) to introduce unpopular but needed policies with an alibi, policies they otherwise would or could not adopt, having the next election in mind. These benefits diminish with closeness to Emu entry (vanish upon entry) while the costs remain. The latest rout in the first round of French elections, however, demonstrates that even that subterfuge -- the call for sacrifice in the interest of the final push and is about to be abolished without being influenced by the outcome of the French elections -- is far from being a sure thing: It worked in March 1983, when France, with its decision to stay in the ERM made a 180 degree turnabout and adopted anti-inflationary policy; but neither Mitterrand nor Chirac got the referenda they had hoped to get.

#### 8. The EU's unemployment

Great hopes have been set in the Emu's ability substantially to reduce EU unemployment. The European Union's unemployment, however, is as much microeconomic in nature as it is macroeconomic and has become fundamentally a structural problem. Europe's unemployment problem cannot be solved by macroeconomic policies alone but requires hard-to-accomplish structural changes. The OECD has calculated that the overwhelming portion of unemployment is structural -- in the neighborhood of 9

percent or above -- rather than cyclical, which in most cases is somewhat above one percent.<sup>9</sup> In its 1995 recommendations, the OECD's Economic and Development Review Committee recommended for continental Europe to increase labor and product market flexibility.<sup>10</sup>

As long as needed painful adjustments are resisted -- as they still are in many European countries, including France and Germany -- fiddling with a single currency alone will and cannot perform the stunt. Changes in exchange rates of old could not solve countries' internal and balance of payments problems, as long as exchange-rate changes were not accompanied by flanking domestic economic policies.

An abundance of private and official studies have been published dealing with the unemployment issue. While the studies may vary somewhat in detail, there seems general agreement on major points:

- Economic growth alone will, no longer suffice, "one of the paradoxes of industrialized economies";<sup>11</sup>
- structural changes are needed:
  - greater mobility of the labor force;
  - changes in the structure: health and pension benefits; retirement age; reduction in the burden on employers to finance those social benefits;<sup>12</sup>
  - reduction in regulations, e.g., those concerning hours of work or hours businesses are permitted to stay open, and many other regulatory controls.

The European Community Commission in 1993 has attempted to map out analyses and policies to deal with the European Community's unemployment problems. In May 1993, the Commission agreed on an initiative to pursue a "more employment-intensive pattern of production in the Community" -- arguing this

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<sup>9</sup>Organization for Economic Cooperation and Development, OECD Economic Outlook 61(June 1997):11 and Table 9.

<sup>10</sup>Reference to this in Organization for Economic Cooperation and Development, OECD Economic Outlook 61(June 1997):12.

<sup>11</sup>Alan J. Donnelly, Member of the European Parliament, United Kingdom, Chairman of the Parliamentary Delegation for Relations with the United States, in The Structural Adjustment of Economies: Transatlantic investment and Economic Interdependence (International Roundtable Seminar, conducted by The European Institute. Washington, DC: July 1993, 14.

<sup>12</sup>In France, e.g., payroll taxes add 52 percent to the cost of employment.

was "both economically rational and socially desirable."<sup>13</sup> Strange reasoning here, as in so many other instances: the Community seemed, as it should be, also concerned about Europe's worsening international competitiveness.<sup>14</sup>

Germany seems to have been able to get some concessions from at least one of the unions -- the IG Chemie -- which signed a "milestone agreement" allowing troubled employers conditionally to cut wages up to 10 percent in return for job security.<sup>15</sup> It's a beginning in the right direction.

France, on the other hand, even before Chirac's election debacle of June 1, 1997, has been moving in the wrong direction, by reducing the work-week -- from 35 to 30 hours -- without a reduction in wages or salaries and with a four percent increase in the minimum wage, thereby losing some of the meager improvements it had made. France's slender sacrifices may consequently bear no fruits. France and Germany are prime examples as to the difficulty Europe faces in its attempt to introduce Anglo-Saxon flexibility.

The latest developments on the employment front: a move afoot at the IGC (May 1997) to prevail on Germany -- the only country opposed to it, not wanting employment policy dictated by Brussels (Hello, Maggie) -- and to include the employment issue in the revision of the Maastricht Treaty: it is "unthinkable" that the euro could be a strong and stable currency while unemployment in Europe was rising to 20 million and beyond.<sup>16</sup> Christian Democrats and their junior partner, the Free Democrats, maintain that employment should be handled at the national level.

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<sup>13</sup>Commission of the European Communities, Directorate-General Employment, Industrial Relations and Social Affairs. Employment in Europe. COM(93)314. Brussels-Luxembourg, 1993, p. 3.

<sup>14</sup>At the Copenhagen summit in June 1993, the European Council gave the Commission a mandate to produce a White Paper on growth, competitiveness and employment.

<sup>15</sup>This stands in stark contrast to the IG Metall, with 2.4 million members Germany's strongest union and traditionally the pace setter for other wage settlements throughout Germany, which set its sight on a reduction in the work week to 32 hours. On the other hand, Chemie's settlement (700,000 union members) reflects reality, inasmuch as close to 30 percent earn less than the Cartel determined wage. Greg Steinmetz, "One union accepts reality, breaking with inflexible past." Wall Street Journal, June 12, 1997, p. A14.

<sup>16</sup>"Unthinkable", the word of Ad Melkert, Dutch minister for Labor and Social Affairs at a conference on EU reform organized by Germany's Social Democratic Party. Peter Norman, "Dutch plea on jobs," Financial Times, May 27, 1997, p. 4.

### C. Emu and the Single European Market (SEM)

It is often argued that a single market needs a single currency. Hence, Emu is to complete the "Completion of the Single European Market," accomplishing in the monetary field what "Project 1992" was supposed to have done for Europe in the real sector: bind countries together in their effort jointly to re-start Europe's sputtering economic engine, raising its growth trajectory and reducing unemployment. The argument in the 1980s preceding the Single European Act was that a single country could no longer successfully deal with anemic economic growth and inadequate international competitiveness. The combined European Community effort, benefiting from economies of scale, higher investments through the elimination of all remaining internal barriers, would rekindle Europe's economic activity.

A single market it is not yet for the EU, despite the SEM project and the passing of over 4-1/2 years since its beginning (January 1, 1993). Actually among the project's worst offenders we find France and Germany. As Monti observed: "It would only be normal to expect from those members states, which are the driving forces of integration altogether and economic and monetary union, in particular to be showing the way."<sup>17</sup> Perhaps even more ironic, according to at least one observation, "The move [by Brussels' EU's single market Commissioner Mario Monti, to publish a list of Project-1992 violators in order to embarrass members] is in response to concerns that member states are backsliding on their single market obligations , focusing instead on preparations for economic and monetary union."<sup>18</sup>

Alternately, for some the euro is to wrest Europe from dollar influence -- which still exists in the minds of many Europeans, and/or to gain control over the Bundesbank and its generally persistent anti-inflation policy; then there is a third line of thought: to shield Europe from the impact of global competition and thereby enhancing the chances of reducing the continuously high and even rising unemployment rates in most European Union countries -- i.e., finally to create something like a "Fortress Europe" to help the EU solve its unemployment problem.

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<sup>17</sup>Quoted by Emma Tucker, "Single market rules: Brussels to shame EU states." Financial Times, February 17, 1997.

<sup>18</sup>Emma Tucker, "Single market rules: Brussels to shame EU states." Financial Times, February 17, 1997.

The above thinking is fundamentally flawed, and the expectations are highly exaggerated, in particular the last one, which has led some proponents to argue in favor of a "euro at any price". "Project 1992" is not complete, nor has it fulfilled the exaggerated expectations -- you merely have to look at EU growth and unemployment rates. Neither will nor can Emu live up to the exalted expectations: Emu is not the EU's deus ex machina nor could it be, at least not for Europe's unemployment.

D. Preparation, size and construction of the Emu Spaceship

The preparations for this particular Emu to fly have been long in coming. The engineers had thus plenty of time to prepare, refine, revise, and revise again their plans. Between 1969 (Barre Plan), 1970 (Werner Plan), 1989 (Delors Plan), 1991 (Maastricht Treaty) and 1997 (Maastricht II), the designers were busy modifying their blueprints so as to reassure at least themselves, if not necessarily all of us, that the participants and the onlookers will witness a successful launch and, extraneous factors (e.g., weather) permitting, a not-too-bumpy ride.

The introduction of a common currency for many sovereign countries joining in a monetary union prior to a political union is practically unprecedented. The introduction of the euro for politically independent countries, thus, departs from traditional practice. Exceptions to the rule, for instance the Swiss-Liechtenstein and the Belgium-Luxembourg monetary unions, have emerged for practical reasons: these were small nations decisions to tie their fates to existing monetary institutions in a larger country, whose economic policy it willingly adopts, and thereby to reap the benefits of scale economies.<sup>19</sup>

As to the size of Emu, not only all present EU members but also future ones will have to be accommodated -- provided they have established the proper qualifications -- qualifications which are clearly spelled out -- or are they? -- in the Maastricht Treaty. Consequently, with proper identification they can come aboard at any time in the future, there will always be a docking -- and ducking? -- opportunity.

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<sup>19</sup>The Belgium-Luxembourg monetary union almost broke up in 1982, when Belgium devalued the Belgian Franc in the EMS without prior notification of Luxembourg. Tactically, this was a mistake and Luxembourg warned Belgium not to repeat such action without prior notification, if not consultation with Luxembourg.

### E. Timetable for Emu

While the Three-Stage plan to Emu of the Delors Plan wisely desisted from committing us to a firm timetable -- so as not to frighten the faint-of-heart, the Maastricht Treaty sealed the fate of Emu's launching date -- if not prior to, then certainly not later than January 1, 1999 (really on Friday?). No, they will still wait, till Tuesday, January 1, 2002, or better still, till the latest possible date, July 1, 2002, by which time the euro will have become the only legal tender in the Emu countries, having replaced the national currencies.

Many uncertainties remain between now and the onset of Emu, especially as far as setting exchange rates is concerned, and many fear greater volatility in exchange markets as the date approaches.

### **III. TRANSITION TO EURO AND EXCHANGE RATE PRESSURES**

We are faced with several difficulties not only as the time approaches and decisions as to who will be on the space ship and who not, but also with the speed of the transition to the euro. We shall turn to some of the concerns.

#### A. Deviations of spot rates from central parities

Begg et al. looked at deviations of exchange rates and found that they all are within 4 percent from central parities, most even considerably closer and having moved in the right direction between 1995 and end-January 1997.

#### B. Central parities as equilibrium rates<sup>20</sup>

Three questions should help find an answer concerning equilibrium rates for the longer term:

- ◆ are the rates compatible with recent inflation trends?
- ◆ are the economies in external balance or capable of achieving this through common policies?
- ◆ "is there evidence of recent asymmetric shocks to potential Emu economies, or evidence of macroeconomic tension across potential Emu members" -- conditions which could be severe handicaps if the EU is not an optimum currency area (OCA). The significance of the EU not (yet)

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<sup>20</sup>Based on Begg et al., EMU: Getting the End-game Right. London: Center for Economic Policy Research, February 28, 1997, pp. 49-50.



being an OCA has, however, been downplayed lately.<sup>21</sup>

#### 1. Inflation rates

Inflation rates and differentials matter because they create adjustment pressure as countries' competitiveness is affected. Begg et al. find that wage inflation adjusted for productivity growth have been converging since 1993 -- the last (so far) major ERM upheaval.

The cumulative effect of even small inflation differentials might make a big difference; again, their analysis shows that unit labor costs have converged through realignment of central parities between 1987 and 1997, and real exchange rate movements for a core group of countries have shown "no sizable changes in real exchange rates" [51].

#### 2. Internal and external balances

**External balances** are relatively small in relation to national output, also when considering Emu-7 (Austria, Belgium, Germany, France, Ireland, Luxembourg and the Netherlands), or Emu-10 (Emu-7 plus Finland, Portugal and Spain); they were rising between 1994 and 1997 but stayed within 1 percent of gdp; with Italy in Emu, thus Emu-11, the positive external balance jumps in 1997 to an estimated 1.5 percent of GDP, but is insufficient to cause a major problem for the future of central parity [53].

Concerning **internal balances**, there has been a substantial output gap in the EU -- the exception being Ireland -- and signs of recovery are weak at best and uncertain in light of further macroeconomic belt-tightening required to meet the Maastricht criteria.

In conclusion: "there are surprisingly few hurdles in the path of central parities as a basis for bilateral conversion rates, a decision rule preannounced and in operation by the time ins are selected" [55].

I should point out, Begg's et al. analysis deals exclusively with the question of announcing the future exchange rate and chances that there might be turmoil in the foreign exchange markets based on

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<sup>21</sup>On asymmetric shocks and the debate over the relevance of the optimum currency area, see Paul De Grauwe, The Economics of Monetary Integration. Oxford: Oxford University Press, 1994. Second edition.

divergence in fundamentals. Begg et al. were not interested in assessing other EU issues -- to which we shall turn our attention.

### 3. Asymmetric shocks

Asymmetric shocks have existed in the EU and will continue to do so and reveal the weakness of a monetary union when economic conditions in member countries are fundamentally disparate. In the 1970s and 1980s European Community countries were differently exposed to the oil shocks and policy reactions differed, not only in response to differences in the shocks but also to differences in their understanding of the working of their economies. Similarly, a decade later, Germany's economic, monetary and social unification affected Germany differently from the other EC countries, i.e., was asymmetric shock for EC members. Germany had to fight the inflationary pressures stemming from unification and conducted tight-money policy, whereas Britain's and Italy's deep recession required easy-money policy -- absent exchange rate adjustments, which by then had become difficult in the ERM.

The semblance of nominal exchange rate fixity since January 1987 put undue pressure on the ERM, the accumulated differences finally exploding in summer 1992 with the first of a string of crises in the ERM. Exchange rate flexibility in the 1970s and 1980s helped in absorbing the asymmetric shocks and policy differences and the post-ERM crisis of widening of exchange rate margins returned the system to stability.

Different was the situation in Bleu, the Belgium-Luxembourg monetary union: Belgium's balance of payments deficit and high unemployment rate in the early 1980s coincided with Luxembourg's full employment and external surplus. Therefore, Luxembourg was concerned that the Belgian franc devaluation would lead to inflationary pressures at home.

It has been argued that asymmetric shocks might have been aggravated by the Bundesbank conducting monetary policy for Germany with a generalized EU impact, and that the ECB, by conducting

monetary policy for the entire EU area, will ameliorate asymmetric shocks.<sup>22</sup> Question remains nevertheless whether the Bleu case can be extrapolated to the EU; in that case one would be less optimistic over the disappearance or gravity of asymmetric shocks in the EU.

A severe problem from the beginning of closer exchange rate arrangement for the EU has been the lack of mobility of labor between the various countries and even between regions within countries. This forebodes ill for adjustment to shocks when neither monetary nor fiscal policy are available to alleviate them. The former is absent with the establishment of the ECB. The latter is missing owing to the stability (and growth) pact, if even during economic expansion countries' deficits are not substantially reduced below the 3 percent ceiling.

C. 'Big bang' versus process

1. Technical difficulties

First, there was the issue whether the transition would/should be a 'big bang' event, as proposed particularly by the French, or a gradual process, whose main proponent was Germany.<sup>23</sup> While a big bang might have been preferable to a process, it is highly unlikely that it could have been the former, if for no other reason than the technical difficulties of introducing and distributing the new money high-speed. With a big bang, there will be clarity and less vulnerability to the system and no volatility in the market for foreign exchange than with a gradual approach. And indeed, interpretation of "the draft Regulation is compatible with only one explanation of the events which occur on 1 January 1999: **the euro comes into existence and becomes *the* currency of each of the Participating States. The national currency of each of those states ceases to exist as a currency, and is substituted by the euro. This substitution occurs both at the conceptual and theoretical level, and also at the concrete level, where an obligation occurs which was formerly an obligation in national currency is now an obligation in**

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<sup>22</sup>Peter B. Kenen, "Common Currencies versus Currency Areas: Preferences, Domains, and Sustainability." American Economic Review 87(2, May 1997):212.

<sup>23</sup>On this issue see also Financial Law Panel, Economic and Monetary Union -- The relationship between national currencies and the euro. London: Financial Law Panel Limited, November 1996. Processed.

euros. However, the euro as a concept has two physical emanations: it appears as euro units (in bank statements, legal instruments etc., and after the end of the transitional period in the form of notes and coins) and during the transitional period it will also be evidenced by references to the national currency in legal instruments, and evidenced in the form of national currency notes and coins." <sup>24</sup>

As long as national currencies exist, there is the danger that the solidity of Emu and the 'irrevocability' of intra-Emu exchange rate stability and unification might be tested in the markets for foreign exchange. This is a different story from exchange rate stability of the euro vis-à-vis the dollar and the yen. Conceptually, intra-Emu exchange rate changes should no longer be possible, "since national currencies will no longer exist. However, speculation would be possible in practice, if not in theory. Foreign exchange contracts do not deal with currencies as intellectual concepts. They deal with physical emanation of those concepts. If during the transitional period it is possible to have obligations denominated in national currencies, it will equally be possible to enter into contracts to transfer the benefit of those obligations. Thus, although the deutschmark and the French franc (say) will no longer exist, each will have the appearance of doing so, and it will be possible for markets to trade in those appearances." <sup>25</sup>

## 2. Economic reasons

There are reasons that should have been clear right from the beginning: if for economic reasons not all countries can be founding members, then it cannot be an event but a process. And here we then have a parallel to the Project 1992, which is still not complete.<sup>26</sup> And yet, the parallel is not clear-cut: it is an event for those who are getting into Emu; once they have entered, there is hardly a way out; for the "outs" it is a process toward joining the "ins" -- but for the "ins" it remains a process inasmuch as the membership will increase -- thus a slightly messy situation.

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<sup>24</sup>Financial Law Panel, Economic and Monetary Union -- The relationship between national currencies and the euro. London: Financial Law Panel Limited, November 1996, p. 8. Processed. Emphasis in original.

<sup>25</sup>Financial Law Panel, Economic and Monetary Union -- The relationship between national currencies and the euro. London: Financial Law Panel Limited, November 1996, p. 10. Emphasis in original. Processed.

<sup>26</sup>As of June 1997, none of the countries has lived up to all the directives anchored in the Single European Act of 1986.

How will the euro exchange rate fare. Do current central rates of Emu members point toward equilibrium and thus foreshadow high probability of euro- stability? Begg et al. have investigated several crucial aspects in this connection and find that the trend has been in the right direction, so much so that the central rates might even be pre-announced rates for the changeover on January 1, 1999.<sup>27</sup>

#### **IV. THE TRAVELERS AND THEIR ABILITY TO GET ALONG**

Members -- not all, of course -- of the EU will occupy the spaceship; and not all the travelers will be equal; some will be more equal than others. Their status will be reflected in the proportional representation and qualified majority voting -- still to be determined, even after the June 1997 Amsterdam summit. The apportionment of decisionmaking power between the various members has remained a point of contention, as has been the selection of the next head of the ECB. (See under the heading CBI.)

##### **A. Creating harmony**

To assure the least possible friction and reasonably guarantee stamina for the trip, passengers will have to pass a fitness and endurance test: during the Maastricht negotiations, the planners carefully selected yardsticks -- convergence criteria and sustainability of the effort of meeting the Maastricht criteria. They are the oft-recited pre-conditions for Emu readiness:

##### **B. Convergence criteria**

- a deficit not to exceed 3 percent of gdp;
- an overall public debt, not to exceed 60 percent of gdp; both government debt and deficit being "a risk factor for sound monetary policy;" this applies also for debt/deficit after accession, as stated in the "stability" pact;<sup>28</sup>
- an inflation rate not to exceed 1.5 percentage point the average inflation rate of the three lowest-inflation rate countries;

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<sup>27</sup>Based on Begg et al., EMU: Getting the End-game Right. London: Center for Economic Policy Research, February 28, 1997, pp. 48-55.

<sup>28</sup>Rudi Dornbusch, "Fiscal Aspects of Monetary Integration." American Economic Review 87(2, May 1997):221. He thought it was "overkill" since the Maastricht Treaty guarantees ECB independence and prohibits interference by any public authority as well as bailout of any government. He wrote this however before the May 1997 Waigel gold debacle.

- an interest rate on long-term government debt not to exceed 2 percent the average of the three best-performing countries [the assumption being that countries with the lowest inflation will also be the ones with the lowest interest rates];
- the country's currency having remained in the normal ERM band without having experienced a devaluation within two years prior to Emu membership [i.e., the country must have been an ERM member; and the normal band, which initially was +/-2.25 percent was re-interpreted after the 1993 widening of the band as being +/-15 percent].

Question now is, whether meeting the Maastricht **convergence** criteria **before** boarding Emu assures harmony once on the plane, even before take-off, let alone thereafter. We have already discussed some areas of disagreements prior to the starting date, and we can be sure that they will not vanish after take-off; rather, other areas of contention will surface as we go along. None might be as significant as is CBI.

We still have to ask whether the convergence criteria that have to be met -- or at least so the story goes -- are the right ones, and if so, whether they suffice in order to attain the goals the EU members have set for themselves. Essentially, the criteria deal with macroeconomic but not the microeconomic aspects and it is the latter that have created Europe's woes, or, if not created, they must not be neglected in order to get Europe out of the high-unemployment situation.

### C. Interpretation of the Maastricht convergence criteria

These preconditions seem rather straightforward and unambiguous. Yet, it is here that we enter a mine field:

#### 1. Maastricht -- satisfying the convergence criteria

First, especially the debt and deficit criteria are subject to expected and, as it turned out, to unexpected interpretations;

- the Maastricht Treaty (MT) left a leeway for countries that do not meet the debt and deficit criteria but were considered to have made substantial progress and can be expected to meet the criteria in the near future;

- a somewhat unexpected interpretation has been as to how some countries intend to get there: the stipulation that the policies to meet debt and deficit criteria must be 'sustainable' was essentially ignored by France and Italy, and prompted an outcry by Germany; which then was quickly stilled by Eurostat, the European Commission's statisticians, "not immune to political pressure."<sup>29</sup> It was not the determination by the European Commission, Council, or Parliament that France's or Italy's "one-off trick", as the Germans called it, were legitimately applied to meeting their 3 percent deficit/gdp ratio. Never mind that France Télécom could be sold only once and the application to the pension payment was thus clearly a one-time affair, nor that Italy's "Europe-tax" was intended to be a one-shot affair, only to be reserved later.<sup>30</sup>

## 2. The 'golden' opportunity of May 1997

And guess, who has joined the French and the Italians? None other than Theo Waigel, who, on May 15, 1997, saw a 'golden' opportunity for the Germans, their entry ticket being paid for by the Bundesbank's revalued gold supply and foreign reserves and to be used to reduce Germany's deficit to (below) 3 percent of gdp.<sup>31</sup>

With the gimmick (or "trick" as the Germans called the French télécom proceedings) of changing the value of Germany's gold reserves, Waigel has transgressed several principles -- without possibly solving any of the crucial problems facing Germany.<sup>32</sup> It was not even certain that the manoeuvre would have been in time to reduce Germany's crucial 1997 budget deficit sufficiently. Waigel's tactic would have violated

- ◆ central bank independence -- irrespective of the finesse Mr. Waigel put on, arguing that "[w]hile

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<sup>29</sup>The Economist, May 31, 1997, p. 48

<sup>30</sup>The sale of France télécom brought in FFfr37.5bn (£4bn) to cover future pensions liabilities and reduced the 1997 government deficit by 0.5 percent.

<sup>31</sup>Gold reserves valued at DM13.69bn were more than DM40bn below market value. Peter Norman, "Bonn plans gold move to support public finances. Finance Minister outlines proposals for revaluation of country's gold reserves" Financial Times, May 16, 1997, p. 1.

<sup>32</sup>For a collection of some of the reactions see Deutsche Bundesbank, Auszüge aus Presseartikeln, No. 30, May 27, 1997.

the Bundesbank is sovereign in monetary policy, parliament is sovereign in its legislative decision;<sup>33</sup>

- ◆ the law that government 'consumption' expenditures -- as opposed to capital investment -- must be financed out of current receipts; Waigel intended to use the revaluation gain to be channeled into the "redemption fund for historic burdens"<sup>34</sup> originating from German unification;<sup>35</sup> thus, at best, the windfall from gold revaluation would have had to be allocated to capital expenditure;
- ◆ the principle of sustainability of reducing deficits in order to meet one of the criteria:<sup>36</sup> with the proposed gimmick, Waigel introduced a one-off transaction;<sup>37</sup>
- ◆ destroyed the credibility in the soundness of: the DM; the euro; and, indirectly at least, the credibility of Bundesbank and the future European Central Bank independence.

The government's plan consists of revaluing the DBB's gold and currency reserves (currently valued at DM13.69bn) to near market rates, now more than DM40bn below that rate. The plan is to draw on some DM60bn "of locked up value in the Bundesbank's gold and currency reserves to reduce the public deficit and debt," with an estimated DM118bn ... shortfall in budgeted revenues between now and 2001.<sup>38</sup> The finance ministry's group of experts estimated that overall tax revenues for 1997 of DM813.1bn would fall short of their November 1996 forecasts by DM18bn. Moreover, "the experts forecast tax shortfalls of

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<sup>33</sup>Quoted by Andrew Fisher, "SPD challenges Kohl to call election; Gold revaluation plan has hit credibility of German policy, says opposition leader." Financial Times, May 2, 1997, p. 1. There is some ambiguity in the Maastricht Treaty concerning central bank independence; see Hugo M. Kaufmann, "The Importance of Being Independent: Central Bank Independence and The European System of Central Banks." In Carolyn Rhodes and Sonia Mazey, eds. The State of the European Union Vol. III: Building a European Polity? Boulder, CO: Lynne Rienner, 1995, pp. 267-91.

<sup>34</sup>Peter Norman, "Waigel finds a pot of gold at time of need." Financial Times, May 16, 1997, p. 2.

<sup>35</sup>"Bonn plans gold move to support public finances. Finance Minister outlines proposals for revaluation of country's gold reserves" Financial Times, May 16, 1997, p. 1.

<sup>36</sup>Sustainability of policies is mentioned twice in the Maastricht treaty.

<sup>37</sup>Thus also a member of the Bundesbank Directorate, Edgar Meister, who warned that "a sustainable fulfillment [of the Maastricht criteria] cannot yet be guaranteed." Quoted by John Carreyrou, "Dollar tops mark, yen reflecting fears Germany will flunk currency criteria." Wall Street Journal, May 20, 1997, p. C15.

<sup>38</sup>Peter Norman, "Germany: Turmoil over plan to revalue gold reserves." Financial Times, May 17, 1997 (over W3). "The fund would be paid by the Bundesbank in the form of an extraordinary profit into the 'redemption fund for historic burdens'. There they would offset other public deficits to ensure that Germany's overall deficit stayed below the limit set by the Maastricht Treaty's criteria for emu membership ..."



DM32bn a year and more for the following three years."<sup>39</sup> Part of the debt stems from Germany's unification and in 1995 that debt was moved into the general government deficit (as defined by Maastricht).

On other occasions, Theo Waigel made two -- contradictory -- statements: an emphatical one that concerning the Maastricht criteria "three percent is three percent" and on another occasion, before reverting to the initial statement, he asserted that he was "not nailed to the cross of three percent".

Germany's latest moves have demonstrated a convergence to the French gimmicks -- but perhaps more ominously, a blunt violation of CBI for political expediency, all in the name of Emu. Indignation initially came not from the DBB, whose silence was very loud. It came from the three opposition parties -- probably for different reasons than merely for the defence of CBI, although the latter must not be ruled out or minimized. The Financial Times somewhat interpreted the Bundesbank's "atypical non-reaction" a concession that politics not economics ultimately drives Emu -- all the technical details and hard rules of the MT and previous solemn declarations by none less than Theo Waigel himself to the contrary.<sup>40</sup> True, the reaction was somewhat long in coming. Observes Peter Martin, "The ... principle, illustrated as clearly by Chancellor Bismarck as by Chancellor Kohl, is that determined governments will always find a way round purely technical barriers, however formidable they may appear to more literal-minded observers."<sup>41</sup>

And like in the French case, where a branch of the European Commission -- the Eurostat -- gave its instantaneous blessing, over the objections of Germany, European Commission officials bestowed the same courtesy to Germany in their predicament by declaring "the move should remove all doubt about Germany's commitment to meeting the emu criteria."<sup>42</sup>

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<sup>39</sup>Peter Norman, "German economy: Bonn plans gold move to support public finances." Financial Times, May 16, 1997.

<sup>40</sup>Later, there emerged also dissension within the coalition, both by the Free Democrats and the Bavarian Christian Social Union. Ralph Atkins and George Graham, "German FDP calls for talks on gold row." Financial Times, June 3, 1997, p. 3.

<sup>41</sup>"Lessons on baht and barriers." Financial Times, May 19, 1997, p. 20.

<sup>42</sup>Peter Norman, "Germany: Turmoil over plan to revalue gold reserves." Financial Times, May 17, 1997 (over 3W).

### 3. Abandonment of the 'golden' opportunity

Under growing pressure from the opposition, and even from within Kohl's own party and from other countries who have been the recipients of Germany's lecturing, but more so owing to strong and growing resistance from the DBB itself, which strongly rejected the revaluation plan on May 28, 1997, the government finally declared on June 3, 1997 -- after emphatic declaration of Chancellor Kohl to the contrary only a few days prior to that -- it will abandon the plan of revaluing the gold holdings for budgetary purposes -- until 1998, too late to help meet the deficit criterion in 1997.<sup>43</sup> The implication of this move is that it has remained unlikely that Germany will stay within the 3 percent deficit/gdp ratio.

### 4. Determination concerning performance in 1997

The European Commission (a political body of non-elected officials) and the EMI (independent, precursor of a supposedly independent central bank will judge how closely the Maastricht convergence criteria have been achieved by the various aspirants. Their reports will be presented to ECOFIN (European Council of Ministers of Economics and Finance, a political body) which will decide -- with qualified majority and upon a recommendation from the Commission -- which member states fulfill the criteria and will be ready to move to Stage III. ECOFIN will recommend its decision to the European Council of the Heads of State or Government. The European Parliament will also form an opinion and submit it to the Council.<sup>44</sup>

#### D. Fiscal discipline once in Emu

There is a strong temptation to misbehave, once in Emu. What prevents a government from excessive deficits, shifting the burden on other member countries?

#### 1. Stability and Growth Pact

The Stability and Growth Pact was agreed at the December 1996 Dublin summit. It stipulated, among others:

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<sup>43</sup>Edmund L. Andrews, "Germans' slick bookkeeping to meet euro goal is scrapped." The New York Times, June 4, 1997, p. A8.

<sup>44</sup>David Begg, "The EMU End-game," in Begg et al., EMU: Getting the End-game Right. London: Center for Economic Policy Research, February 28, 1997, p. 1.

- ◆ Countries are to be discouraged from running excessive deficits -- to make this condition effective fines have to be paid -- it be then that there was a disaster or gdp fell by 2 percent over a year;
- ◆ if a country fails to correct the situation, its fines will not be returned;
- ◆ where gdp has fallen between .75 percent and 2 percent, EU finance ministers will have discretion as to whether there should be fines imposed.

## 2. Employment chapter into the treaty

Chief proposals:<sup>45</sup>

- ◆ require each member to provide an annual report on its employment measures;
- ◆ call on the council of ministers to evaluate implementation of those measures;
- ◆ on the basis of these evaluations, have the council and European Commission make a joint report on employment in the EU.

Safeguards have been introduced -- question is only how strictly they will be observed, especially in light of the emphasis on the employment picture. Even a cursory look at the current European spectacles leaves me less than Europhoric. Question still remains whether countries violating the conditions will be punished and it might well turn out that the heaviest burden would fall on the weakest countries -- which then might well be accommodated under heavy political pressure and appeal to "cohesion" of the EU.

## V. CENTRAL BANK INDEPENDENCE

### A. Meaning of CBI

When discussing CBI one has to distinguish between de jure and de facto national CBI -- under different exchange rate regimes -- on the one hand, and CBI in the ESCB as well as independence of the ECB on the other. One has furthermore to distinguish between goal independence and policy independence.

It has been argued that central banks have lost (most of their) de facto independence with the opening of capital markets resulting from the abolition of capital controls and the churning of over \$1.5 trillion in foreign exchange markets on an average day. Consequently, so the argument goes, combining

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<sup>45</sup>Financial Times, June 12, 1997, p. 13.

the national central banks under the roof of the ECB and creating the European System of Central Banks, eliminating national central banks' power to set interest rates and having closely linked interest rate levels throughout the Emu, will not change much.

This is not quite correct: true, under a system of flexible exchange rates, asset market returns on each currency will be equalized for each investor through arbitrage, but it still "allows this rate of return to vary across investors in different currency regions."<sup>46</sup> Nominal interest rate differentials can persist, while real interest rates **might** be equalized. Except in the long run, the link between inflation rates and exchange rates is quite tenuous (as the post-ERM UK experience shows).<sup>47</sup>

Some interest differences will remain, not owing to different monetary policies but to market perception of differences in the riskiness of different assets -- including government assets.

#### B. Legal aspects of ECB independence (ECBI)

The national central banks, together with the ECB constitute the ESCB which, upon German insistence at the time of the MT negotiations was to be independent and not subject to political interference; it also had the charge to pursue the goal of price stability. The ECB does not have goal independence but policy independence; but this also implies that "there may be no difference between the observable preferences of those who led the Bundesbank and those who will lead the ECB".<sup>48</sup>

Two elements stand out in assuring CBI: structural/legal aspects and personality of the head of the central bank. It is not unreasonable to suggest that we might encounter cases where strong legal guarantees are paired with weak personalities at the helm of a central bank; more menacing is, however, that even strong personalities combined with strong legal assurances have been successfully ignored by the politicians: for instance DBB objections to EMS were ignored by Giscard d'Estaing and Helmut Schmidt when they

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<sup>46</sup>Economist Intelligence Unit, EIU Research Report: The Pros and Cons of EMU. 1997, Ch. 2. "The power of the markets." EIU Research Report: The Pros and Cons of EMU. 1997, Ch. 2. "The power of the markets." [http://www.eiu.com/latest/rr\\_emu/cr7zz100-7.html](http://www.eiu.com/latest/rr_emu/cr7zz100-7.html).

<sup>47</sup>Economist Intelligence Unit, EIU Research Report: The Pros and Cons of EMU. 1997, Ch. 2. "The power of the markets." [http://www.eiu.com/latest/rr\\_emu/cr7zz100-7.html](http://www.eiu.com/latest/rr_emu/cr7zz100-7.html).

<sup>48</sup>Peter B. Kenen, "Common Currencies versus Currency Areas: Preferences, Domains, and Sustainability." American Economic Review 87(2, May 1997):212.

went ahead to create the European Monetary System in 1978. Karl Otto Pöhl's negotiations with his East German counterpart to set an economically viable exchange rate for converting the Ostmark into the DM were blithely ignored by Chancellor Kohl.<sup>49</sup> Alternately, Japan which previously did not have an independent central bank by law had some strong central bankers who asserted independent leadership and independence.

Closer to home -- the EU, that is -- the first and surprising decision taken by the new Labor government's Chancellor of the Exchequer, Gordon Brown, was to set the Bank of England free to determine interest rates. Equally important are the appointments for the Bank's monetary policy committee.<sup>50</sup> On May 26, he declared the Bank would no longer have the banking supervisory function -- an act that almost prompted the resignation of Bank of England president Eddie George. The splitting of supervisory function from that of setting monetary policy does, however not negate CBI -- in Germany, too, these functions are separate. There is a debate in the academic banking literature as to whether such separation is not the more desirable setting.<sup>51</sup>

#### 1. Concepts of independence -- France versus Germany

Nothing summarizes French thinking in this discussion better than the following statement "We don't want all decisions on economic, budgetary, fiscal and monetary policy to be shaped by a technocratically-driven, semi-automatic system under the sole authority of the ECB. That is not our concept of democracy," thus Jacques Chirac.<sup>52</sup> This statement finds its echo in the France's pushing for head of the ECB "a multi-talented personality, whose antennas reach beyond the monetary and economic minutiae"

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<sup>49</sup>On this issue see also Christopher J. Waller and Carl E. Walsh, "Central-Bank Independence, Economic Behavior, and Optimal Term Lengths," American Economic Review 86(December 1996):1139-53.

<sup>50</sup>The four are Charles Goodhart, Willem Buiter, Sir Alan Budd and DeAnne Julius all academicians or one-time academicians with distinguished careers and, significantly, "without strong Labor party affiliation." "Top economists to advise central bank," Financial Times, June 3, 1997, p. 10.

<sup>51</sup>In The U.S., the system is much more complex with supervisory function split between the Federal Reserve, the Federal Deposit Insurance Corporation, and State supervisory authorities.

<sup>52</sup>Financial Times, December 14, 1996, p. 8. Quoted in Harold James, "Monetary and fiscal unification in nineteenth-century Germany: What can Kohl learn from Bismarck?" International Finance Section Princeton University: Essays in International Finance No. 202, March 1997, p. 30.

referring in all likelihood to Michel Camdessus. The Germans, in turn would want "a competent central banker to lead a team that would relentlessly and independently pursue the Maastricht treaty's prescribed goal of price stability. The Germans are also deeply suspicious of anything that smacks of political interference in monetary policy."<sup>53</sup>

In addition to the question of which personality would best head the ECB, and thus possibly undermine its independence, CBI is threatened yet from a more formal source -- also of France's doing:

## 2. Emu "Stability and Growth Council" -- ECBI threatened

A recent development causes concern for those who want to be certain that ECBI is guaranteed. Upon French insistence, having demanded political impact upon the ECB, Germany reluctantly, with "qualified endorsement" agreed to a ministerial "stability and growth council" whose task it is to "coordinate economic policy" within the Emu. There was an apparent promise by Jean Arthuis, former French finance minister, that the council "would not encroach" on the European Central Bank's independent right to set monetary policy.<sup>54</sup> Nevertheless, the whole affair is sufficiently equivocal that it might be a clear violation of Art. 107 of TEU which states unambiguously that

... neither the ECB, nor a national central bank, nor any member of their decision-making bodies shall seek or take instructions from Community institutions or bodies, from any government of a Member State or from any other body. The Community institutions and bodies and the government of the Member States undertake to respect this principle and 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.

Not convincing is the distinction Bundesbank President Tietmeyer drew when thanking the German and French finance ministers for "making clear that the stability council 'will focus on economic policy'" thus leaving monetary policy to the central bank. There is no fire wall that clearly protects the ECB from economic policy spillover effects and would not threaten its independence.

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<sup>53</sup>Wolfgang Münchau, "Paris, Bonn at odds over ECB." Financial Times, May 27, 1997, p. 4.

<sup>54</sup>David Buchan, "Germany: Emu stability council proposals reassure Kohl," Financial Times, March 13, 1997. Although this is a watered-down version of France's original plan to have a stability council composed of Emu countries as political counterweight to the ECB, it is difficult not to harbor suspicion about its intention and the difficulties it will create for central bank policy. "Beware of the Greeks bearing gifts" might now have to be augmented by "Beware of the French bearing proposals."

### 3. Other historic episodes

In a recent study, Harold James observes<sup>55</sup> CBI was insisted on as a result of the 'catastrophic German hyperinflation' of the 1920s after it had monetized government debt. "Legal autonomy was enforced as a prerequisite for international assistance in stabilization and currency reform." He continues "The fact that the 1922 law was later violated by Hitler made central-bank autonomy appear even more desirable at the end of Hitler's war." Unfortunately, he failed to put the experience into sharper relief: CBI is always threatened -- irrespective of the legal protection, and irrespective of national or international agreements [see the above discussed recent French demand to install a "stability and growth council" as political counterweight to the ECB]. Dictators do not observe the rule of law or, if they do, as under the Nazis, who punctiliously observed the laws -- they will do so after having changed them.

#### C. Exchange-rate regime determination -- and implications

Liberalization of capital movements and flexible exchange rates have driven home the impact of exchange rate movements as well as interest rate changes on the domestic economy and the monetary policy transmission mechanism -- the framework for monetary policy nowadays is international.

The determination of an exchange rate regime and exchange rates is a messy situation, similar to the one existing in the US: there are two elements to the exchange rate angle:

#### 1. Setting of the exchange rate system

It is the government that

- ◆ determines the exchange rate regime to which the country will adhere;
- ◆ the Treasury and not the central bank is in charge of (determining) exchange rate transactions (interventions), thus threatening CBI; under these conditions it matters little whether the ECB has a monetary or inflation goal as its guiding principle.

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<sup>55</sup>Harold James, "Monetary and fiscal unification in nineteenth-century Germany: What can Kohl learn from Bismarck?" *International Finance Section Princeton University: Essays in International Finance* No. 202, March 1997, p. 2.

## 2. France versus Germany on ECB foreign exchange transactions

Dispute between France and Germany over "whether the ECB should have the power to conduct foreign exchange and some money market operations" upon the start of Emu.<sup>56</sup>

Germany and the smaller EU countries lobby [whom?] for the ECB to be able to "fine-tune the money and foreign exchange market operations." The French argue that the power should remain with the national central banks. "Suddenly what we thought had been agreed on now seems not to be so. This [the French position] is quite surprising: Financial center considerations are behind this."<sup>57</sup> France also disagrees with other members over whether the ECB should be directly linked to TARGET.<sup>58</sup>

## VI. CONCLUSION

What does all this amount to? Emu is probably going to get off the ground; the political will is not only there, but the chief politicians -- Helmut Kohl and Jacques Chirac -- are firmly committed to its launching **date** -- less so to its launching **pre-conditions** -- without having left themselves any face-saving escape hatch. And the business community has already sunk a substantial amount into preparing for the changeover to the new currency. It will not want to have to write this off as a loss, but considers it an investment for the long haul. But even if Emu starts, and starts on time, the question still remains whether it is feasible from an economic point of view.

What seems unassailable, though, in this exercise is that anything but a one-speed Emu will split the European Union and invalidate the contention that one market needs one money. How well the bird, or is it a space craft -- perhaps Graf Zeppelin? -- will fly, and how the onlookers will fare, remains to be seen. "The Emu is a bird which has two unusual characteristics: it can only proceed forward and it cannot

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<sup>56</sup>Wolfgang Münchau and Andrew Fisher, "France and Germany divided over ECB role." Financial Times, May 8, 1997, p. 2.

<sup>57</sup>Wolfgang Münchau and Andrew Fisher, "France and Germany divided over ECB role," citing an unnamed "senior European central banker who is a member of the council" of the EMI. Financial Times, May 8, 1997, p. 2.

<sup>58</sup>Wolfgang Münchau and Andrew Fisher, "France and Germany divided over ECB role." Financial Times, May 8, 1997, p. 2.



fly.<sup>59</sup> Or odder still, the Emu might fly, but the euro will sink. The countdown to January 1, 1999<sup>60</sup> (paraphrasing Samuel Johnson) might concentrate the countries' leaders' minds wonderfully -- but in the European context -- asymmetrically.

*No matter what, after Emu's lift-off, it better remain in orbit.*

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<sup>59</sup>Malcolm Crawford, One Money for Europe. The Economics and Politics of EMU. New York: St. Martin's Press, 1996. Second edition, p. 8.

<sup>60</sup> Or, more accurately, May 1998, the date when the decision about founding membership will be made.

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