European monetary integration: experiences and future prospects

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Faculty of Social Sciences
Lingnan College
Hong Kong
1993
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EXPERIENCES AND FUTURE PROSPECTS

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European Monetary Integration: Experiences and Future Prospects

by
Dieter Cassel and Thomas Apolte

University of Duisburg
Germany

1. Potential Benefits and Risks of a European Monetary Union

2. Did ERM Force Monetary Stability and Convergence in Europe?

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1. Potential Benefits and Risks of a European Monetary Union

In November 1991, some 12 years after the installation of the European Exchange-Rate Mechanism (ERM), a further step towards monetary integration in Europe was decided upon in Maastricht. This has led to an intensive debate among politicians and economists about the potential benefits and drawbacks of a European Monetary Union (EMU). In Germany, it is first and foremost the "scientific community", which doubts the benefits and emphasizes the risks concerning EMU (see BAELE; et al., 1992; BAREIS; et al., 1992), while most politicians and managers accentuate the benefits rather than the risks. In the other member countries, however, the situation is somewhat different.

As a matter of fact, the dispute about how much monetary cooperation and integration in Europe should be pursued is anything but new. Ever since the ERM was installed, it has frequently been discussed whether or not it is capable of improving exchange-rate stability and monetary convergence with a low level of inflation. Correspondingly, it has also been disputed whether this system serves as an appropriate preparation for the next step, the EMU. This paper attempts to provide some answers to these questions. First, the most prominent potential benefits of a single European currency are briefly presented. Then, the ERM's impact in forcing monetary convergence and stability in Europe is analyzed. The resulting question: Can a further monetary integration in the direction of a single European currency guarantee macroeconomic stability, both in the transition to EMU and later on is discussed in the third part. Finally, some remarks on the importance of fiscal discipline in the EC member states will be made.

The Commission of the EC identifies the following major benefits of a single European currency (COMMISSION, 1990; see also: GROS/THYGESEN, 1991, pp. 98):

- Transactions costs of intra-community trade and of trade with non-EC-countries decline, since an increasing share of world trade would be invoiced in the European Currency Unit (ECU) instead of US-$. 

- Risks from exchange rate variability decrease. As long as the share of trade with non-EC-countries invoiced in ECU increases, problems of exchange-rate variability of the US-$ become irrelevant.

- EC banks will have more comprehensive opportunities. These will arise from the fact that all activities of Community banks inside EC member states will be based on one single currency, which will then be the domestic currency for all European banks.
The European Central Bank (ECB) will reduce its international reserves. Since there will be no need for exchange-market interventions within the Community, international reserves could be reduced by approximately 200 billion US-$. Furthermore, since more ECU reserves will be held globally, seignorage revenues for the ECB of some 0.045 percent of EC's GDP could be generated.

Macro-policy coordination in the Community will improve. Since there will be only one authority concerned with monetary policy, coordination of stabilization policy should become easier. Coordination of monetary and exchange-rate policy worldwide could also benefit from the EMU, since there will be only the ECB to negotiate with.

As a further political benefit, the EMU could serve as a motor for political integration in Europe, forcing politicians and bureaucrats to cooperate more fully and develop more efficient decision-making processes.

However, it is not yet clear whether these positive results can be realized with the help of EMU or, if they can, how much of the Community's welfare could be boosted. Not surprisingly, sceptics have concentrated on the risks of EMU. In Germany, the leading question is how much macroeconomic stability can be guaranteed by a European Central Bank. Will such a bank be able to aim its policy on price stability alone, or will it just compromise between, at least, twelve different points along the Phillips curve? At the same time undue transitional shocks are feared in the event of a poorly prepared slip into the monetary union, similar to the problems following the German monetary union in 1990. The problem of preparation leads us back to ERM, the basis on which EMU will be set up.

2. Did ERM Force Monetary Stability and Convergence in Europe?

ERM has been viewed as a success by its proponents primarily because it has fostered both higher monetary convergence and the stability of member states. Both convergence and stability are important for an EMU for two reasons: First, they are necessary preconditions for a transition to EMU without undue monetary and real-economy shocks. Second, to the extend that higher convergence and stability are in fact a result of monetary cooperation via ERM, this system can be seen as a proper instrument to prepare EMU with the help of a gradually intensified monetary cooperation.
Unfortunately, the successful evolution of ERM since 1987 was interrupted in mid 1992. After only two years of British, Spanish and Portuguese membership as well as the introduction of normal Italian exchange-rate margins, intensive currency speculations and imbalances forced the community to realign. Moreover, Italy and the UK even left the mechanism temporarily. And in August 1993, the exchange-rate margins have been extended from 2.25 percent to 15 percent in each direction. Considering the fundamental data of the respective countries, part of this development should not have surprised anybody. The British pound entered the ERM with an overvalued exchange rate, and since then considerable differences in inflation among the ERM-currencies have undermined the stability of the ERM parity grid. However, the evolving enthusiasm for European integration following the Single European Act in 1986 sometimes diverted attention from economic reality. The following section will address the question as to how far ERM could have forced higher convergence and stability of its member states.

2.1. Major Theoretical Arguments

In theory, there are at least three arguments for a stabilizing role of ERM (SMEETS, 1993): First, as far as those countries which are obliged to purchase foreign currency to prevent appreciations realize to neutralize the expansion of their monetary base, the symmetry of interventions’ effects on the monetary base will be undermined in favor of a bias towards more stability. This is also true to the extend that intra-marginal interventions within the ERM dominate. In this case, as long as the intervening central bank uses its own foreign exchange reserves or takes on credit from the capital market, there is a contractive monetary effect but no corresponding expansive effect in the other country. Between 1979 and 1990, approximately 73 percent of the interventions’ expansive effects on the monetary base in Germany could be neutralized by the Deutsche Bundesbank. At the same time, more than 88 percent of all exchange-market interventions were intramarginal interventions. Thus, successful neutralization policies, as well as intramarginal interventions, have obviously given some asymmetric bias towards more monetary stability in the ERM-states. In the long run, however, different monetary growth rates, and thus, different inflation rates, cannot be maintained without either a realignment or a convergence of monetary growth.

Second, given that exchange rates are fixed or can only float within some limits, inflation leads to a real appreciation, and hence, to a loss in international competitiveness. Given that political competition works, this puts pressure on politicians to avoid inflation. Third, even if actual rates of inflation are equal, a higher interest rate will be necessary in countries which are regarded as less able to maintain price stability. This could result in a
more restrictive monetary policy in those countries which have relaxed monetary control in the past.

Those effects may have contributed to monetary stability in Europe in the past, with the Deutsche Mark as the dominating currency (see Herz/Röger, 1992). As monetary integration proceeds, some of these effects are likely to decrease in importance, while others could become even more important (for a public-choice perspective, see: Von Hagen/Fratianii, 1991).

2.2. Empirical Evidence

A tendency towards convergence as well as stability is most striking in the development of inflation rates (see Table 1). In 1979, the average growth rate of consumer prices in the 8 original ERM-countries (including Italy) was 9.45 percent with a standard deviation of 4.26. Both figures rose considerably within the following year (13.16 percent inflation with 6.2 standard deviation) but then dropped steadily to 3.91 percent and 1.45, respectively.

Table 1: Level and Standard Deviation of Inflation in the Original ERM-Countries*

<table>
<thead>
<tr>
<th>Year</th>
<th>Inflation Rate (Average)</th>
<th>Standard Deviation</th>
</tr>
</thead>
<tbody>
<tr>
<td>1979</td>
<td>9.45%</td>
<td>4.26</td>
</tr>
<tr>
<td>1980</td>
<td>13.16%</td>
<td>6.2</td>
</tr>
<tr>
<td>1981</td>
<td>3.91%</td>
<td>1.45</td>
</tr>
<tr>
<td>1982</td>
<td>2.85%</td>
<td>1.2</td>
</tr>
</tbody>
</table>

Source: Author’s calculations, based on Eurostat data.
* Germany, France, Italy, Belgium, the Netherlands, Luxembourg, Denmark and Ireland.
Long-term interest rates evolved similarly (see Table 2). In 1979, the average return on bonds amounted to 10.87 percent, climbing up to 14.65 percent in 1982. During the same period, the standard deviation rose from 3.18 to 4.43. After 1982, however, return on bonds dropped to 9.3 percent with a standard deviation of only 0.95. While the smallest and largest return in 1979 was 6.8 and 15 percent, resulting in a range of 8.2 percentage points, this range narrowed to 3.4 percentage points in 1991 (from 8.2 to 11.6 percent). According to this data, the ERM obviously brought about some stabilization as well as a higher convergence within the member states. In fact, since changes of nominal interest rates are highly correlated to changes in inflation, both results can be attributed to a greater monetary stability in general (see also: BAYOUMI, 1992).

Table 2: Level and Standard Deviation of Long-Term Interest Rates* in the Original ERM Countries**

![Graph showing level and standard deviation of long-term interest rates](image)

Source: Author's calculations, based on Eurostat data.
* Returns on bonds.
** Germany, France, Italy, Belgium, the Netherlands, Luxembourg, Denmark and Ireland.

A less clear tendency towards convergence and stability can be observed in the growth of gross domestic product (GDP). Not surprisingly, overall growth rates of GDP followed
the well-known cycles of the 80's and early 90's. But the standard deviation of growth rates has not declined significantly since 1979 (see Table 3).

Table 3: Level and Standard Deviation of GDP-Growth in the Original ERM-Countries*

<table>
<thead>
<tr>
<th>Year</th>
<th>Average</th>
<th>Standard Deviation</th>
</tr>
</thead>
<tbody>
<tr>
<td>79</td>
<td></td>
<td></td>
</tr>
<tr>
<td>80</td>
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<td>91</td>
<td></td>
<td></td>
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<tr>
<td>92</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

Source: Author's calculations, based on Eurostat data.
* Germany, France, Italy, Belgium, the Netherlands, Luxembourg, Denmark and Ireland.

Table 4 gives the same impression. It shows the symmetry in the European business cycles as correlation coefficients of the member countries’ trend adjusted real GDP growth-rates. In the first row of the respective country, coefficients of the period between first quarter of 1979 to the last quarter of 1991 are shown; the second row presents the period between first quarter of 1987 to last quarter of 1991. It shows, that not only are coefficients surprisingly low, but that most even decreased in the latter period.
Table 4: Symmetry of Business Cycles in Europe

<table>
<thead>
<tr>
<th></th>
<th>G</th>
<th>FRA</th>
<th>ITA</th>
<th>NEL</th>
<th>BEL</th>
<th>UK</th>
<th>DEN</th>
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<tbody>
<tr>
<td>G</td>
<td>--</td>
<td>0.27</td>
<td>0.65</td>
<td>0.70</td>
<td>0.53</td>
<td>0.30</td>
<td>0.36</td>
</tr>
<tr>
<td></td>
<td>0.16</td>
<td>-0.01</td>
<td>0.62</td>
<td>0.47</td>
<td>-0.33</td>
<td>0.00</td>
<td></td>
</tr>
<tr>
<td>FRA</td>
<td>--</td>
<td>0.51</td>
<td>0.14</td>
<td>0.49</td>
<td>0.50</td>
<td>-0.01</td>
<td></td>
</tr>
<tr>
<td></td>
<td>0.79</td>
<td>0.53</td>
<td>0.59</td>
<td>0.61</td>
<td>-0.25</td>
<td></td>
<td></td>
</tr>
<tr>
<td>ITA</td>
<td>--</td>
<td>0.25</td>
<td>0.62</td>
<td>0.38</td>
<td>0.12</td>
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<tr>
<td></td>
<td>0.08</td>
<td>0.49</td>
<td>0.85</td>
<td>-0.15</td>
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<tr>
<td>NEL</td>
<td>--</td>
<td>0.47</td>
<td>0.31</td>
<td>0.35</td>
<td></td>
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<td></td>
</tr>
<tr>
<td></td>
<td>0.96</td>
<td>-0.09</td>
<td>0.07</td>
<td></td>
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<td></td>
<td></td>
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<tr>
<td>BEL</td>
<td>--</td>
<td>0.43</td>
<td>0.31</td>
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<td></td>
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<tr>
<td></td>
<td>0.79</td>
<td>0.54</td>
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<td></td>
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<tr>
<td>UK</td>
<td>--</td>
<td>0.29</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td></td>
<td>-0.06</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>DEN</td>
<td>--</td>
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<td></td>
<td></td>
</tr>
</tbody>
</table>


The low convergence in business cycles can partly be explained by the special development of Germany since the end of 1989, following the breakdown of the German Democratic Republic. The potential for an economic slowdown, which could be observed all over Western Europe, was quickly offset by a surge in demand, sending Germany into a "reunion boom", while at the same time France, the UK and other European countries slipped into a serious recession. Since then, Germany has been hit by the recession as well. All in all, even if symmetry in business cycles is still low, there has obviously been some convergence within ERM, particularly in the case of monetary data (see also: COMMITTEE, 1992, pp. 17; KLEIN, 1991).

Unfortunately, the latest events in the European financial markets point in the opposite direction. Future development will show whether the widening of the exchange-rate margins are able to fight speculative attacks and to reestablish stability and convergence as it has been the case up to 1992.
3. Will EMU be a Union of Monetary Stability?

3.1. Fundamental Properties of EMU

According to the DELORS-Plan and the Treaty of Maastricht, the EMU will be set up in three stages, the first of which was launched on 1 January 1990. This first stage was intended to foster cooperation between the national central banks. Remaining restrictions on capital movement will be abolished and all member states of the EC should have been integrated into the ERM. The second stage will see the establishment of a European Currency Institution, the main task of which is to coordinate national monetary policies and to make the institutional arrangements necessary for the foundation of the European Central Bank. This second stage of EMU is scheduled to begin on 1 January 1994. In the third stage of EMU, the ECB is to be founded in order to lay the groundwork for monetary union. Monetary union will be realized either by issuing but one single currency from the beginning of EMU or by the irrevocable fixing of nominal exchange rates. Simultaneously, responsibility for monetary policy will be shifted from the national central banks to the ECB. According to the Treaty of Maastricht, stage Two will begin either in 1997 or in 1999, depending on the degree of economic convergence and stability achieved up to 1996.

Convergence and stability will be measured with the help of certain criteria. Concerning monetary policy, a limit on inflation and on long-term interest rates exists: these must not exceed the respective rates of the three countries with the lowest inflation by more than 1.5 and 2.0 percentage points, respectively. Additionally, there are two criteria for fiscal stability and convergence: current budget deficit must not exceed 3 percent of GDP, and total public debt must not exceed 60 percent of GDP.

No later than 31 December 1996, the Council of the EC will decide whether a majority of member countries have fulfilled the conditions for joining the EMU and, on this basis, whether or not to launch the third stage on January 1997. In order to accomplish this, they will have to take into account the convergence criteria. Note that to fulfill the conditions the member countries will not need to be within the range in every respect, since convergence criteria are merely rough and non-binding guidelines. If the Council decides to launch the third stage as early as 1 January 1997, it will also have to decide if any member country will remain temporarily outside the EMU. However, this decision is also not bound to the fulfillment of convergence criteria. If, on the other hand, the Council decides not to launch EMU in 1997, the third stage will automatically come into
being on 1 January 1999. In this case, no later than 31 December 1998, the Council will decide again, which countries are ready to join EMU and which are not.

3.2. The Meaning of Convergence Criteria

Few issues in the debate over the EMU have been as heavily disputed as the convergence criteria. The question arises whether this dispute is as important as it seems to be, since it is well known that these criteria are not obligatory. Rather, the extent of permissible deviation from these criteria seems to be a question of political marketing. Similarly, political power will decide which countries will be permitted to join EMU and which not. Whatever the situation might be, it will be simply impossible to exclude e. g. France or Germany. The same seems to be true for the Netherlands and Belgium, even though neither fulfilled the fiscal criteria in 1991 and it will even be technically impossible for Belgium to decrease its public debt from more than 131 percent of GDP to less than 60 percent, by 1997 or by 1999 (see Table 5). It is also questionable whether the criterion of total public debt is relevant at all for the judgement of stability and convergence.

Table 5: Fulfillment of the Convergence Criteria in 1991

<table>
<thead>
<tr>
<th>Country</th>
<th>Annual growth rate of consumer prices in percent</th>
<th>Current budget deficit in percent of GDP</th>
<th>Total public debt in percent of GDP</th>
<th>Return on bonds in percent</th>
</tr>
</thead>
<tbody>
<tr>
<td>EMU reference figure</td>
<td>4.4</td>
<td>3.0</td>
<td>60.0</td>
<td>10.8</td>
</tr>
<tr>
<td>Belgium</td>
<td>3.2</td>
<td>-5.7</td>
<td>131.5</td>
<td>9.3</td>
</tr>
<tr>
<td>Denmark</td>
<td>2.4</td>
<td>-1.7</td>
<td>59.6</td>
<td>9.3</td>
</tr>
<tr>
<td>Western Germany</td>
<td>3.5</td>
<td>-3.2</td>
<td>43.4</td>
<td>8.5</td>
</tr>
<tr>
<td>France</td>
<td>3.1</td>
<td>-1.7</td>
<td>47.1</td>
<td>9.0</td>
</tr>
<tr>
<td>Greece</td>
<td>18.9</td>
<td>-17.9</td>
<td>85.2</td>
<td>23.3</td>
</tr>
<tr>
<td>UK</td>
<td>5.9</td>
<td>-2.1</td>
<td>36.7</td>
<td>10.1</td>
</tr>
<tr>
<td>Ireland</td>
<td>3.2</td>
<td>-2.7</td>
<td>113.0</td>
<td>13.0</td>
</tr>
<tr>
<td>Italy</td>
<td>6.4</td>
<td>-10.1</td>
<td>103.8</td>
<td>13.0</td>
</tr>
<tr>
<td>Luxembourg</td>
<td>3.1</td>
<td>1.9</td>
<td>6.9</td>
<td>8.1</td>
</tr>
<tr>
<td>Netherlands</td>
<td>3.9</td>
<td>-3.5</td>
<td>79.8</td>
<td>8.7</td>
</tr>
<tr>
<td>Portugal</td>
<td>11.3</td>
<td>-5.4</td>
<td>64.7</td>
<td>17.1</td>
</tr>
<tr>
<td>Spain</td>
<td>5.9</td>
<td>-3.9</td>
<td>45.3</td>
<td>12.4</td>
</tr>
</tbody>
</table>


At this point in the discussion it seems useful to distinguish between convergence and stability. If we agree in principal that an appropriate institutional setting of ECB is the only guarantee for long-term monetary stability and that it is the very task of convergence prior to the third stage to avoid undue shocks in the transition to EMU, we
should avoid confusing the two concepts. That is to say, convergence criteria should not be used to evaluate future macroeconomic stability but only to measure the present tendency of convergence. As long as the inflation rates and interest rates of potential member countries are in a narrow range, and as long as reasonable exchange rates according to purchasing power have been maintained for some time, monetary adjustment shocks are unlikely, even if inflation prior to transition averaged 1 percent or 5 percent. On the other hand, there is no guarantee that inflation will remain low if the ECB is improperly constructed, even if it were zero prior to transition.

In addition to monetary imbalances, fiscal imbalances will be without doubt a source of future macroeconomic instability. But here, it is current budget deficit rather than total public debt which should be observed carefully. True, fiscal imbalances are not a direct source of inflation, so that it might be argued that monetary stability may well be maintained as long as ECB is strong enough to reject any quests for monetary expansion. But even if ECB is given a high degree of autonomy, pressure from outside might become too great to resist, as has frequently been the case with the relatively autonomous Deutsche Bundesbank (HAMACHER/KLEIN, 1993; SARGENT/WALLACE, 1981). Moreover, large budget deficits could push up European interest rates and cause a recession if ECB does not ease money supply. Finally, with a single monetary authority in Europe there will be no chance for the member states to inflate away public debts. Thus, as long as no further credits can be taken on, the only remaining source of public revenue will be taxes, which cannot be increased infinitely without eroding the tax base. Therefore, even though the Treaty of Maastricht contains a "no bail-out clause", political pressure caused by insolvency in one of the countries or by economic pressure from macroeconomic spillovers arising from the debt problem of some countries could lead to violations, or even a de facto abolishment, of the non bail-out clause.

The following conclusions can be drawn from the above analysis:

- Concerning the threat of monetary shocks in the transition period, the convergence criteria seem to be adequate guides to the respective countries' monetary situation, since they provide information about convergence in inflation rates, interests rates, and a longer period of exchange-rate stability. Somewhat less satisfactory is the non-obligatory character of the underlying criteria as well as some imprecise formulations with respect to exchange-rate stability.
By contrast, for assessing long-term monetary stability, convergence criteria appear to be inappropriate. Here, the institutional setting of ECB should be analyzed, because this will be the future source of inflation or of stability.

Current deficit gives some insight into the fiscal stability of a country, while total public debt does not. But since fiscal stability is of special importance for the stability of EMU, measuring current deficit is not enough. The future structure of fiscal authorities, as well as their opportunities to acquire revenues or to spill over costs of unsound fiscal policy to other member countries, will be the most important aspects of a future EMU.

3.3. The Importance of the European Central Bank’s Constitution

At least formally, the ECB is basically a copy of the Deutsche Bundesbank (see Kenen, 1992, pp. 17). Not even the strongest opponents of EMU deny that. As with the Bundesbank, the Council of the ECB consists of an executive board together with the president and the vice president of the ECB and four additional members; the governing council is made up of the governors of the National Central Banks and the members of the executive board. The governing council is obliged to adopt guidelines and take the necessary decisions to ensure a stable European currency. The executive board is required to implement monetary policy according to the guidelines and decisions of the governing council. The members of the executive board are to be appointed by the heads of state or government for eight years.

The ECB will be independent in the sense that neither the ECB itself nor one of the national central banks is obliged, or even permitted, to carry out any order from the institutions of the EC or those of one of the member states. Furthermore, any kind of credit facility given to the Community itself or to one of its member states is strictly prohibited.

Even though the ECB closely resembles the constitution of the Deutsche Bundesbank, and independence in some respects is formally even more strictly guaranteed, some authors doubt the material independence of the ECB members. As is the case with the Deutsche Bundesbank, the members of the executive board will be appointed by the heads of the governments or states. But the Deutsche Bundesbank deals with only one government, and this government only suggests the members, while it is the more independent president of the Federal Republic who appoints the members in the end. Finally, the governors of the National Central Banks, all of whom will be members of the
governing council, are appointed according to different rules in the respective member countries alone. True, before the third stage of the EMU will be launched, all European central banks will have been given independence. But this could be realized only one day before, so that a new National Central Bank’s governor might be elected right before the EMU comes into being, join the governing council and act only according to the wishes of his national government.

Critics of EMU focus on the higher degree of "federalism" inside ECB and on the possibly higher degree of material dependence of the governing council’s members on their respective governments. In fact, they are not against federalism in European monetary policy, but against federalism within a centralistic institution. Combining both arguments, they fear the following: Given that each member of the governing council will represent his own country’s interest, and given that each country will have its own "inflation mentality", i.e. each country will prefer one specific combination of inflation and unemployment along the Phillips-curve menu, the result can never be monetary stability. After being compromised between the different preferences, there will be no price stability but more or less an average of the inflation rates that existed prior to EMU (see e.g. BERTHOLD, 1992, pp. 178; GRETSCHMANN, 1991, pp. 703; SIEBERT, 1992, p.42). But what is more, as federalism along with the degree of different preferences inside ECB rise, compromising between different preferences will become more difficult, and thus could lead to more complicated decision-making processes.

To be sure, we do not agree with this position. This is so for mainly three reasons:

- Even though it initially seems obvious, the existence of different "inflation mentalities" is in doubt. There is no reason to depart from our fruitful economic assumption that people act according to existing circumstances, institutional structures, incentives and disincentives rather than to dubious "mentalities". Germany has experienced two destructive inflations in this century and a high degree of macroeconomic instability in the interim. Only since the institutional structure of an independent central bank has been in existence, a certain degree of long-term monetary stability has been maintained. There is simply no reason to believe that monetary stability in the FRG has to do with anything other than an appropriate institutional structure.

- The history of the Bundesbank teaches that whatever the political origins and former dependencies of the respective members might have been, and whatever region they came from, be it a region hit by high structural problems and unemployment or a
prospering one with low unemployment, there have never been significant differences in their behavior as members of the governing council or even of the executive board. Be it Mr. Pöhl from the Social Democrats or Mr. Schlesinger from the Christian Democrats, there has been no significant difference in monetary policy.

It is true that right before the ECB starts its work, some countries might appoint some loyal governors, hoping that they will represent their political interest. But this can only be a temporary phenomenon, since after a while governors will be reelected according to new rules. Furthermore, after election the governors of the National Central Banks will remain on their jobs for at least 5 years, no matter which kind of policy they actually pursue.

To conclude, from a more conservative viewpoint one might opt against EMU, since due to constitutional ignorance (Hayek) we cannot make precise and reliable predictions about how the institutional structure of ECB will work. On the other hand, analyzing this structure gives little reason to believe that ECB will do worse than the Deutsche Bundesbank. However, this is not to say that this structure is the best we can think about. On the contrary, the Deutsche Bundesbank and its monetary policy can be criticized severely. Especially the meaning of formal independence in the absence of an explicit objective function of the actors of monetary policy is discussed intensively. In order to improve monetary performance in an EMU compared to the German one and reduce the risks of EMU stemming from constitutional ignorance, it therefore seems helpful to search for better arrangements, ones which include explicit incentives for the monetary-policy makers.

4. The Role of Fiscal Policy

To accept that the institutional structure of ECB and Deutsche Bundesbank do not differ considerably is one thing. But from this alone it does not follow that EMU will produce macroeconomic stability. As noted above, even the Deutsche Bundesbank has not been completely immune to quests for a more expansive policy to combat an economic slowdown. This could also be true for the ECB and, moreover, the underlying problems might be EMU-specific. The crucial question here is whether the decision-making process concerning fiscal policy of the EMU-members can be trusted or if some reform is necessary prior to EMU. On this point, according to earlier views from the theory of fiscal federalism (Oates, 1968) some call for a greater degree of centralization in order to force stability in the member countries, while others argue for fiscal competition
among the European states (ISSING, 1993, pp. 158). However, in every case the question is whether a bail out of budget debts can be strictly excluded.

The underlying problems cannot be discussed in detail here, but some should at least be mentioned because of the negative experience with the German monetary union. The sudden integration of two regions induced a strong tendency towards rising wages in the economically weaker region. This in turn caused massive unemployment and an unprecedented demand for transfers (AKERLOF; et al., 1991). Moreover, to enforce fiscal discipline, rapid reunification, and thus, political centralization, became indispensable. Even though the situation concerning wage negotiations, factor mobility and the autonomy of governments in the EC is significantly different from that in the two German regions, those experiences should nevertheless be taken seriously. There will undoubtedly be some tendency to equal wages following the EMU, and there will also be some enhancement of factor mobility. Simultaneously, calls for a harmonization of social insurance-systems will become stronger and can hardly be ignored.

All this could strain the fiscal capacity of the poorer countries. Together with an incentive to spill over domestic fiscal problems via greater budget deficits, which raises interest rates and crowds out private investments in the whole union or via direct transfers, the threat of fiscal instability seems to be the most serious risk of EMU.

Therefore, those questions should be given much more attention than convergence criteria or the construction of the ECB. Here, future investigations and, more importantly, the search for proper institutional arrangements should be the focus in order to avoid problems similar to those that have occurred in Germany (see also: GÄCKLE, 1992; KENEN, 1992, pp. 68).

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