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“EMU between the Introduction of Euro Cash and EU Enlargement”

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Introduction

The creation of the euro area at the beginning of 1999 was arguably the most important change in the international monetary system since at least the shift from fixed to flexible exchange rates in the early 1970s. The introduction of euro cash in early 2002, which was remarkably smooth, further consolidated the monetary union. The enlargement of the European Union to 25 member states in 2004 would set the stage for a similar expansion of the euro area. The present, nearly four years after the formation of the monetary union, is thus opportune for an examination of the impact of the euro on Europe and international relations.

Because this conference addresses matters of politics as well as economics, my remarks will begin with some observations about security. I will then address matters related to the internal management of the euro area, then the external relations of the monetary union.

Analyses of EMU during the 1990s contained some bold predictions and warnings, some regrettable and some prescient. My candidate for the most regrettable is

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Martin Feldstein's suggestion that monetary union and attempts to consolidate political integration could lead to civil war in Europe. Although war was not inevitable, he wrote in 1997, "it is too real a possibility to ignore when weighing the potential effects of EMU." Two years ago, he reiterated that the monetary union is still more likely to increase conflict in Europe than cooperation. (Feldstein 1997 and 2000)

An opposing forecast was offered by Valéry Giscard d'Estaing, the former President of France and current president of the European Convention. He said that two decades from now the euro will be such an accepted part of the European economic landscape that people will look back on twentieth century and wonder with perplexity why countries insisted on each retaining their individual little currencies for such a long time.

Well, the first four years of the monetary union provide not a shred of evidence that political disintegration and war are now more likely in Western Europe. This forecast was completely misguided from the outset. The introduction of the euro in cash form made it an even less likely prospect. Convergence within the euro area, though not complete, further buttresses this conclusion. (See, for example, Michael Artis's paper for this conference.) I expect the next several years to put Feldstein's fear to rest. Giscard's forecast is far more likely to prove to be valid.

I also believe that the monetary union is very much in the interest of the United States, Japan, and the rest of the world and will be seen to be mutually beneficial ultimately. However, there is, of course, still more work to do before arriving at this happy outcome. (For a broad treatment of EMU and its impact on global monetary governance, see, Andrews, Henning and Pauly 2002.)

Internal Matters

Monetary Policy

Prior to the monetary union, we saw predictions that monetary policy would, for various reasons, be too tight or too lax. We also heard some predictions that European fiscal policy would be highly expansionary, that the ECB would be forced to tighten in response, leading to the Reagan-Volcker policy mix, with undesirable consequences for exchange rate and balance-of-payments stability. Fortunately, during most of the early phase of the monetary union, fiscal and monetary authorities seemed to have understood the logic of the interdependence between their policies, and pursued instead the Clinton-Greenspan mix.

However, the easy relationship between monetary and fiscal policy during the first three years has given way to conflict between monetary and fiscal authorities. In the face of weak growth, fiscal deficits have been rising in the euro area, pressing or exceeding the limits permitted under the Maastricht treaty and the Stability and Growth Pact in some countries. Such deficits have made the European Central Bank somewhat reluctant to ease monetary policy. Meanwhile the ECB's stance -- which was stiffened for a time by popular perceptions of price gouging after the introduction of notes and coins -- aggravates the fiscal dilemmas of member states.

Stability and Growth Pact

Conflict recently boiled over with the European Commission's criticism of the new French government's budget plans announced in late September 2002, an Ecofin vote against France, the German government's admission that it will run an excessive deficit this year and its pressure on the ECB to ease monetary policy. The president of the European Commission called the Stability and Growth Pact "stupid." (Economist, October 26, 2002) Officials now openly speculate about revisions to the Stability and Growth Pact. Several amendments have been proposed. The most prevalent proposal is to make the structural deficit, not the actual deficit, the focus of national obligations. Another is to define the commitment not in terms of a single year but over the medium-term or business cycle. A third is to make allowance for member states with low levels of debt relative to GDP. A fourth is to introduce the "golden rule," allowing states to borrow the amounts that they invest in capital improvements without scoring them against their permitted deficit. A final proposal would incorporate unfunded pension liabilities in calculations of fiscal sustainability.

I believe that changes to the SGP are desirable – to focus on cyclically-adjusted deficits and thereby avoid pro-cyclical policy adjustments (such as Germany is now embarked upon). That need not imply more laxity in the European fiscal regime as a whole. But it is admittedly difficult to redefine the rules when major countries are exceeded the formal limit without creating the widespread impression that the rules are being made generally more permissive. Ideally, the redefinition of the regime should take place at the peak, rather than the trough, of the business cycle. Instead, the euro area is revising the Stability Pact at a decidedly inopportune moment. It can limit damage to

its credibility by strengthening the monitoring and enforcement of the amended rules, as the European Commission has proposed. Needless to say, this is a critical moment for the credibility of the fiscal regime of the European Union.

Central Bank Independence

Much has been made of the independence of the ECB and the Eurosystem. Some (see, for example, Cooper 1992) have argued that it is excessive, while others (German economists) have worried that it is insufficient. Beyond the autonomy provided by the Maastricht treaty, the institutional position of the ECB is closely connected to transparency and accountability; the roles of the national central banks relative to the center; the downsizing of staff in the system as a whole. (For discussion, see, Berman and McNamara 1999; Meade 1999; Caporaso 2000.) Moreover, the ECB is affected by the enlargement of the membership of the European Union and the broader reforms of the EU institutions that might redress the democratic deficit, such as the reforms being considered in the present European Convention.

Sometimes missing in the economic discussions (Lohmann is an exception) is an appreciation of the importance of a societal constituency for central-bank independence, one that goes beyond the financial sector. Political analysts of European integration have a greater appreciation of this and have been writing about the democratic deficit faced by the ECB as part of the broader democratic deficit of the EU and indeed part of the broader concern about political legitimacy of international institutions in general.

It is important to stress that independence should not be confused with being apolitical: central banks that remain independent over long periods of time are in fact highly political and they actively cultivate a constituency for their autonomy. It is fairly

safe to say that the ECB would not be wise to rely exclusively and passively on its protected status in EU law. The ECB will have to cultivate this constituency as adroitly as the Federal Reserve and Deutsche Bundesbank have done. Its institutional and political environment is considerably more complex and fluid -- with successive intergovernmental conferences on institutional reform and enlargement of the EU. But the introduction of euro notes and coins have given the ECB a direct relationship to European citizens as the guarantor of the value of money in their pockets. This may be one of the most significant consequences of the introduction of euro cash.

The experience of the Federal Reserve, the Bundesbank and now the European Central Bank, and in particular the importance of actively cultivating societal support for autonomy, may hold particular lessons for the Bank of Japan as it addresses the formidable economic problems of Japan.

Endogenous Currency Area

Prior to the creation of the monetary union, we heard a great deal about whether the euro area met the tests of the theory of optimal currency areas. Most of the normative debate over EMU hinged on these tests. Opponents argued that fiscal policy was too decentralized, real wages too rigid, and labor too immobile for the euro-12 to constitute an optimal area. Under these conditions, they argued, the monetary policy appropriate for one country (Germany) might well be inappropriate for another (Ireland).

While largely conceding some of the OCA arguments, proponents of EMU argued during the 1990s that monetary union would set in motion a set of policy reforms that would render the euro area optimal after the fact. This has come to be called the

“Endogenous Currency Area Hypothesis.” (Frankel and Rose 1998; Padoan 2002; Kenen 2002) The validity of this hypothesis is a question on which the ultimate judgment on EMU by the rest of the world could well hinge. Clinton administration officials argued that further flexibility in European economies was needed in order to ensure that monetary union was good for Europe and the rest of the world.

Monetary union has spawned some further integration in European capital markets, the money and bond markets in particular. But more needs to be done. Stock markets, banking and insurance remain too segmented on national lines. European-wide standards on accounting, corporate governance, mergers and acquisitions, bankruptcy, financial supervision and capital requirements – among other things – are needed to complete the “internal financial market.” EMU has contributed to cross-border competition and to deregulation; more needs to be done here too.

The stickiest and most important area is the labor market. Here the evidence is decidedly mixed. Some countries have moved toward greater flexibility; others’ progress has been disappointing. Two observations are in order. First, this is a (very) long-term process; it would be premature to conclude that endogeneity is not sufficient. Second, the process of reform is not simply an economic one but fundamentally political. We will need a decade for a definitive answer to the endogeneity thesis.

External Matters

The external relations of the euro area raise a number of intriguing questions. Why has the euro been so weak against the dollar? Will it strengthen in the face of unprecedented U.S. current account deficits? Will the euro eventually displace the dollar as an international currency? How can the euro area better organize the making of its external monetary policy and represent it to the outside world?

The most intriguing overarching question for me is: Will international monetary cooperation improve or decline with the consolidation of the monetary union and its eventual expansion to new members? On this point, analysts have been all over the map. The dominant forecast of the mid-1990s among economists was one of “mutual benign neglect.” A minority view was offered by the European Commission in a 1991 report, *One Market One Money*. It argued that having a single dominant monetary power was not in fact necessary for international monetary stability -- against the so-called “hegemonic stability thesis” of some political scientists -- and that creating a larger more powerful partner in the euro area would actually improve macroeconomic bargaining outcomes among the United States, Europe and Japan. This would be done, the report argued, by constraining the United States to “good policy.” The experience of the first four years suggests that mutual benign neglect is the more valid of the two predictions.

The U.S. official posture has been complacent. When asked whether he feared the creation of the euro, former Treasury Secretary Lawrence H. Summers said, “the fate of the dollar is in our own hands.” This is basically true. But it is also true that the United States has made serious policy mistakes in the past – monetary policy in the 1970s

and fiscal policy in the 1980s – and could well commit such errors in the future. (Perhaps the making of tax cuts permanent would be such an error now.) But any such future errors will confront a greatly changed international environment: there would now be a serious alternative currency to the U.S. dollar backed by a large internal market for goods and capital.

The U.S. current account deficit has reached very high levels. Within the next few years, the finance-ability of deficits of this size could be called into question. The “new economy” and impressive productivity gains kept the U.S. markets buoyant and capital flowing in recent years. (Mann 1999) Uncertainty surrounding U.S. accounting rules and corporate governance, any stalling of productivity improvements, or persistent weakness in growth could reduce the attractiveness of U.S. assets. There is no guarantee that the balance-of-payments adjustment will be smooth. In fact, given the dependence of the United States on capital inflows, one could easily paint a fairly ominous scenario.

The year 1987 holds particular relevance for this scenario. Owing partly to the depreciation of the dollar since the Plaza accord, private capital flows into the United States largely dried up in that year. The large current account deficit at that time was instead financed by European central banks and the Bank of Japan through foreign exchange intervention. America’s partners were willing to act in this way in order to stem the appreciation of their own currencies, thus the reduction in their trade surpluses and, by extension, in their growth and employment.

If private capital inflows were to dry up in the next few years, as they did in 1987, the United States would now be facing a monetary union rather than individual European monetary authorities. The euro area would be less vulnerable to exchange-rate

fluctuations than the individual European countries had been prior to the monetary union's creation. European authorities might not be forced into the breach. If they choose to finance U.S. deficits, European officials might this time insist on U.S. policy adjustments as a *quid pro quo*. The instances where the monetary union could impinge on the choices of U.S. policymakers will almost certainly be rare, but they are more likely to occur when the United States is running large current account deficits.

Under such circumstances, it would be important to have well-functioning mechanisms for international consultation and a demonstrated capacity for more deliberate and sustained joint action in the markets than manifest in the Autumn 2000 foreign exchange intervention – the only such episode since the inception of the monetary union, and a fiasco in terms of transatlantic coordination.

Much attention has been given to creating a “Mr. Euro,” a proposal that I advocate and endorse. (Henning 1997; Everts 1999) But the identity of this person and the title he/she holds is less important than giving this person – perhaps the eurogroup chairman – the mandate to negotiate agreements, both formal and informal, within the G-7 and with other political authorities as circumstances (such as a major financial or currency crisis) require. This official must do more than simply read from texts prepared in the Economic and Financial Committee and Ecofin, but negotiate flexibly with counterparts. Moreover, Ecofin should agree in advance to procedures for quickly ratifying (or rejecting) any agreement that the representative, in consultation with the ECB and the commission, negotiates. The EU should not allow external monetary decisions to be held hostage to consensus or unanimity, and should move toward greater transparency on these as well as other matters. The European Convention currently

underway offers an opportunity for progress on these institutional matters. These provisions would help to avoid the pattern of deadlocks overcome only by crises, as witnessed in transatlantic trade negotiations, which would be particularly damaging in the monetary arena, where quick, decisive action on the part of policymakers is required from time to time. (For elaboration of these arguments, see Henning 2000a and 2000b.)

For their part, U.S. officials must ensure that they are well coordinated internally and avoid ambiguity, for example, over whether the Treasury or the White House-based National Economic Council speaks on exchange rate matters. The same is of course true for Japan and the United Kingdom, which, along with Canada, constitute the remainder of the G-7 countries.

In this environment, it is also important that the U.S., European and Japanese officials foreswear competition over the international roles of their currencies. (See Prof. Kaji's paper presented at this conference.) Some Europeans will be sorely tempted to promote the euro through diplomacy and official measures. But the right way to promote the euro is by integrating, broadening and deepening the European financial market, making the euro more attractive. A similar logic applies to strengthening the international role of the yen. This kind of competition should be welcomed by international partners.

Conclusion

This presentation has made several arguments, of which I wish to highlight four in conclusion. First, the monetary union has been successful and will probably come to be

seen as in the interest not only of Europe but the rest of the world as well. Second, there is nonetheless more work for Europe to do to consolidate this success and prepare the monetary union for enlargement. These tasks include introducing greater flexibility into the economy in general, labor markets in particular, and completing the pan-European capital market. Third, the Stability and Growth Pact should be revised to focus on structural rather than measured deficits, to make pro-cyclical adjustments unnecessary; but this change should be accompanied by further measures to bolster the credibility of the revised pact. Fourth, the monetary union should strengthen its institutional capacity to implement an active external monetary policy and coordinate action with the United States, Japan, and other countries. Such measures would help to ensure that the infrastructure for cooperation is in place when it is needed to facilitate smooth payments adjustment and safeguard international financial stability.

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