

THE EUROPEAN MONETARY UNION - WILL IT SURVIVE THE CRISIS?

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A PREPOSTEROUS QUESTION?

APPARENTLY NOT, SINCE A NUMBER OF ECONOMISTS AND SOME POLICY-MAKERS ARE BEGINNING TO RAISE IT

SO LET ME TRY TO ANSWER, BY LOOKING AT

- WHY EMU WAS LAUNCHED
- WHAT THE SITUATION WOULD LOOK LIKE WITHOUT IT
- SOME CONGENITAL INHIBITIONS OF EMU – AND
- HOW THESE DEFECTS ARE BEING REMEDIED

WHY WAS EMU PUT ON THE EU AGENDA?

- THE PROGRAMME FOR THE SINGLE INTERNAL MARKET 1985-92 STRENGTHENED THE NEED FOR A SINGLE CURRENCY
- GREATER CAPITAL MOBILITY WOULD MAKE THE LOOSER ARRANGEMENT IN THE EUROPEAN MONETARY SYSTEM UNSTABLE
- ECONOMIC PERFORMANCES, PARTICULARLY NATIONAL INFLATION RATES, WERE BECOMING MORE SIMILAR, HENCE WEAKENING THE NEED FOR – AND POLITICAL ACCEPTABILITY OF – GERMAN (BUNDESBANK) LEADERSHIP IN THE EMS
- THE NEED FOR A MORE UNIFIED STANCE VIS-À-VIS USD VOLATILITY

THESE ARGUMENTS MAY BE QUESTIONED BY SOME, BUT TO
ME THEY CONTINUE TO PROVIDE A SOLID FOUNDATION
FOR EMU/THE EURO

THE SINGLE MARKET COULD HARDLY HAVE WEATHERED THE
CURRENT ECONOMIC DOWNTURN WITHOUT THE EURO – AND
THE TOLERANCE WITH EU-COUNTRIES THAT ALLOW THEIR
CURRENCIES TO DEPRECIATE STRONGLY IS NOW STRAINED

CAPITAL MOBILITY IS ONE OF THE BASIC ELEMENTS OF
EUROPEAN INTEGRATION AND HAS, TOGETHER WITH THE
EURO, CREATED A EUROPEAN CAPITAL MARKET

MAYBE FRANCE AND ITALY 10-20 YEARS AGO WERE TOO IMPRESSED BY THEIR ABILITY TO CONVERGE TOWARDS GERMAN INFLATION AND TOO OPTIMISTIC ABOUT THEIR COMPETITIVENESS SUBSEQUENTLY (IN EMU)

TEMPORARY INFLATION DIFFERENTIALS BETWEEN EURO AREA PARTICIPANTS MAY NOT MATTER, BUT MORE PERSISTENT ONES ARE DANGEROUS (IF NOT DUE TO 'CATCHING-UP' BY NEW MEMBERS)

SWINGS IN THE USD AND OTHER POLICY IMPULSES FROM THE UNITED STATES ARE PRIME EXAMPLES OF SYMMETRIC DISTURBANCES WHICH SHOULD BE HANDLED JOINTLY

WHAT WOULD THE SITUATION LOOK LIKE WITHOUT EMU?

- NATIONAL CURRENCIES WOULD HAVE MOVED A LOT DESPITE LIKELY DEFENSIVE ACTIONS BY NATIONAL CENTRAL BANKS – MARKETS EXAGGERATE DIFFERENCES
- DESIGNING NATIONAL STIMULUS PACKAGES MUCH MORE DIFFICULT – COORDINATING THEM BARELY POSSIBLE
- SHARP SHIFTS IN COMPETITIVENESS WOULD HAVE TRIGGERED PROTECTIONIST INITIATIVES UNDERMINING THE SINGLE MARKET
- DEPENDENCE ON THE USD AND ON US ECONOMIC POLICIES WOULD HAVE BECOME STRONGER (STILL)

SOME CONGENITAL INHIBITIONS OF EMU

THE EFFORTS IN 1985-91 WHEN EMU WAS CONCEIVED AND DESIGNED WERE STRONGLY FOCUSSED ON CREATING A EUROPEAN CENTRAL BANKING-SYSTEM (ESCB)

- FIRMLY INDEPENDENT OF POLITICAL AUTHORITIES, NATIONAL OR EUROPEAN, AND
- COMMITTED TO ACHIEVING MEDIUM-TERM PRICE STABILITY, i.e. LOW AND STABLE INFLATION

GREAT CARE WAS TAKEN TO PROTECT THE ESCB AGAINST THREATS TO ITS ABILITY TO CONTROL MONEY CREATION BY

- RULES AGAINST MONETARY FINANCING OF PUBLIC ENTITIES
- SEVERE LIMITATIONS ON THE CAPACITY TO UNDERTAKE LARGE-SCALE INTERVENTIONS IN THIRD CURRENCIES, AND
- KEEPING THE ESCB OUT OF RESCUE OPERATIONS FOR NATIONAL FINANCIAL INSTITUTIONS AND LEAVING SUPERVISION OF THEM IN OTHER (NATIONAL) HANDS

AT THE TIME OF THE LAUNCH OF EMU AT MAASTRICHT THERE WAS A (HAPPY) DEGREE OF COINCIDENCE BETWEEN WHAT SEEMED ECONOMICALLY ADEQUATE AND POLITICALLY FEASIBLE FOR GOVERNMENTS RELUCTANT TO CEDE SOVEREIGNTY OVER FISCAL POLICY AND FINANCIAL SUPERVISION

MONETARY AND EXCHANGE-RATE POLICY WAS IN A SPECIAL CATEGORY WITH MAJOR SPILL-OVER EFFECTS OF ANY NATIONAL ACTIONS, WHILE IT SEEMED SAFE TO LEAVE FISCAL POLICY LARGELY IN NATIONAL HANDS ALONG WITH RESPONSIBILITY FOR FINANCIAL STABILITY

THESE "CONGENITAL INHIBITIONS" HAVE NOT MADE EMU UNWORKABLE SO FAR:

AS REGARDS FISCAL POLICY THE MAASTRICHT TREATY DEFINED UPPER LIMITS TO PUBLIC SECTOR DEFICITS AND DEBT, SINCE ELABORATED IN THE STABILITY AND GROWTH PACT (SGP) OF 1997, MODIFIED IN 2005.

ALTHOUGH THESE RULES WERE DESIGNED TO CONSTRAIN NATIONALLY DEVIANT BEHAVIOUR, THEY INDIRECTLY COORDINATE FISCAL AND MONETARY POLICY IN A CONSTRUCTIVE WAY, COMBINING CAUTIOUS FISCAL POLICIES WITH LOW AND STABLE INTEREST RATES

THE DESIGN DID NOT ENDORSE EXPLICIT COORDINATION AS DESIRED BY SOME, NOTABLY FRANCE, THOUGH IT DID LEAVE DISCRETION TO INTERPRET THE RULES WITH THE COUNCIL OF FINANCE MINISTERS – AND THEY SEIZED IT

DESCRETION WAS ENLARGED IN 2005, BUT THE SGP HAS RETAINED CONSIDERABLE VALUE IN MONITORING FISCAL POLICIES, NOTABLY BY ITS INSISTENCE ON LONGER-TERM SUSTAINABILITY OF PUBLIC FINANCES

THIS PERSPECTIVE REMAINS MORE VISIBLE THAN IN SAY THE UNITED STATES AND JAPAN – SPECIFIC COMMITMENTS TO GET BACK TOWARDS BUDGETARY BALANCE ARE ABSENT THERE

AS REGARDS EXCHANGE RATE POLICY

- MAASTRICHT TREATY EFFECTIVELY GAVE THE UPPER HAND TO THE ECB WHICH HAD A "DOMESTIC" OBJECTIVE
- BUT THE FINANCE MINISTERS COULD STILL FORMULATE "GENERAL ORIENTATIONS" FOR EXCHANGE-RATE POLICY
- THEY HAVE BEEN UNABLE TO AGREE ON SUCH ORIENTATIONS, BUT THE CHALLENGE OF A WEAK DOLLAR MAY STILL PROMPT THEM

AS REGARDS FINANCIAL RESCUE OPERATIONS AND – MORE BROADLY – RESPONSIBILITY FOR FINANCIAL STABILITY THE TREATY HAD UNDERESTIMATED THE INVOLVEMENT OF THE ESCB

THE EURO HAS BEEN A STRONG TRIGGER FOR DEEPER FINANCIAL INTEGRATION AND CROSS-BORDER ACTIVITY

FINANCIAL SERVICES ACTION PLAN OF 1998 MAJOR REGULATORY STEP, BUT IMPLEMENTATION TOO DECENTRALIZED

LAMFALUSSY'S BOOST TO COMMITTEES OF NATIONAL REGULATORS/SUPERVISORS, INITIALLY FOR SECURITIES MARKETS, LATER FOR BANKS AND INSURANCE COMPANIES A FURTHER STEP

BUT THE SUPERVISORY FRAMEWORK TOO MUCH FOCUSSED ON INDIVIDUAL INSTITUTIONS, NOT ENOUGH ON SYSTEMIC RISK

SPECIAL EFFORT NEEDED TO DEAL WITH LARGE CROSS-BORDER INSTITUTIONS AND MACROPRUDENTIAL ISSUES AND NEED TO KEEP ESCB AS LENDER OF LAST RESORT INFORMED

THE COMMISSION SET UP IN OCTOBER 2008 A HIGH-LEVEL GROUP CHAIRED BY JACQUES DE LAROSIERE TO STRENGTHEN EUROPEAN SUPERVISORY ARRANGEMENTS

THE GROUP'S REPORT OF FEBRUARY 2009 PROPOSES A SIGNIFICANT UPGRADE OF THE THREE "LAMFALUSSY COMMITTEES" AND CLOSER INVOLVEMENT OF THE ESCB IN MACROPRUDENTIAL SUPERVISION THROUGH A NEW EUROPEAN SYSTEMIC RISK COUNCIL

IT ALSO PROPOSED A MORE COHERENT EU REPRESENTATION IN INTERNATIONAL ECONOMIC AND FINANCIAL FORA, INCL. IMF

THIS WAS AS FAR AS SUCH PROPOSALS COULD GO WITHOUT
REQUIRING A TREATY REVISION – SOMETHING THAT WOULD
HAVE BE IMPOSSIBLE FOR QUITE SOME TIME

THE CONSTITUTIONAL CONVENTION – THE MOST RECENT
OCCASION FOR A TREATY REVISION – CONSIDERED THIS AND
OTHER PROPOSALS ON ECONOMIC AND FINANCIAL POLICY BUT
COULD NOT (IN 2003) AGREE ON THE NEED

SO WE ARE STUCK IN EMU WITH A FORMALLY INADEQUATE
FRAMEWORK FOR POLICY-MAKING

MY CONCLUSION IS OBVIOUSLY A YES TO THE QUESTION

EMU WILL SURVIVE DESPITE ITS CONGENITAL INHIBITIONS AND EVEN THOUGH THE LATTER CANNOT BE FULLY REPAIRED

EMU PLACES PARTICIPANTS IN A MORE REASSURING POSITION THAN IF IT DID NOT EXIST – COMPARE SLOVAKIA TO HUNGARY - NO WEAK ECONOMY WOULD RISK EXIT AND REINTRODUCE NATIONAL CURRENCY

THERE IS A READINESS TO EXPERIMENT AND DEVELOP POLICIES THAT UNDERPIN EMU – ON FISCAL POLICY, EXCHANGE RATE ISSUES AND FINANCIAL SUPERVISION

EMU WILL CONTINUE TO EXPAND

WITHIN FIVE YEARS THE THREE CENTRAL EUROPEAN COUNTRIES (CZECH REPUBLIC, HUNGARY AND POLAND) AND THE THREE BALTICS WILL HAVE JOINED

MORE UNCERTAIN WHEN OR WHETHER THE THREE OLD MEMBER STATES (DENMARK, SWEDEN AND THE UK) WILL JOIN

DENMARK WILL APPARENTLY HOLD A REFERENDUM IN 2010
ON JOINING

DOES THE OPTION VALUE OF RETAINING THE NATIONAL
CURRENCY JUSTIFY THE – RELATIVELY MODERATE –
ECONOMIC COSTS AND THE – SIGNIFICANT – POLITICAL
COSTS?

MY ANSWER IS NO – IF DENMARK HAS NOT EXERCISED THE
OPTION OF EXIT FROM A FIRM LINK TO THE EURO IN THE PAST
22 EVENTFUL YEARS, WHEN WOULD IT EVER WANT TO EXIT?

FOR SWEDEN AND THE UK BOTH OF WHOM HAD TO INVEST IN AN ALTERNATIVE MACROECONOMIC FRAMEWORK WHEN THEIR CURRENCIES WERE EJECTED FROM THE EMS IN 1992 THE ECONOMIC ISSUES ARE MORE COMPLEX

EVEN THOUGH THESE FRAMEWORKS DID NOT OFFER BETTER PROTECTION AGAINST THE CRISIS AND HAVE NOW, AT LEAST IN THE UK CASE, BECOME DYSFUNCTIONAL

OBVIOUSLY, WITH A LIKELY TORY VICTORY IN THE UK 2010 ELECTION, THERE WILL BY NO MOVE TO JOIN EMU