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"EUROPEAN MONETARY AND FINANCIAL INTEGRATION: EVOLUTION AND PROSPECTS"

Five Speeches by

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Introduction
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SUERF – The European Money and Finance Forum
Vienna 2004

CIP

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Vienna: SUERF (*SUERF Studies:* 2004/2)

ISBN 3-902109-21-1

Keywords: Economic History, Monetary Policy, Financial Stability, Central Banking, International Monetary System, International Monetary Arrangements, European Monetary Integration, Financial Institutions and Services.

JEL Classification Numbers: E42, E44, E52, E58, F33, F34, F36, G10, G20, G21, N14, N24

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Introduction

by Eduard H Hochreiter and David T Llewellyn

On October 24, 2003, SUERF celebrated its 40th anniversary in the Galerie Dorée of the Banque de France with an especially high level and rich seminar. The memorable occasion was further elevated by Jean Claude Trichet giving the tenth SUERF Annual Lecture in his last public speech as Governor of the Banque de France, prior to taking over as President of the European Central Bank.

This study brings together in slightly edited form the four papers presented at the seminar and the Annual Lecture. In combining these presentations in one Study we also want to point to the breadth of SUERF's academic and applied activities over the forty years of SUERF's existence. It is also worth mentioning that the speakers at the seminar not only held high offices for SUERF but they also reflect the three pillars of SUERF's constituencies, i.e., central bankers, practitioners from the commercial financial sectors, and academics.

The past forty years have witnessed substantial changes in all aspects of European and international finance with many changes in both the international and domestic architecture and monetary regimes. The business of banking and the operation of financial institutions and markets have also changed beyond recognition. Jean-Paul Abraham's monumental overview of forty years of monetary and financial thinking in Europe as seen through SUERF's twenty-four Colloquia succinctly focuses on key monetary and financial developments since the early 1960s. The author's recollection of the content of SUERF's Colloquia during the last four decades therefore covers pivotal events such as the demise of the Bretton Woods system in the first half of the 1970s, the push for deregulation and liberalization of markets in the 1980s and the "making" of Economic and Monetary Union in the 1990s that fundamentally changed Europe's economic landscape. The 1990s also saw the collapse of the centrally planned economic system and the reintegration of the economies of central and eastern and Europe into the world economy that culminates with their accession to the European Union in May 2004. As Abraham points out it is specifically in the last decade that SUERF has increasingly also focused on micro-financial issues such as risk management, mergers and acquisitions and the like.

Franco Bruni's focus on fiscal discipline in a monetary union could not have been better chosen more timely. Just one month before the decision by ECOFIN to suspend the excessive deficit procedure for France and Germany, he convincingly argues the need for fiscal rules in EMU. Elaborating on the dangers of free riding, moral hazard due to lack of credibility of the no bailout clause contained in the Maastricht Treaty and an inefficiency of market-imposed fiscal discipline, he supports rules along the lines of a Stability and Growth Pact. Bruni further argues for a radical reform of European fiscal legislation including the establishment of a better-targeted quality of national budgets and of an independent centralized agency for fiscal policy to overview binding fiscal rules.

Alexandre Lamfalussy takes issue with the challenges facing the European System of Central Banks in the light of financial market integration in Europe and in the context of financial globalization. The author highlights and assesses the current institutional arrangements in Europe. Currently the role that central banks play in financial market supervision is in flux due to the restructuring of the institutional set-up of financial market supervision in Europe. In this regard he voices some concern because of the different degrees of involvement of national central banks in operational supervision in the euro area and its effect on the role to be played by the ECB. Yet, regardless of the precise institutional set-up, he strongly argues that central banks need to be involved in financial market supervision in one way or another because of their core task to safeguard financial stability.

Robert Raymond takes a look at the state of affairs in European financial market integration. In his paper he analyses the remaining obstacles for an efficient European financial market, such as the heterogeneity of legal frameworks in the euro area as well as the existence of a large number of cross-border settlement systems. He also discusses the prevalent fears with regard to consolidation of national supervisory and regulatory bodies. Two recommendations emerge: First, the harmonization of legal provisions along the lines suggested by the most recent *Giovannini Report* and second, a consolidation of cross-border transfers of securities taking the existing US architecture as an example.

A decisive analytical tool in assessing the benefits and costs of joining a monetary union has been based on the "optimal currency area" (OCA) approach pioneered by Robert Mundell. Recent developments of this theory suggest that OCA criteria have to be seen also as endogenous. Besides, the New Economic Geography (NEG) provides a relevant theoretical framework to capture the endogenous dynamics influencing the optimality of OCAs. Jean-Claude Trichet combines these concepts to discuss the interrelationship between OCA and economic policies in the euro area. His main contention is to explain that EMU is a dynamic and not a static concept. In this context Trichet sees the OCA properties of EMU shaped by endogenous forces possibly leading to more (regional) specialization and to agglomeration of activities benefiting to the most dynamic areas.. Trichet discusses risks and opportunities arising from these dynamics. Monetary stability and beyond macroeconomic stability constitute obviously the desirable background and Trichet firmly believes in the need for fiscal rules along the stability and growth pact for EMU to be sustainable in the long term. Furthermore Trichet draws attention on the decisive part of well-designed structural policies to fully benefit from the opportunities of NEG dynamics underpinning the (endogenous) optimality of EMU. He stresses that this should gradually go hand in hand with stronger European economic governance and in particular ever closer coordination of structural reform policies.

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Monetary and Financial Thinking in Europe since the Sixties: Evidence from the SUERF Colloquia

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1. Before getting started

Thirty years ago, at the fourth SUERF Colloquium, held in Nottingham UK in April 1973, a little incident occurred at the final speech, which included the usual acknowledgements and thanks. Professor Wilson was giving that speech as President of SUERF and Chairman of the Colloquium. He noted the following about that session in the personal memoir he wrote twenty years later, in November 1993. Speaking of Raymond Bertrand, a high-ranking OECD official who was to become President of SUERF later on: "*Bertrand was annoyed that I spoke only in English and himself rose to declare (several times): "Il faut dire* '*merci' en français*" (in bold in the text).
Dix ans après cette note, je tiens à compenser quelque peu cette omission tout au début, non à la fin de mon exposé, en disant 'merci' en français plusieurs fois ('several times') ou comme disent nos amis luxembourgeois 'vielmals merci' :

- Merci au Conseil de la SUERF et tout spécialement à son actuel Président, David Llewellyn, d'avoir, d'abord, accepté mon refus d'écrire l'histoire-bataille de la SUERF, de m'avoir ensuite chargé d'explorer le développement de la pensée monétaire et financière en Europe à travers les Colloques et les Publications SUERF et surtout d'avoir continué à me soutenir et à m'encourager au moment où des ennuis de santé m'incitaient plutôt à considérer ce mandat comme un 'cadeau empoisonné';
- Merci au Secrétariat SUERF, en particulier l'infatigable Beatrix Krones, à plusieurs membres du Conseil et aux amis à mon université et à la Banque Nationale de Belgique, d'avoir plongé dans leurs archives et bibliothèque personnelles et de leur institution, ce qui a permis de reconstituer et de mettre à ma disposition une collection complète des publications liées aux 24 Colloques;
- Merci à tous ceux et celles – en particulier les membres du Comité des Publications SUERF – maintenant appelé Editorial Board – et son Président Morten Balling, qui m'ont aidé avant, pendant et après la rédaction du texte;
- Merci à ceux et celles, y compris mon épouse, qui ont tenté de 'civiliser' mon anglais, encore plus rugueux que mon français;
- Merci à toute l'équipe du Secrétariat à Vienne, qui, sous la direction de Edi Hochreiter et de Beatrix Krones, a assuré la publication du texte en un temps record, ainsi qu'à l'équipe de Dexia Banque Belgique, en particulier Peter Van Dijcke, qui a transformé mon texte en une présentation en Power Point:

- 'Last but not least', merci à Monsieur le Gouverneur et à la Banque de France, qui me permettent de présenter le travail dans le cadre prestigieux de cette Galerie Dorée.

Shifting back to English and to a more down-to-earth level, I emphasise that, of course, all the remaining errors are mine. Moreover, the whole study is not the work of a professional historian. I have simply tried as an academic economist and as an ex-banker to follow the development of monetary and financial thinking in Europe since the Sixties, over four decades and 24 Colloquia, held in 16 different countries, as this development is evidenced by 22 Colloquia-Books and 10 Colloquia-related brochures. Do not think that I have read in detail each of the more than 8000 pages of the basic documentation. I have concentrated on keynote addresses, the General Reports, the Marjolin Lectures trying to ascertain the dominating themes in each Colloquium. Then, I looked through the individual contributions, neglecting statistics, techniques and mere descriptive information and choosing representative quotations.

2. Getting Started: An overall presentation

The whole study is based on three organising principles, which I call my three main assumptions. They explain the overall structure of my study and also that of my presentation.

2.1. The dominant themes and the title of the colloquia have been determined by the '*force of events* 'more than by academic theories. This constitutes the link between the topics and important events or major shifts in policies and financial activity. It leads to a characterisation of the main issues in five distinct periods marked out by major events or major shifts.

2.2. The contributions in each Colloquium Book are interesting not only for *what* – the content – but also for *who* (the author) has said something and for *how* this has been said or written. This explains the structure of the study, which comprises an important *Anthology* (Part 2), besides a *Survey* (Part 1). Part 2 can be called the *SUERF Book of Quotations* and constitutes the documentary base of the study, organised in the chronological order of the colloquia. I have insisted that the anthology should not be dealt with as an annex to the survey. About two-thirds of my time went into composing the anthology, which makes for 70% of the volume.

2.3. The Survey should be based on a mix of a *synchronic* approach emphasising the general mood (*l'air du temps*) in a given period and a *diachronic* one, which focuses on developments and changes through time. This explains the internal structure of the Survey. This oral presentation concentrates on an analysis per period, according to the synchronic approach in the survey and illustrated by some quotations, in the original language, English or French.

For each period the presentation concentrates on three items:

– The stage: the major events, the colloquia, *l'air du temps*,
– The dominant themes and the outstanding contributions and their authors,
– An assessment of the contribution of the colloquia to the development of monetary and financial thinking.

Let us now have a look at each period, linking monetary and financial thinking to the major events and the discussions at the SUERF Colloquia.

3. Surveying the Survey per Period

3.1. Period I: 1969- early 1974

April 1969	Tilburg	The Future of the International Monetary System
October 1970	Tarragona	Monetary Policy and New Developments in Banking
January 1972	Strasbourg	Aspects of European Monetary Union
April 1973	Nottingham	Multinational Enterprises – Financial and Monetary Aspects

To this period, I have given the rather dramatically sounding title of '*The demise of the Bretton Woods System.*' All the *Anciens* here will remember the atmosphere of strain, followed by shock at the formal announcement of the inconvertibility of the $ by President Nixon on August 15, 1971 and ending in desperate, but unsuccessful efforts to restore the old order at the Smithsonian Conference, in December of the same year. In the European Community, the Werner Plan was doomed to fail because it had been built on what Gros and Thygesen called in their 1992 Survey '*its implicit reliance on the Bretton Woods System*.'

In that period SUERF held four colloquia: Tilburg, Tarragona, Strasbourg and Nottingham. Of course, the macro-economic issues in international and European monetary relations dominated the scene.

Comparing the contributions to the 1969 meeting in Tilburg with those of Strasbourg in 1972 suggests some kind of tragicomedy. The title of the former was: *The Future of the International Monetary System.* Eventually, it was a future that would never materialise: the '*Future of the Past'*. Discussions were concentrating on a reform *within* the existing system while that system was going to break down shortly afterwards.

This was already apparent in Strasbourg in January 1972. Louis Camu, the highly esteemed President of the Banque de Bruxelles, opened the meeting by linking the Nixon Declaration of 1971 with a Napoleon Decree of 1810 and stating: "... *Ce jour là* (i.e. the day after the Nixon words), *nous avons appris qu'une structure monétaire du monde avait vécu et s'il faut regarder cet évènement, qu'il me soit permis de citer Sartre* '*avec des yeux réinventés'.*"

He announced that the persistent creation of liquidity through the deficits of the US Balance of Payments financed by the rest of the world had come to an end. His forecast has proved to be totally wrong. We still speak of the American current deficit financed by the rest of the world.

However, what has proved completely right is the need and also the opportunity to strengthen and accelerate the search for a specific European monetary identity, for some kind of EMU, which would not have the defects of the Werner Plan. The ideas about the concrete design of such EMU were still far from clear and unanimous. There was the traditional opposition between the so-called monetarists and economists and a common currency seemed impossible without and before a political union.

In the Tilburg Colloquium Book and in the papers of the Strasbourg one, I found two extensive academic contributions, which seem to have been forgotten in most of the subsequent literature. At Tilburg, a then young professor at Wisconsin State University, Robert W. Russell, presented a brilliant analysis of the pressures on the existing Bretton Woods system and on the proposals of reform. Eventually, it was an impressive synthesis of most of the discussions in the Sixties, on the basis of five variables: freedom of international economic relations, alterability of exchange rates, internationally accepted monetary reserves, autonomous mechanisms of adjustment of balance of payments and, finally, foreign holding of key currencies. He concluded that the most promising changes would be to make exchange rates *somewhat* more flexible and to activate the special Drawing Rights Arrangement of the IMF.

At Strasbourg, on the other side, Professor Onida, from the University of Milan, criticised a mere theoretical architecture of EMU derived from the literature on the optimum currency area. He also opposed an over-emphasis on exchange rate stability in the sense of irreversible parity pegging, a position typical of Italian thinking at that moment.

Retrospectively, the other issues discussed at the Colloquia of this period remained on the sidelines of the central theme .May I just mention them without much comment:

– the monetary aspects of the entry of the United Kingdom in the EEC – particularly the future role of he pound sterling as a reserve currency,
– the relations and frequent tensions of multinational companies with national state policies,
– the implications of various theories on the design of monetary policy.

On the whole, this period left me with the impression that reading the pre-Nixon literature felt like listening to an orchestra stoically playing on a sinking ship, on a Titanic. On the contrary, reading the Strasbourg booklets 1972 was discovering an early landmark in the sequence of SUERF Colloquia. There the breakdown of Bretton Woods spurred a new and unavoidably imperfect search for European monetary identity.

3.2. Period II

September 1977	Wiesbaden: New Approaches in Monetary Policy
May 1979	Basle: Europe and the Dollar in the World-Wide Disequilibrium

Roughly speaking; Period II covers the second half of the Seventies, from late 1974 till early 1979. It suffered from the aftermath of two oil shocks, from a worldwide inflation disaster and from some resounding bank failures such as that of the Herstatt Bankhaus in June 1974.It was a time of disarray, of search and experiments for new monetary anchors and of stormy relations between Europe and the dollar. But it was also the time when, amidst the disarray and by trial and error, new theories, which previously were only discussed in academic circles, penetrated into practical policymaking.

Four colloquia were held in this near-quinquennium: Venice, Brussels, Wiesbaden and Basle.

Among the topics discussed, international monetary relations stayed at the forefront. Two main issues emerged. Number one concerned the exchange regime, in short the fixed-versus-floating exchange rate debate. Already in Venice in 1974 previous expectations about floating exchange rates proved to be an illusion. In the opinion of several Italian authors at that meeting no system of exchange rates, either floating or fixed, could work well under the pressure of the enormous oil deficits and worldwide inflation.

However, contrasting with what in Europe was called the benign neglect policy of the American authorities, exchange rate stabilisation progressively became a priority in Europe. This led, first, to – not very successful – experiments with various kinds of *Snake* Arrangements. They had the merit to be a training ground for launching, early in 1979, the European Monetary System (EMS), whose mechanisms were analysed at the Basle Colloquium 1979 by one of its founding fathers, Jacques van Ypersele.

Issue number two was the anchorage problem. How to redefine or replace the role of the inconvertible but inescapable $? A typical statement by Henri Bourguinat: '*Une chose est de constater qu'il n'est plus qu'une monnaie de second best, une autre de lui trouver un remplaçant: il n'en a point*.' The prevailing view was that the dollar would remain the main intervention currency, but would lose some of its reserve functions – which did not occur to a significant degree, even after the launching of the euro.

Amidst exchange rate volatility and stormy relations between Europe and the $, inflation rose everywhere, to even two-digit inflation rates in many countries. Therefore, the focus in the colloquia shifted, at least partly, from international to overall monetary policy, domestic and international. The overriding question became: how to cope with what was called '*The World-wide Inflation Disaster'* by Irving Friedman, in a book that even attracted the attention of the Encyclopaedia Britannica.

Already at the Venice Colloquium Rainer Masera had stressed the link between exchange rate regimes and money creation. However, it was only at the Wiesbaden Meeting in 1977 that overall monetarism penetrated and dominated the discussions under the title '*New Approaches in Monetary Policy'*. Apparently monetarism no longer was a mere topic of academic analysis and debate, but had penetrated practical policy-making. The dominant but not unanimous message was worded by Jacques Sijben in a remarkable contribution linking theoretical basics and practical problems:

'*The post-war macro-economic stabilisation policy based on the Keynesian analysis has not been successful in curbing the inflationary process during the past decade...We cannot endorse the philosophy of* '*learning to live with inflation'...The inflationary process is essentially a monetary phenomenon which cannot come into effect unless the monetary authorities provide the required* '*monetary fuel'...Wage negotiations and price-setting by firms should not be determined by the rate of inflation in the recent past, but rather by the lower rate of inflation, which will be allowed by monetary authorities in the near future...'*

In this context, much attention went to the Bundesbank as a reference for a pragmatic quantitative approach to monetary policy, as described in a contribution of Helmut Schlesinger, Member of the Vorstand.

International policy coordination as a matter of money supply policies and not of exchange surveillance and intervention rules raised some controversy.

Theo Peeters (University of Leuven) considered this kind of policy coordination as a logical consequence of the monetarist approach, but Council Member Niels Thygesen argued (I quote) '*that without focus on some declared objectives for exchange rates, clear guidelines for monetary policy coordination were not feasible.'*

Finally, exchange rate volatility and inflation had, of course, their impact on the functioning of the financial markets and the management of individual financial institutions .This was apparent at the 1976 Brussels Colloquium, where Roland Vaubel brilliantly advocated a generalised indexation of financial instruments. It raised the objection that, if indexed financial tools may protect individual firms and persons against inflation, they also help to institutionalise inflation and to weaken the incentive to suppress inflationary pressures.

On the other hand, the uncertainties resulting from inflation and exchange rates were reinforced by the repercussions of important bank failures. In Brussels, it was emphasised that these repercussions could no longer be considered as mere 'accidents', but were indicators of inadequate liquidity and solvency in the banking sector. They pointed to the need to improve national banking supervision and international coordination of national supervision, a 'chorus' which will be heard in many subsequent colloquia.

In a global assessment, it should be repeated that macro-economic issues continued to dominate the SUERF colloquia; with some shift from currencies and exchange rates policy towards overall monetary policy, aiming at coping with the inflation disaster. Developments at the level of markets and individual institutions were also primarily analysed as being induced by macro developments: exchange rate volatility and inflation.

I nominate the 1977 Wiesbaden Colloquium as the archetype of a good SUERF Colloquium because of its combination of academic research, monetary policy-making and practical targeting. I strongly recommend that at each colloquium an outstanding academic should be invited to sketch '*in the state of the art and of theoretical thinking'* on the general topic at stake (as Jacques Sijben did in Wiesbaden and later in 1994 in Dublin).

3.3. Period III

Two events in 1979 paved the way for our Period III, which we simply called *The Eighties*: the reversal of US monetary policy towards a disinflationary quantitative control of the money supply, led by Federal Reserve President Volcker and, in Europe, the launching of the European Monetary System

Usually the dividing line in the decade of the Eighties is drawn at the Plaza Meeting of September 1985, when the Ministers of Finance, confirming an already initiated market reversal of the dollar rate, stopped the unilateral implementation of the US monetary policy and tended towards multilateral policy cooperation.

I myself prefer the wording of our colleague in the Council Management, Michael Artis, who, in a remarkable contribution to the 1986 SUERF Colloquium in Luxemburg distinguished the post 1979 episode of (I quote) '*putting one's house in order'* and the '*issue of the day'* afterwards, which he called 'unemployment' and which I want to transform into 'market-led growth'. Anyway, the dividing line lies somewhere at the middle of the decade, at the time when SUERF held a Colloquium in Cambridge, UK, under the ominous title of '*Shifting Frontiers*.'

Eventually, our organisation held seven colloquia in that decade:

October 1980	Helsingør: Bank Management in a Changing Domestic and International Environment
April 1982	Vienna: International Lending in a Fragile World Economy
October 1983	Madrid: Government Policies and the Working of Financial Systems in Industrialized Countries
March 1985	Cambridge: Shifting Frontiers in Financial Markets
October 1986	Luxembourg: International Monetary and Financial Integration – The European Dimension
May 1988	Helsinki: The International Adjustment Process – New Perspectives, Recent Experience and Future Challenges for the Financial System
October 1989	Nice: Financial Institutions in Europe Under New Competitive Conditions

3.3.1.

In the first half of the decade the mood at the conferences was rather gloomy in the wake of the second oil shock, the US-led disinflation drive and the huge government deficits at that time. Two main themes emerged:

– international financial crisis?
– crowding out?

The April 1982 Colloquium in Vienna was marked by a rather general concern that the post 1997 episode would end in an international financial crisis. In the words of Alexander Swoboda that concern went, (I quote): '*beyond the usual gloom associated with every recessionary or stabilization phase'*. Luigi Spaventa chose as the title of his contribution: '*Gloom without drama*.' This concern was justified: in the latter part of the same year, the Mexican crisis broke out, it was a drama, but finally it did not result in a generalised international financial crisis.

At every difficult moment there is a search and even a hunt for 'villains', for those held responsible for the difficulties and tensions. In Vienna the three main ones were:

- The international bankers, who were accused of reckless profiteering from the recycling of the oil surpluses,
- The Eurocurrency markets, whose seemingly mysterious mechanisms were suspected of hampering the conduct of monetary policy,
- The supervisors, whose restraining interventions against imprudent banks might precipitate the very crisis, which the prudential regime is designed to avoid.

One of the top villains, Rainer Gut, Chairman of Credit Suisse, had a sharp reaction on the first issue. Some 'excerpts' from his paper: "*The oil price hike created international payments and financing problems on an unprecedented scale. At the time, the banks seriously doubted their capacity to cope with this huge task. However, the governments which were called upon to support not only hesitated, but, moreover, were forced by domestic restraints to cut development aid precisely at a time when it was needed more than ever...The international banking system had therefore to fill the gap, almost against its will*' (sic)*...The fear of the consequences of their own courage* (sic) *is understandable and has found expression in a banking climate which may be described as cheerful pessimism."*

On the second issue, David Llewellyn demystified the Eurocurrencies markets and concluded that these markets constituted no threat to the conduct of monetary policy if this policy was what the Germans call: *marktkonform*. In other words, market imperfections and impediments are the true villains.

As to the third issue, Peter Cooke, who later became famous for his capital adequacy 'Cooke coefficients', recognised the supervisors' dilemma but stated, (I quote): "*In playing their part in coping with this dilemma, the* *supervisors have to speak out for their first priority which must be to maintain a sound prudential framework for the international banking system"*.

In Helsingør 1980 and Madrid 1983, crowding out of the private sector and also of the normal corporate banking activity became a major theme. At the former, Pierre Ledoux, at the time President of the French Bankers' Association started his address in Shakespearian terms:

'*Nous sommes ici au pays de Hamlet et la question fondamentale du colloque ne devrait-elle pas se formuler: Pourra-t-on continuer à être banquier dans les années 1980 ?'* We still survive...

Three years later, crowding out became the star of the Madrid Colloquium, at least in the sayings of the General Rapporteur, Christian Lutz. This meeting focused on the explosion of budget deficits in a period of stagflation. Otto Emminger, former President of the Bundesbank, proposed a law of government retrenchment instead of the well-known (at least in Germany) Wagner law of increasing government expenditures.

3.3.2.

In the second half of the decade, the mood became more cheerful and forward-looking, also at the SUERF Colloquia. In Nice 1989 Joël Métais, Paris-Dauphine, even developed a theory of '*la banque à géométrie variable'*.

I singled out three dominant themes:

– Exchange stabilisation efforts inside and outside the EMS,
– Shifting frontiers from a government-led to a market-led system of markets and institutions,
– Acceleration of the deregulation and liberalisation drive at the end of the decade.

At the 1986 Luxembourg Colloquium Jean-Jacques Rey, together with Jan Michielsen, reported on the first successes of the EMS. These mainly concerned the stabilisation of exchange rates *within* the system: the so-called intra-EMS rates.

European exchange rate stabilisation together with the positive outcome of international counterinflation, opened new prospects for a tripolar policy cooperation between the US, Japan and Europe and for an international adjustment process leading to a new equilibrium in international monetary relations. This was the time of the 1987 Louvre Accord on international exchange rate stabilisation and, in the literature, of the proposals about various kinds of target zones for the key exchange rates.

At Luxembourg, Christian de Boissieu seemed seduced by the idea of a system of three interdependent monetary blocks, but was sceptical about the robustness of such a system. I quote: '*le scénario de trios blocs monétaires est séduisant parce qu'il rétablit de la symétrie dans des systèmes fondamentalement asymétriques. Cependant, il a toutes chances d'être transitoire'*.

Retrospectively, this statement proved to be prophetical, as far as the outcome is concerned: a short time afterwards, the Louvre Accord proved not to be able to resist market pressures. The optimism for global adjustment, which was also to involve tackling the US payments imbalances and financing developing countries, was still apparent at the Helsinki Colloquium 1988. It disappeared afterwards, rendering obsolete a significant part of the literature on policy cooperation that had been developed at that time.

What finally seems to have been the most important and the most enduring development in the Eighties from the point of view of economic thinking, is implied in the title of the 1985 Cambridge Colloquium: *Shifting Frontiers in Financial Markets.* It resulted in a greater reliance on market forces as a consequence of deregulation.

In Cambridge, the transition from a government-led towards a market-led financial system was coined '*the marketisation of banking and finance'* by Jan Koning, of the Dutch Central Bureau of Statistics. It did not take place at once and at the same pace everywhere. In the mid-Eighties it still differentiated the US and the UK from most countries of Continental Europe. But at the end of the decade the process accelerated and generalised as exemplified by the last colloquium of the decade: the 1989 Nice meeting.

There Alfred Steinherr, of the European Investment Bank expressed a common feeling when introducing his presentation by the question:

"*Why does it all happen now? …What happens now is both a quantitative and a qualitative jump with deregulation proceeding in many countries at a sharp accelerated pace, capital controls being reduced in many parts of the globe, innovation becoming a driving force and finance rapidly internationalising.*

It is the simultaneous occurrence of these factors in many parts of the globe, at a rapid pace, which is the new phenomenon."

Assessing this decade of the Eighties, we may state that the SUERF Colloquia correctly and timely analysed and discussed the danger of an international crisis in the early Eighties. This makes the 1982 Colloquium a landmark in the series of meetings.

The same positive assessment applies to the shift from government-led towards market-led financial activity with its intensification at the end of the decade. Here the landmark is rather the 1985 Cambridge meeting. The market-led activity induced more attention to bank organisation and bank management in the subsequent development of SUERF.

As a contrast, SUERF was, in my opinion, rather late in assessing the outcome of the disinflation effort, of the '*remise en ordre*' in the first half of the decade. It was only in 1988 in Helsinki that this effort was considered as a '*good job of crisis management*' by the authorities (Peter Oppenheimer). However, nowhere I have found an in-depth analysis putting into the balance the ultimate positive effort and the hardships that had to be endured in the process. At the end of this third period, we may provisionally round up our survey by having a brief look at the list of the fifteen SUERF Colloquia held since Tilburg 1969.

3.4. Periods IV and V

At this stage of my exposé, after three periods, many among you will think: still two periods to go. Anyway, so did I, when preparing this presentation. It will be a relief for all of us, ladies and gentlemen, when I merge the last two periods in the series: The Nineties and the Millennium Turn from 2000 to 2003.There are good reasons for such a merger. The topics and main themes of the two periods are linked with one another, partly as action and reaction, partly as action and further action. Moreover, many among you have been personally associated with the developments in those periods, as actors or at least as well-informed observers. We all have had a shock at the Fall of the Berlin Wall in November 1989 and at the agreement on the Maastricht Treaty in December 1991. Afterwards, we all felt the uncertainties and the risks of transition, in the East as well as in the West. Many among us shared the exuberance of markets at the end of the Nineties, at the launching of the euro, followed by the reversal of financial markets, from bull to bear from the second quarter of 2000 on. We are all aware of the new prospects but also of the new and difficult challenges resulting from the simultaneous accession of 10 countries to the European Union in May 2004 .We all know that we live in a globalised world, dominated by technological progress, where volatility, risk and fragility have become keywords of the financial discourse.

Amidst these developments SUERF held nine colloquia, six in the Nineties, three in the present decade, up to the Tallinn Colloquium last June.

May 1991	Lisbon: Fiscal Policy, Taxation and the Financial System in an Increasingly Integrated Europe
October 1992	Berlin: The New Europe – Evolving Economic and Financial Systems in East and West
May 1994	Dublin: The Competitiveness of Financial Institutions and Centres in Europe
October 1995	Thun: Risk Management in Volatile Financial Markets
May 1997	Budapest: Corporate Governance, Financial Markets and Global Convergence
October 1998	Frankfurt: The Euro – A Challenge and Opportunity for Financial Markets
April 2000	Vienna: Adapting to Financial Globalisation
October 2001	Brussels: Technology and Finance Challenges for Financial Markets, Business Strategies and Policy Makers
June 2003	Tallinn: Stability and Efficiency of Financial Markets in Central and Eastern Europe

By the ‘force of events’, Europe got involved, nearly at the same time, in two transitions, and the SUERF Colloquia in what we call Transition Economics. However, the two transitions were quite different in objectives and phasing. They are only expected to converge in the present decade.

As you all know, in the East, the transition was one towards a privatised market economy and a two-tier bank system, whereas in the West it was the road towards full EMU and a single currency through a process in three stages.

I have assembled the main themes discussed in the Nineties under three headlines:

– Transition in the East, after the Fall of the Berlin Wall,
– Transition in the West: the bumpy Road to EMU, successfully ending in the launching of the euro,
– The Domination of Markets.

3.4.1. Transition in the East

At the beginning, the length of the transition from 1989 until the start of 'self-sustained growth on market principles' was evaluated in a too optimistic way at the SUERF Colloquia, just as in many other organisations. At the May 1991 Lisbon meeting Conrad Reuss spoke of 6–7 years. However, at that same meeting, which concentrated on the saving-investment relation, several contributors expressed the concern that savings would be insufficient to cover the investment and financing needs of the Nineties. Governor Mervyn King, at that time Professor at the London School of Economics, pointed out that, in the 1980s the aggregate saving ratio had declined by roughly 6 points in all major countries. From the German side, no doubt was left about the increased public transfers and expenditure induced by German economic and monetary unification.

Already at the next Colloquium, held in Berlin in October 1992 under the well-chosen title of 'The New Europe', the approach was more down-to-earth. Deputy Governor Tietmeyer stressed that there was no unique blueprint or 'royal road' to successful reform. IMF Associate Director Guitián stated that one had almost to start from scratch. Participants discussed the pros and cons of different systems of corporate ownership on the basis of a paper by Colin Mayer, at that time Professor in the University of Warwick. A series of experiments in various transition countries was mentioned and discussed with many question marks and qualifications. In general, opinions and statements stuck to 'the middle of the road', between what Roy C Smith (New York University) and Ingo Walter (INSEAD) called the Anglo-American model of going 'cold turkey' into a free market system and a gradualism without time path or limit. Much emphasis was put on the imperative of '*institution building*' and '*the infrastructure of laws and institutions*', which should accompany stabilisation.

Four and a half years later, at the May 1997 Budapest Colloquium, where Alexandre Lamfalussy gave the final lecture, the keyword became convergence. Council Member Morten Balling spoke in his introductory presentation of common principles of corporate governance. However, most contributions dealt with corporate governance problems in the West, quoting aspects that were not immediately applicable to the East, at least at that time. Afterwards, the convergence issue gained momentum when a significant number of countries of Central and Baltic Europe applied for entry into the enlarged European Union.

At SUERF we had to wait for the 2003 Tallinn Colloquium to assess the progress made in the six years after the Budapest event. In the book, I characterised this meeting as '*the event with the right topic, at the right time and at the right place,* in small but active Estonia. The title of the Colloquium was already an indicator of the progress made since Budapest 1997: '*Stability and Efficiency of Financial Markets in Central and Eastern Europe*. This refers to issues which also dominate discussions in the West. Even more, I noticed that a number of high quality papers did not, as in Budapest, originate from the West or from international organisations, but from researchers working in the accession countries themselves. Progress in techniques and analysis was impressive and points to a large convergence in economic and financial research between East and West.

A significant number of contributions dealt with aspects of the sequence: from transition towards convergence, from convergence to accession, from accession to full European Union membership, from EU membership to full Economic and Monetary Union and the euro. Applied to the prospects for the financial sector, the main findings were:

- Much has been done in the last ten years but even more has still to be done.
- The growth potential of the financial sector is high because this sector will at the same time benefit of the general growth of the countries involved and of a catch-up effect linked with the present state of underdevelopment of the financial sector itself.
- For growth, efficiency is more important than size.
- The role and performance of foreign banks in accession countries has been and is still very positive (this was a striking but not unanimous assessment).
- Prevention of currency and banking crises is essential. Monetary policy focusing on exchange rate targeting and even on currency boards seems to be preferred.
- After accession, more time is needed for full EMU membership and euro.

This indicates that transition in the East will not come to an end at the moment of accession. However, it will develop in a stronger institutional set-up. In this respect, Luigi Passamonti (IMF) suggested that if the benefits of the Single Financial Market can be unlocked (I quote): "*it is quite possible that the new member states may become the main beneficiaries of the European Union Financial Sector Plan."*

3.4.2. Transition in the West.

The road to full EMU along the three stages of the Maastricht Treaty was bumpy, even very bumpy at the beginning, before reaching a successful end with the launching of the euro on January 1, 1999. Robert Raymond struck the right tune when concluding his Marjolin Lecture at the 1995 Thun Colloquium: '*If the target can easily be determined, difficulties are in the transition...'*

At the Lisbon Colloquium Giovanni Ravasio pointed to the basic difficulties of each transition. I quote: '*Il y a une asymétrie des coûts et avantages dans le temps. La Communauté supporte aujourd'hui les coûts d'ajustement, ceux liés à l'incertitude de change... A l'opposé, les avantages de l'UEM ne seront recueillis*, *pour l'essentiel qu à la troisième étape avec la monnaie unique*.'

He also hinted at the permanent tension between the logic of integration and the fear of losing too much national sovereignty. Consequently, he recommended a transition as brief as possible. At the same meeting, Jean-Jacques Rey sketched the current situation in mountaineering terms: (I quote) '*In mountain climbing, it is well known that climbing starts only when one has walked a long time already*.' Instead of diminishing, the uncertainties just mentioned increased and led to the exchange crises of 1992–1993. Nevertheless, Hans Tietmeyer, then Deputy Governor of the Bundesbank stated at the 1992 Colloquium in Berlin that "*EMS is an important stop-over and also a test on the road to EMU".*

The most decisive development and also the most interesting one from the point of view of economic and monetary thinking was what Tommaso Padoa Schioppa wrote in his 1994 book, 'The Road to Monetary Union in Europe', and what Niels Thygesen recalled in his masterly survey of *Twenty Five Years of European Monetary Unification*, presented at the 1998 Frankfurt Colloquium:

*(*I quote)... '*The utopian perspective of full currency was confirmed as a realistic option by the 1992–1993 crises in the EMS. With the degree of capital mobility achieved at the end of the 1980s, fixed but adjustable exchange rates might have become impossible to maintain'.*

As a consequence and despite the hesitations of some central bankers and the staunch opposition of many academics, which was also felt at the SUERF Colloquia, the Single Currency and the Single Monetary Policy became the main targets and the symbols of Full EMU. Symbolically, the 1998 Colloquium was held in Frankfurt about six months after the final decision to introduce the single currency and less than three months before the effective launching of the euro. This explains why most papers reflected some exuberance on the prospective structural effects of the introduction of the euro and of the single monetary policy.

At that moment Europe resisted the East Asian Crisis rather well, which induced Governor Tietmeyer to say, in his opening address, that the euro had passed its first acid test, since it proved that the markets had accepted the transition to monetary union as '*irreversible*' and regarded the euro as a *safe haven*. Academics, bank economists and also distinguished financial practitioners explored the prospects for markets and institutions of the introduction of the euro.

However, the optimism was not unlimited. Michael Artis argued, on the basis of a clustering exercise on 18 countries, that a single monetary policy could probably not always fit all and that policies to substitute for the loss of independent monetary policies in some countries should be considered.

The most impressive and most balanced contribution to the colloquium was undoubtedly the already mentioned survey of twenty-five years of European unification in the Marjolin Lecture by Niels Thygesen.

He analysed the current state of monetary union in the light of five evolving ambitions, constituting a logical sequence. His assessment was that only the first three, or rather two and a half, of these ambitions had been fulfilled at the start of full EMU and the launching of the euro:

– reducing, then eliminating nominal exchange rate fluctuations,
– reducing, then eliminating inflation,
– developing rules for non-monetary policies.

The qualified exuberance noticed at the Frankfurt Colloquium should be explained and assessed as the celebration of the successful end of a long and difficult journey. However, it would significantly be weakened by the subsequent reversal of markets at the Millennium Turn. In a significant move, the attention at the 2000 Vienna and 2001 Brussels meetings went to more autonomous developments in the financial sector, driven by globalisation and technological progress. And at the 2003 Tallinn Colloquium monetary integration and EMU was only the ultimate and more distant part in the sequence starting from transition.

3.4.3. The Dominance of Markets

In this oral presentation the developments at the level of markets and institutions in the Nineties and after the Millennium Turn were an acceleration and intensification of the forces and trends which broke through in the Eighties, rather than a new and profound break in the financial system. Financial activity in Europe remained market-led more than government-led but *within* that framework some shifts occurred and much volatility was noticed.

These shifts attracted the attention of SUERF, particularly but not exclusively in the mid-Nineties, and again after the Millennium Turn. A short list of keywords may suggest the main issues discussed at the Colloquia:

In the Nineties:

– The shift from traditional intermediation by banks towards finance through capital markets, which also involved the intervention of non-bank intermediaries, such as securities houses. At certain moments, it was felt that banking might well exhibit the characteristics of a declining industry. The reversal of markets after the Millennium serious undermined this trend towards capital markets.
– Competitive Environment: A review at the 1994 Dublin Colloquium pointed to *varying* national bank strategies but often *analogous* pressures of competition for more efficiency, more profitability and a reduction of risks through diversification in large commercial banks. Except for the last point, this also applies to the cost-cutting and restructuring imperative after the Millennium Turn.
– Risk, Risk Management and Financial Fragility.This topic attracted much attention from practitioners, who presented their experience at the 1995 Thun Colloquium. Martin Hellwig (University of Bern) related risk to the erosion of margins in traditional banking and to the reduced ability of banks to rely on oligopoly rents to withstand shocks.
– Volatility, Bubbles, Crises. At Thun, Charles Goodhart relativised volatility and worsening risk perception. Empirical work in several Colloquia, done by Claudio Borio & Robert McAuley and Philip Davis suggested that recent outbursts of crises were due to the own dynamics of the market(s) involved more than to fundamental economic and financial factors

After the Millennium Turn:

– Globalisation with its impact on efficiency and consolidation at the micro-and meso-level and on financial stability at the macro-level,
– Technology, as a dominant driver in a 'paradigm shift', changing all aspects of banking in a fundamental way.

As a round up I have tried to make a list of top contributors to the analysis of financial thinking at the Colloquia in the last fifteen years (and only in that respect): besides Robert Raymond and Alexandre Lamfalussy in their Marjolin Lectures, Andrew Crockett, Charles Goodhart, David Llewellyn, Niels Thygesen, Axel Weber, and the empirical researchers Claudio Borio (in association with Robert McAuley) and Philip Davis.

May I mention, in a subjective mood my four personal favourites, adding a short quotation after each name?

– Jacques Sijben for his paper on the credit view in monetary economics at the 1994 Dublin Colloquium: '*The recent research on the operation of credit markets and the revitalization of credit in macroeconomics is based on the new economics of asymmetric information and incomplete markets... Based on the Stiglitz-Weiss' analysis the rise of bad loans in the banking system and its attendant increase in outstanding debt of firms and households*, *coinciding in time with a cyclical downturn, has increased financial fragility...'*
– Andrew Crockett, for his analysis of risk and financial instability at the 1995 Thun and at the 2000 Vienna Colloquium: '*Just as policy makers appeared to be emerging victorious from one exhausting battle, that against inflation, another equally challenging front was opening up. Financial globalisation has transformed geography, with significant implications for the character of instability. Globalisation has heightened the significance of "common factors' in the genesis and unfolding of financial distress."'*
– David Llewellyn for his contributions on the New Economics of Banking at the 1992 Berlin Colloquium and the 2001 Brussels Colloquia: "*...If economies of scale relate predominantly to bank processes rather than institutions, and external contracts can be managed efficiently, the existence of economies of scale does not mean that only large banks can be competitive and survive. What in practice is likely to emerge is a spectrum of different types of bank."*

– Charles Goodhart: for his critical views on conventional opinions about volatility and risk at the 1995 Thun Colloquium and about financial regulation at the 2001 Brussels Colloquium: *"Volatility is not secularly increasing; the recent globalisation is not only desirable, but takes us back towards the condition that had already been obtained at the start of this century... ...It would not surprise me if, by the year 2010, we looked back at the decades of the 1980s and 1990s as being one of general stability and relatively little structural change... Many of the problems and disturbances that we face today are neither new, nor by the most objective standard particularly virulent..."*

Taking an overall view of the Nineties and the first years after the Millennium Turn and assessing these two periods lumped together, we are overwhelmed by the frequency, the diversity and the intensity of events and changes: at the international level, increasing globalisation; in Europe, single currency and single monetary policy in the West; in the East, starting from scratch, a totally new institutional financial framework; at the level of markets, technological progress, competition and ebullience, followed by sharp reversals, banking as a risky business. Sure, some of these developments will lose significance in future assessments but much will prove irreversible.

Through its colloquia and its other activities and publications SUERF followed and analysed these developments. Its membership and its audience enlarged: more financial practitioners next to academics and bank economists, more researchers and practitioners from the East. To capture the developments into publications, the Colloquia Books no longer sufficed, they have been supplemented by a new series of SUERF Studies, to which my Survey and Anthology belong. However, I am convinced that the Colloquia books, with their selection of the best papers of each Colloquium will remain a reference and an anchor of overall SUERF activity. This brings me to my final remarks. As I do not forget Nottingham, I will phrase them in French.

4. Remarques Finales

Récapitulons donc et concluons. Je vous soumets trois points.

I. De la force des évènements à la force des idées.

Notre démarche a été de partir du thème général de chaque colloque, thème dicté généralement par la force d'évènements récents, pour analyser les réactions et réflexions et tenter d'en dégager le développement des idées en matière monétaire et financière. La question se pose alors: Que valent ces idées, ne sont-elles pas purement circonstancielles, ont-elles une valeur qui dépasse le moment et le lieu de chaque colloque? En répondant, je tenterai d'être nuancé. Dans beaucoup de cas, les idées exprimées ne sont pas des idées nouvelles. Elles circulent déjà dans d'autres enceintes que SUERF. Mais aux colloques elles sont analysées et testées par trois groupes à formation et orientation professionnelle différentes: des banquiers centraux et leurs économistes, des praticiens bancaires et leur service d'études (lorsqu'il existe encore), et des académiques. Elles aident ceux-ci à former, confirmer ou corriger leurs propres opinions et travaux, à disséminer les conclusions dans leur propre organisation et éventuellement dans un public plus large et dans les médias. C'est cela leur valeur ajoutée.

Question complémentaire: ces idées, ont-elles à leur tour un impact sur les événements? Directement: sûrement non. La SUERF est un forum et non un lobby ou une école de cadres. De façon indirecte? Oui, je l'espère, selon la voie mystérieuse que suggère une phrase empruntée à un ouvrage récent du journaliste italien bien connu et fortement respecté Enzo Biagi: *Non è vero che le idee sono sempre innocenti...*

II. La diversité des problèmes et la succession souvent rapide des idées au cours des quatre décennies étudiées.

Peut-on y déceler une certaine cohérence, des fils directeurs? J'ai tenté de le faire mais c'est à vous de juger. En tout cas, je vous recommande, lorsque vous lirez le Survey dans le livre, de distinguer, mieux que ce que je ne l'ai fait, les aspects suivants:

- les constantes dans l'évolution,
- les mutations de types différents, parmi lesquels – les mutations de '*rupture*': comme après l'effondrement du système de Bretton Woods et le

départ à zéro à l'Est, après la chute du Mur de Berlin. Ces mutations sont généralement suivies d'une période de tûtonnement et d'expérimentation, ce qui donne aussi l'occasion à des théories nouvelles de pénétrer dans la pratique et la politique monétaire et financière.

– les mutations '*dialectiques'*, avec thèse et antithèse, action et réaction. Exemples: le passage de l'approche keynésienne au monétarisme, de l'activité financière dominée par les autorités à celle dominée par les marchés. Les théories sapent les systèmes existants mais les mutations se produisent graduellement et souvent à un rythme différent de pays à pays.
– les mutations '*rectilignes:* les accidents de parcours mis à part, ces mutations ne sont pas des renversements mais des mouvements dans la même direction, fondés sur la même approche théorique mais se réalisant à des rythmes et des modalités différents selon les circonstances. Exemples: au niveau mondial, le mouvement de globalisation, au niveau européen: l'intégration monétaire.
– Enfin, les problèmes non évoqués ou non résolus, qui, à la SUERF, peuvent devenir sujets de nouveaux colloques et de nouvelles publications. C'est ce qu'évoquait Peter Oppenheimer à la fin de son rapport au Colloque d'Helsinki en 1988: *"The solutions of one quinquennium or one decade or one generation turn into the problems of the next. Happily so, in order that the world's economists and bankers may go on conferring..."*

III. Les Colloques SUERF comme reflet et caisse de résonance des mutations.

Par leur régularité, leur préparation soignée et leurs efforts de publication, les Colloques SUERF sont un lieu et un instrument privilégié pour suivre, analyser et discuter les mutations. L'invitation publique à soumettre des contributions (le 'call for papers') a élargi à la fois l'éventail des sujets traités et des auteurs. Des jeunes académiques mais aussi des jeunes praticiens bancaires répondent à l'appel. Le grand nombre de propositions reçues à l'occasion des derniers colloques sont à la fois signe de succès et source de préoccupation. Comment, même après une sélection sévère, garantir, outre la faisabilité physique, la cohérence interne du programme, concilier les préoccupations de prudence, de vigilance et de stabilité des responsables, des policymakers, et la passion des jeunes pour les techniques et les initiatives de marché? Il ne m'appartient heureusement plus de relever ce défi. Je souhaite bonne chance au Président et à ses collègues au Conseil et au Secrétariat. J'incite vous tous, Mesdames, Messieurs, à participer aux Colloques des quarante prochaines années, en reprenant à mon compte la tentative de limerick irlandais que notre ami et ancien collègue, Richard O'Brien proposa à la fin de son rapport au Colloque de Dublin en 1994:

"...Competition for Markets and Turf
In finance can get pretty rough
But to see a real fight
Where everyone's right
Attend a Colloquium of SUERF..."

Merci, thank you.

Fiscal Discipline in a Monetary Union: Issues for the Euro Area

by

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[1] Some friends have offered valuable suggestions. I am particularly grateful to Carlo Bastasin and Edi Hochreiter. The usual disclaimer applies.

European monetary unification has a strong relationship with fiscal discipline, which was enshrined in the Treaty and reinforced with the Stability and Growth Pact (SGP). I would like, first, to revisit the theoretical and policy justifications of this relationship and then use them to refer to the current debate on the SGP.

The initial justifications for connecting monetary union with fiscal discipline were of four types. The first is the most official and cited one. Using a recent wording of the ECB[2], "in monetary unions sovereign issuers receive stronger incentives to engage in debt financing because the impact of higher liabilities in the form of higher real rates is not entirely borne by those authorities which embark on fiscal expansion, but more widely shared by all their fellow participants in monetary union". Let me label this first justification *free-riding*. A non-cooperative game can lead to a deficit of the whole monetary union larger than the optimal level that would be chosen through cooperation. To deal with this incentive problem disciplining rules can be agreed upon such as the Maastricht 3% limit and the SGP.

The second justification is *moral hazard*. The disappearance of national currencies introduces a default risk for all sovereign issues of the monetary union. As the default of a country has substantial spill-over effects, the incentive of each national government to discipline its budget is weakened by the belief that other governments of the union and/or the common central bank have good reasons to bail-out a defaulting country. This justification of stability-pact-type constraints is difficult to confess with sincerity for the authorities, as it presupposes a lack of credibility of the no-bailout clause of Art 103 of the Treaty, an imperfect trust in the robustness of central bank independence as well as in the efficiency of market discipline that should discourage excessive borrowing by adding an appropriate default risk premium to the interest rate.

A third justification, that I will label *room for stabilisation,* refers specifically to the SGP. The Pact imposes convergence toward structurally balanced budgets in order to make room for fiscal stabilisation without breaking the 3% Maastricht limit. This room is available for the working of automatic stabilizers but it also allows some discretionary measures. It is indispensable to counter asymmetric negative demand shocks in the euro area, where no autonomy is left for national monetary policies.

[2] ECB, *The relationship between monetary policy and fiscal policies in the euro area*, Monthly Bulletin, February 2003, p.42

I think a last, more general justification explains both the Maastricht 3%–60% limits and the SGP. Fiscal rules have been adopted to render more homogeneous and sustainable the weights of the public sectors in the economies of the euro area. With tax competition, limiting deficits indirectly lowers public expenditures. The weights of the public sectors are crucial structural parameters of our economies and influence in several manners the way they work. Converging public sector weights are thus part of the minimum structural harmonisation which is desirable to maximize the benefits of a single currency. From this point of view EU fiscal rules are in place not only to avoid, in a negative sense, fiscal indiscipline, but also to generate a certain amount of *positive coordination*. This positive aim is most evident in the SGP's prescription of well documented yearly Stability Programmes, including the qualitative description of planned fiscal measures, as well as in the connections between these programmes and the "Broad Economic Guidelines" on the basis of which the Ecofin coordinates economic policies according to Art 99 of the Treaty.

Fiscal discipline can obviously be an end in itself. But it has a very near relationship with the functioning of the monetary union, which is brought into relief by the four justifications listed above. Therefore ECB's comments and critiques on fiscal policies cannot be considered undue and arbitrary inroads on governmental responsibilities, even though another, parallel European independent agency, with the objective of coordinating and enforcing the common fiscal policy guidelines[3], would constitute a more diligent interlocutor of ECB's fiscal monitoring than the governments themselves.

The above listed justifications of fiscal discipline in the EMU make also clear that the word "growth" in the SGP neither is an occasional presence nor acts as a pleasing counterpoise to the sad flavour of the word "stability". The point is that monetary and financial stability is a necessary condition for sound and sustainable growth.

To what extent are these justifications still valid today? Five years of experience with the euro do not disprove the hypothesis of "free-riding". Placing euro-denominated government securities has been easy even for highly indebted member countries. As far as "moral hazard" is concerned the euro area still includes some countries where public debt is very high and where partial forms of default[4] are not unimaginable in case, for instance, of

[3] More on this agency below and in footnotes 20–21.

[4] Like interferences with the complete freedom of the market for government securities

a substantial worldwide increase in interest rates. The market premium for this potential risk is very small. This fact could signal the credibility of the SGP as a long-term disciplining mechanism. But it could also mean that markets expect bailouts of defaulting countries or that market pricing is inefficient and the premium is inadequate[5]. The importance of the moral hazard argument for fiscal discipline is difficult to test.

To assess the validity of the "room for stabilization" argument several issues are of relevance. First: which is the main cause of the fact that, in the recent world-wide macroeconomic situation, the SGP seemed to leave insufficient room for stabilization? Is it the special mixture of quality and intensity of the unexpected global crisis that started in the last part of 2001[6]? Or is it the insufficient quality and quantity of the fiscal adjustments that were carried out by several European countries in the three preceding years? In my opinion the latter cause is more important and the European Council has been too weak and forbearing in judging and managing the Stability Programmes.

Second: is the SGP, in its present version, sufficiently flexible to allow compatibility between short-run stabilization in difficult times and medium-term convergence to structurally balanced budgets? I think the answer is a qualified yes. There is flexibility[7], but to make good use of it a better set of incentives is needed. The SGP procedure depends too much on the time-inconsistent behaviour of intergovernmental cooperation. The Council's co-ordination can be counterproductive as countries use the flexibility to pardon each-others' deviations from agreed fiscal consolidation paths. More importantly, the *quality* of the deviations is not taken as a serious issue. Deviations end up reflecting mainly domestic pressures of special interests.

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[5] Perhaps also as a consequence of the high degree of substitutability given to the different countries' government securities by the current refinancing procedures of the ESCB

[6] As M. Buti, D. Franco and H. Ongena argued in their 1998 paper, a potential conflict between discipline and flexibility was foreseeable, when the Pact was signed, precisely in the event of a recession during the early years of EMU "when budget balances are still relatively close to the 3% threshold. Pro-cyclical fiscal policies would have to be implemented ... However the costs of such a one-time action during the transition period ... would have to be weighted against those arising from the loss of credibility due to a loose implementation of the pact. Given their systemic nature, it can be argued that the latter outweigh the former", *Fiscal Discipline and Flexibility in EMU: The Implementation of the Stability and Growth Pact*, "Oxford Review of Economic Policy", vol. 14, No. 3, p. 94.

[7] An increase in flexibility could also result from the proposals to improve the implementation of the SGP presented by the European Commission in *Strengthening the coordination of budgetary policies*, Communication from the Commission to the Council and the European Parliament, Brussels, 21.11.2002. See also the careful analysis of the evolving budgetary surveillance and of the implementation of the SGP contained in European Commission, *Public Finances in EMU* 2003, Brussels, 21.05.2003, Part II, p. 39–72.

The resulting use of the Pact's flexibility is inefficient in coping with asymmetric shocks and useless to enact euro-wide strategies of fiscal stabilization against symmetric shocks.

A third issue is relevant to the discussion of the "room for stabilization" argument: is fiscal stabilisation, generally speaking, an effective policy tool?[8] A scientifically adequate answer to this question would require a long discussion of a highly controversial topic of modern macroeconomics. Suffice here to say two things. To the extent that macroeconomic problems are caused *also* by an unsatisfactory behaviour of aggregate *supply*, fiscal policies can help only if they change the *quality* of public expenditures and receipts. From this point of view, fiscal discipline in Europe is insufficiently quality-oriented[9]. As to the general theory of short-run fiscal stabilisation of aggregate demand shocks, let me limit myself to saying that the probability of perverse non-Keynesian effects as well as of dangerous impacts on long term interest rates is smaller when short-run measures are part of a credible long-term fiscal scenario. This is the reason why there is no trade-off between fiscal stabilisation and fiscal consolidation and why a loss of credibility of the SGP would hurt, and not help, fiscal stabilisation. The Pact should be reformed, if this is needed to enhance its credibility which is currently, I think, in serious danger[10].

In my opinion the rules and the institutional arrangements of fiscal discipline in the euro area should be gradually changed in order to improve its functioning and, in particular, in order to better reflect the fourth justification of the discipline listed above, "positive coordination". There have been many proposals of reform of the SGP, to make it more flexible, more focussed on debt sustainability, on the amount of public expenditure and on the "quality"

[8] Is it sufficiently important to justify a special and complex implementation of fiscal consolidation and fiscal discipline in the euro area?

[9] A recent ECB study looks at the different inputs and outputs of the public administration and shows that the efficiency and the productivity of the public sector is low in the EU. "EU 15 countries are using 27% more public spending than the most efficient OECD countries": A. Alfonso, L. Schuknecht and V. Tanzi, *Public Sector Efficiency: an International Comparison*, ECB Working Paper No. 242, July 2003, p. 24.

[10] "Even the pact's erstwhile supporters no longer rally to the defence of its economic rational": W. Munchau, *Why the EU must reform its stability agreement*, "Financial Times", October 6, 2003, p. 15. "The recent episodes involving France and Germany clearly indicate that they will not ... continue to tolerate such a scenario, which is perceived as keeping them from adopting better economic policies ... But if the outcome were that these countries simply begin to ignore the goals of the ... SGP, other states would follow and the fiscal framework of EMU would fall apart": J. von Hagen, *Fiscal Discipline and Growth in Euroland: Experiences with the Stability and Growth Pact*, Zei w.p. B 06 2003, section 4.

of public finance, more conscious of unfunded pension liabilities, to improve its enforceability, to obtain a more efficient sharing of a euro-wide budgetary target between member countries[11]. My time is insufficient even to list them here[12] and I will only mention two types of reform because they can help to illustrate the case for "positive coordination"[13].

One is the "golden rule" idea of disciplining only the *current* deficit of the public sector, while public investment, net of amortization, should be left out of European fiscal rules[14]. The theoretical merits of this proposal are known[15], including its implication that the steady state public debt equals the stock of public capital while the current SGP's prescription of structurally balanced budgets means that public debt eventually goes to zero. But we are also conscious of the difficulties of agreeing on a suitable definition of public investment and of checking its rigorous application. Moreover, one may have doubts whether or not building useless bridges should be made easier than building human capital or frontier scientific know-how. In more general terms the "golden rule" can be criticized on the grounds that it uses a technicality, a mechanical accounting principle, to help solving an undisclosed, deeply political "positive coordination" problem. Individual governments have inadequate incentives to assign the right priorities to the various kinds of public projects, thus maximizing the collective interest of current and future generations of European citizens. Insufficient public investment is only one

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[11] To allow a market determined distribution of the euro-wide target, for instance, tradable deficits permits have been proposed by A. Casella, *Tradable deficit permits*, in Brunila, Buti and Franco (eds.), *The Stability and Growth Pact: The Architecture of Fiscal Policy in EMU*, Palgrave, 2001, 394-413.

[12] A well organized survey of the main proposals can be found in: M. Buti, S. Eijffinger and D. Franco, *Revisiting the Stability and Growth Pact: grand design or internal adjustment?*, European Commission, Economic Papers n. 180, January 2003. A more recent paper is, for instance, V. A. Muscatelli, P. Natale, P. Tirelli, *A simple and Flexible Alternative to the Stability and Growth Pact Deficit Ceilings. Is it at Hand?*, CESifo Working Paper No. 1006, August 2003.

[13] Changing the Pact when the 3 largest countries of the euro area have difficulties to comply with it could perversely worsen its credibility (see also the quotation in footnote 6 from M.Buti, D.Franco, H. Ongena, 1988) and send a bad signal to smaller and accession countries. The reform should therefore appear very different from an opportunistic slackening of the rules, it should look at the steady state functioning of the Pact and show new ambitions, also from a political point of view.

[14] In a weak form this proposal applies only to the SGP, i.e. to the formulation and monitoring of member countries' Stability Programmes, with the 3% Maastricht limit still expressed in terms of *total* gross public deficit. Maastricht picked the figure of 3% also because it was a reasonable estimate of the upper limit of the long-run ratio between public investment and GDP. The Maastricht limit is therefore a flexible substitute for a zero *current* balance rule. In a stronger form the "golden rule" reform requires a change of the Treaty.

[15] See, for instance, EU Commission, *Public Finances in EMU* 2003, COM(2003) 283 final, section 5.2, p 92-96, and O. Blanchard and F. Giavazzi, *Improving the SGP through a Proper Accounting of Public Investment,* mimeo, 2003.

of the many qualitative defects of public budgets decided on the basis of a distorted set of incentives.

From this point of view, a much more radical reform of European fiscal rules should target the *quality* of national budgets, thus decreasing the probability of counter-productive cooperation[16]. The Council's Broad Economic Guidelines should gradually become a set of binding rules to be followed by governments in planning not only their deficits but also the absolute quantities and the types of public expenditures and receipts[17]. The subsidiarity principle can be respected to the extent that the common rules only refer to the general characteristics of a set of budgetary programs. But general should not mean vague and unenforceable. An incentive mechanism could be established to keep arm's length between centrally chosen guidelines and nationally decided budgets as well as to reinforce the link between controlling the deficits and influencing the quality of the budgets. This mechanism could include fixing a set of coefficients, smaller than one, with which the expenditures corresponding to certain projects favoured by the European guidelines could be weighted to calculate the total deficit relevant for the Stability Programmes[18]. While the political responsibility of the goals of this quality-structural-reform-oriented fiscal discipline[19] should rest in a co-decision by the Council and the Parliament, with the initiative and the assistance of the Commission, the management and enforcement of this type of fiscal discipline would benefit from the creation of an independent agency for euro-wide fiscal policy[20], a sister institution for the ECB, that would receive the general goals by the political level and would interact with

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[16] C. Bastasin and F. Bruni: *Patto di Stabilità: cambiarlo senza far male all'Europa*, "La Stampa", August 14, 2002, p. 6; *Una forza nuova per il Patto,* "La Stampa", September 25, 2002, p. 1; *Una riforma di poche ambizioni*, "La Stampa", Novembre 28, 2002, p. 1.

[17] Qualitative fiscal discipline could aim at avoiding an excessive dimension of the public sectors but also at preventing excessive tax competition and promoting the production of certain types of public goods.

[18] This mechanism would be a generalization of the golden rule which assigns a coefficient equal to 1 to all current expenditures and equal to 0 to the whole amount of net public investment. But the mechanism could be much more selective in favouring certain types of investments, as well as certain current expenditures (and tax-cuts) like, for instance, those connected to education, research, labour market and welfare reforms, and other projects that have *short-term political and economic costs but highly productive long-term results*. Favoured expenditures should be defined in general but rigorous terms and national governments invited to submit specific projects with well specified characteristics. When these characteristics are judged compatible with central guidelines, the corresponding coefficient is assigned to calculate the weighted public deficit entering the accounts of the SGP.

[19] The favoured expenditures system could allow governments to increase, within certain limits, short-run deficits to implement reforms that will surely improve the debt/GDP ratio in the longer run; see, for instance, A. Razin and E. Sadka, *The Stability and Growth Pact as an Impediment to Privatizing Social Security*, CEPR Discussion Paper n. 3621, 2002.

national governments to reach these goals with the right amount of flexibility and in the best possible way[21].

Let me conclude by saying that a new emphasis on the qualitative aspects of fiscal discipline would not weaken its relationship with the single monetary policy, for many reasons, including the fact that it would render easier, better understood and more acceptable, the *quantitative* discipline of public deficits. Moreover, a centralized agency for fiscal policy could have a useful dialogue with the ESCB[22] which would cease to appear as the sole macroeconomic policy agency of the Union bearing all the criticisms, also outside its specific responsibility for price stability. It is unfortunate that neither the proposal of upgrading the coordination of fiscal policies nor the idea of an independent budgetary agency would find any relevant support in the present European political climate[23].

I thank you very much for your kind attention.

[20] An independent fiscal stability council has already been proposed, among others, by J. von Hagen and I. Harden, *National Budget Processes and Fiscal Performance*, "European Economy – Reports and Studies", 3, 1994, 311–418. According to von Hagen, *Fiscal Discipline and Growth in Euroland,* op. cit., "an obvious alternative candidate [as an independent euro-wide institution for fiscal surveillance] would be the European Central Bank": in my opinion this is far from obvious and could deeply complicate the life of the ECB! The creation of Fiscal Policy Committees at the *national* level has been suggested by C. Wyplosz, *Fiscal Policy: Rules or Institutions?*, Group of Economic Analysis of the European Commission, mimeo, April 2002. A system of national agencies would be compatible with a central EU agency and analogous to the ESCB. National public investment agencies are also proposed by Blanchard and Giavazzi, op.cit., to micromanage in a transparent way a system where public investment net of amortization is excluded from SGP's deficit accounting.

[21] This agency would have disciplinary powers as it would decide whether or not a certain project has the characteristics required to be assigned a special coefficient. It should also be suitably involved in the excessive deficit procedure and in the connected fining decisions. A complete enactment of such a reform of European fiscal discipline would require a change of the Treaty. But it is possible to move in the direction of qualitative fiscal discipline in a gradual way, starting with some modifications to the SGP and strengthening the relevance of the Broad Economic Guidelines, without changing the Treaty.

[22] To carry on a dialogue does not mean to try the *ex ante* coordination of monetary and fiscal policies which "gives rise to the risk of confusing the specific roles, mandates and responsibilities" of the two policies (O. Issing, *How to achieve a durable macroeconomic policy mix favourable to growth and employment?*, Conference on "Growth and Employment in Europe", European Commission, May 2000). *Ad hoc* coordination of macro-policies looks particularly inefficient if one takes into account the imperfection of the authorities' information on the functioning and on the status of the macro-economy: " Since it is difficult to identify correctly the nature of shocks and agree on their propagation over time and possible spillovers of joint policy actions, as well as to reach a common understanding of the 'true' model of the economy, the pursuit of active policy co-ordination can often be counter productive": ECB, *Monthly Bulletin*, February 2003, p.43.

[23] "The current preferences for political integration imply that fiscal policy stay decentralised and coordination continues to be mainly of the negative type, reflecting an enduring mistrust among euro area members. Obviously, if the single currency increases the taste for political integration towards a fully-fledged federal structure, a different and more efficient public finance system could be devised": M. Buti, S. Eijffinger and D. Franco, 2003, op. cit., p ii.

Financial Globalisation and Financial Market Integration in Europe: Challenges Ahead for the European System of Central Banks

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The following is a summary of the presentation made at the SUERF seminar. The presentation was in three parts.

The first part describes the broad environment in which financial markets operate today both worldwide and in Europe. Several elements enabled the impact of the 1999 crisis: to be minimised. First, banks' equity endowment was significant; second, risk transfers were efficient and third, both the Fed's and the ECB's reactions were adapted to the situation. As for today, the situation is far from being plain. In particular, questions arise about the treatment of derivatives. Moreover, one can wonder what will be the likely costs of the cuts in US interest rates.

A key issue is whether financial globalisation is leading to a more, rather than a less, crisis-prone financial system? There are several *pros* and *cons* in this debate, and the overall conclusion is that the jury will remain out on this question for some time to come. The point is that in the present environment if a crisis were to erupt in one part of the world it could spread more swiftly to the rest of the world, and could take on more globally damaging proportions than hitherto. To prevent this happening, or to fight an emerging systemic crisis, well organised cooperation needs to be reached among the key monetary authorities of the world. We have, then, to consider the fact that Europe has embarked on a process of financial integration, which is already well advanced in some areas (such as the inter-bank market or the government debt market) but much less in others (such as cross-border bank mergers). There is no doubt that the process will continue and possibly even accelerate. This implies that a local crisis could easily have Europe-wide ramifications, and would therefore have to be handled accordingly. And, since Europe is a significant part of the financially globalised world, its authorities will have to speak with one voice in any "global" policy co-ordination.

The second part of the presentation discusses, at the level of general principles, the role of Central Banks in crisis management and crisis prevention. As regards crisis handling, their role does not appear to be highly controversial: they should provide liquidity to the system as a whole, and should ensure the proper working of the payments system. They should not be called upon to take on credit risks by lending to banks that are, or are about to become, insolvent. "Bailing out", which amounts to putting at risk taxpayers' money, should be a government responsibility. Central banks may give a helping hand in organising rescue operations involving banks, but even here they would be well advised to do this under government guidance.

While the intervention domain of central banks is well established when crisis risks are clear, the behaviour to adopt as regards prevention is more blurred. Since banks are the providers of liquidity to the rest of the financial system, and are at the core of the payments system, the main task of crisis prevention is to rein in the crisis-producing proclivities of banks and to ensure that they possess crisis-resistance capabilities in case of "external" shocks. There is no consensus on whether the prudential supervision of banks should be a central banking responsibility or whether it should be handed over to a specific organisation, more or less under government control. In this regard, we can observe different approaches around the world. I do believe, however, that even when a central bank is not entrusted with operational supervisory responsibilities, it should be institutionally involved, in one way or another, in banking supervision. There are two good reasons for this. No one has ever been able to establish a crystal clear distinction between micro- and macro-prudential responsibilities; equally, in practice it is well-nigh impossible to define when crisis prevention stops and when crisis management begins. The absolute minimum is to ensure a free flow of information among all the participants responsible for maintaining financial stability.

Third, I voice some – moderate – concerns about our current institutional arrangements in Europe. These concerns derive from the observation of three peculiarities of our arrangements. One is this fact that some of the members of the ESCB have operational responsibilities for bank supervision, while others have not. This does not help to define constructively the role to be played by the ECB, to put it mildly. Homogeneity would not solve all the problems, but it would help. Second, the UK is not part of the Eurosystem, while London is Europe's largest financial centre. Third, and perhaps most important, neither ECOFIN nor the Eurogroup of finance ministers seem to possess the institutional simplicity which would endow them with a capability of acting, in the case of a crisis, with speed and clout. EMU stands for Economic and Monetary Union; but while the "M" leg of EMU is well organised and solidly established, the same does not apply to the "E" leg. This asymmetry is unhelpful – but perhaps not more than that – when it comes to designing the optimal macroeconomic policy mix for the euro area as a whole. It could however lead to more serious problems in a situation of systemic crisis when smooth and efficient cooperation between the ECB and the finance ministries becomes an absolute requirement. And the success of any such cooperation critically hinges on cooperation among governments.

Questions / discussion:
a– About the communication between finance ministers and central banks:

The presidency of the Council of European Union, which is only 6 months long, seems too short to develop an efficient organisation of the communication with monetary authorities.

b– About a unique economic decision centre at the European level

As has already been said, decisions have to be immediate. One necessary condition for this is the non-multiplication of decision centres. Whereas there is only one decision centre for monetary policy within the Eurosystem, this is not the case as regards economic policy. The point is to define precisely who is to take the decision and when, knowing that a communiqué is not enough in a crisis context.

c– About the central bank responses to variations in asset prices

If asset prices were to be stabilised by central banks, serious moral hazards could arise which could lead to hazardous and harmful behaviour. Actually, asset prices cannot be handled in the same way as the inflation rate is. The public mind might react badly to the intervention of the central banks in order to stabilise asset prices. However, if monetary policy does not want to fight bubbles, who is to do something against these?

How to complete the Integration of the European Financial Market

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We heard from a previous speaker how the vision of a single currency for Europe matured over time. It took the duration of a generation to make it acceptable. The single currency is today a reality, a structural feature of the European Union, part of the "*acquis communautaire*". This is the absolute truth, even though a few of the 15 member countries continue to keep their own currency. Joining the euro area or not is their problem, it is not a problem for the euro. The euro has sufficient economic basis. Their absence is disappointing only to the extent that it reflects a reluctance to foster European integration.

The euro being our companion for the foreseeable future, the question posed in 1998 was: what comes next? The answer was obvious to many: give the euro an efficient domestic market. This could be seen as a mere completion of what had just been done. It appeared also as a further step in the construction of a true Union in Europe. Economists added the more sophisticated, but essential and convincing argument that an integrated, in a sense single, capital market would be more efficient, i.e. more liquid and with lower transaction costs, than the co-existence of national markets, thus allowing the optimal allocation of capital.

From the start, the EMI-ECB organisation set up a quasi perfectly integrated interbank market, the network of central banks providing for the transfer of central bank money in real time all over the Union. However this did not encompass retail payments, and the integration of the securities and derivatives market proved to be much more difficult. In the latter case, political resistance was a relatively minor factor, as transfers of sovereignty were less than in the case of monetary unification. On the contrary, technical complexity, as well as the vested interest of market participants who do not care too much about a global regional project, were – and still are – genuine obstacles.

Indeed, progress is being made with the Action Plan of the Commission on financial services and the reform of the decision-making process, following the proposals of the Wise Men led by Alexandre Lamfalussy. However, there is still a long road ahead. Let me make four comments on this issue. The first one will consist in analysing more carefully what we are aiming at. The three others will focus on three different parts of what should be done in my view: legal issues, regulation and supervision, and finally the central securities depository function.

1. The Objective

The objective is to create a single domestic capital market which would work efficiently. What do we mean exactly?

It cannot be a market proper to the euro zone. It must cover the whole Union. After all, London may be seen as one of the main financial centres of the euro zone, as all financial entities located in the euro area, which matter on markets, have an investment banking arm in London and do business in euro there.

Neither is it a market specific to EU issuers as non-EU issuers are kindly invited to come, whereas some EU companies prefer to issue abroad, at least partially. Similarly, it is not a market proper to EU investors.

The purpose is, indeed, in an open world, to attract, maintain and develop the business of financial services within the limits of the European Union. In a sense, this is a pure business approach.

In theory, the conditions are clearly identified. In order to cut transaction costs, we must establish a level playing field on which banks, brokers, exchanges and clearing houses can compete in providing services. This requires a single set of rules of the game and a borderless architecture of the infrastructures necessary to transfer not only money, but also securities and contracts. It would result in an increased liquidity of the financial market. I now see this task as being more in the spirit of the Single Act than a follow-up of monetary union.

Vis-à-vis non-residents, success would bring fees to the EU and create jobs, as has already been the case in London in the past. At the same time, on the rebound the euro would become more attractive. Such a market would be part of the attractiveness of Europe and therefore would increase the use of its dominant currency. All residents would benefit from a liquid and cheap capital market, according to the reasoning we had in mind in 1998 and which is still relevant.

It should not be a market restricted to the euro as such, i.e. to financial assets and contracts denominated in euro. It should, indeed, be a market for all securities and derivatives traded within the limits of the European Union. We would certainly be happy to see the entire world preferring the euro to any other currency (although it would probably create a monstrosity), but in the absence of exchange control, the choice of the currency remains open.

As ecumenical as one might be, one cannot however ignore the existence of a tight technical link between this project and the monetary status of the European Union. I see it as follows: within the Union, deals on securities are settled through accounts on the books of resident financial intermediaries which, in turn, hold central bank money on their own account at the central bank. Non-resident intermediaries, not holding directly central bank money, may act through a European correspondent. There would therefore be no difficulty in requesting a settlement in central bank money before any transfer of securities at the level of the central depository agency, either national or European. It is then enough to separate the central depository function, the so-called notary function, where it is associated with commercial services, and to build a bridge with the central bank (either the Eurosystem or the central bank of a country with a derogation). This would be the basis for a European system of delivery versus payment which would be simple, safe, open to all users trading securities in euro or another EU currency. I will come back to this in my fourth remark.

In a nutshell, we should have a business approach but, at the same time, take advantage of the facilities provided by the well-established integrated interbank market to better satisfy the needs of our European compatriots.

2. A European Legal Framework

The diversity of legal frameworks within the European Union is the main obstacle to a true integration of the financial market. This subject, however, is not intensely dealt with. There could be several explanations. One is the nationalistic reaction: our civil and commercial laws are an expression of national culture. Another could be the fear that a comprehensive reform would change many aspects of private life, many habits or traditions, and would jeopardise vested interests, although it is to some extent possible to adopt grandfathering clauses. Finally, the complexity of the whole thing is clearly a disincentive.

As a result, the principles and the architecture of national law are seen as being structural. Diversity among legal regimes is seen as unavoidable. Efforts to harmonise the principles which are the basis of civil laws, company laws, contracts, ownership, etc, are weak. Experts are not many to feel committed. There are very few think tanks working on it.

Some hope might be given by the growing number of Directives adopted at the European level which are converted into national written rules. However, not only is this process slow, but it is also disappointing in two respects. First, national law can complement Directives with additional provisions, the Directive being in this case no more than a minimum constraint. Second, provisions deriving from Directives are sometimes just exceptions to the national regime. They apply to specific operations, without changing the fundamental national law which applies in all other cases. A good example is the Directive on collateral which applies to interbank operations and not to all contracts. Indeed, we should go to the roots of legal provisions in domains related to business.

An apparently good idea, which is now promoted, is to elaborate a sixteenth legal regime, although if it remains optional there is a risk to increase and not reduce complexity.

The last report of the Giovannini group has listed a number of legal issues which require an urgent harmonisation, with a view to improve the functioning of the capital market, such as:

- who is the owner or has the right to behave as the owner (in this case, of securities);
- what restrictions to the right of ownership can be opposed to third parties;
- date of change of ownership following a transaction (important for the trading and delivery industries);
- company laws (important for issuers to act on a level playing field);
- bankruptcy laws (important for investors and the delivery industry).

I should add practical matters mentioned to me by lawyers. These matters have to do with how to go to court, the degree of transparency of the files to be provided to it, the time-length of the procedure.

The European Commission has recently acknowledged the need to harmonise basic laws which matter in economic and financial areas, such the laws on contracts. This may be promising.

To conclude in two words and be constructive, let me say that, although no global solution is to be found tomorrow morning or the day after, we lack of what the Werner report has been to monetary union. I therefore suggest that the Heads decide to lock up a small number of prominent experts with a clear mandate until they have drafted a document including concrete proposals on how to move forward.

3. Regulation and Supervision

The fears inspired by the consolidation of national regulatory and supervisory authorities are exaggerated. Considering first the regulators, I do not deny the value of the proposals made by the Wise Men under the chairmanship of the wisest of them, Alexandre Lamfalussy. I see these proposals as a useful step, which does not prevent to reach an upper level of integration. In the field of securities transactions, nevertheless, it remains to be seen if the new organisation will have given any impetus to the implementation of the Action Plan on financial services. I also hope that controversial issues will not be transferred to level 3, i.e. will just not be harmonised.

I personally would see great benefits to be gained from the creation of a new European System made of national teams ensuring the interface with local financial institutions, and a central body constantly comparing principles and practices, reporting on differences and inconsistencies, making proposals. Of course, I dream of the Secretariat, in this case, of CESR, becoming a European Financial Institute. Better sooner than later.

Should there be three networks, for securities markets, banks and insurance companies or only one? This question has been analysed in an Italian paper at a recent SUERF seminar. Given the blurring of frontiers between the three categories of activities, the intrusion of companies belonging to one sector into another sector, directly or through subsidiaries, I would favour a single organisation with specialised departments and an internal structure ensuring close co-ordination.

Considering now supervision, and to save time, I would just add: follow the same path.

4. Cross-border Transfers of Securities

Cross-border transfers of securities should be done as if there were no borders within the European Union. In particular, cross-border trades should not be subject to extra-costs, as is the case today. We know that some extra-cost is related to the legal heterogeneity of the EU market. This is why, in my second comment, I recommended to work more intensely and concretely on these matters. Besides this, part of the cost is due to the diversity and complexity of the delivery arrangements. The delivery of securities involved in cross-border trades is done through the central depository agency in charge of this type of securities. So far, there is one in each country plus two taking care of international issues: Euroclear based in Brussels and Clearstream in Luxembourg. The two latter, contrary to national CSDs, have mixed this activity with commercial services such as clearing and the financing of negative cash balances. Although some progress is being made by adopting common electronic standards in order to ensure some degree of interoperability, there are still different information systems, diverse conditions for giving access to the CSD, various ways of squaring cash balances.

This is why it seems necessary to many issuers, investors and intermediaries that a uniform architecture prevails across Europe. I fully agree that most financial services should be left to market players competing together: trading, clearing, financing, custody. On the contrary, the notary function should be separated from the rest, located in a single system, which could be decentralised or not, but would in any case provide equal access to all players. With the co-operation of the central banks, it would be possible to link the final delivery with a settlement in central bank money, as explained at the end of my first remark. Resident intermediaries may borrow central bank money on the interbank market or even directly from their central bank through collateralised repos, as has been done in France, fir instance, for years. Non-residents would have to use correspondent banking with resident financial institutions, as is they do for all other categories of payment.

How could we get there? On the one hand, the linkage between the central banks and the settlement in central bank money might be associated with the reform of TARGET. On the other hand, can the establishment of a single CSD be left to market forces?

Some concentration has already occurred. In particular, Euroclear has taken over six national CSDs. However, Euroclear is not the sole big player in this field. There is the risk that it will take a long time before it covers all member countries of the Union, if it ever happens. In addition, there is a need to obtain that the CSD function is isolated within the two ICSDs. I therefore feel that pressure should be put on these various institutions for them to move faster and in the right direction. May I recall that the first gatherings of CSDs and ICSDs were organised by the European Monetary Institute around 1997, under the chairmanship of Mr Hartmann, a member of the Direktorium of the Deutsche Bundesbank, at that time in charge of the Working Group on Payment Systems. As a result of this initiative, these institutions have set up their professional association (i.e. the European Central Securities Depositories Association – ECSDA).

The architecture I have described has prevailed in the United States, where the DTC is the sole central depository agency. There is the risk that, should we miss the train, the biggest players in London, most of them being from an American origin, could circumvent the difficulty by organising something similar for their own needs. Unfortunately, this new product would not be tailored for the size and shape of the European Union.

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I realise that several remarks I made might be shocking for some bankers, exchanges, custodians and lawyers specialised in the resolution of international conflicts. Building up a single market implies more competition, lower costs, less conflicts, no legal or fiscal arbitrage. It is in the general interest.

The euro area, or even better the European Union, should from now on be considered as the domestic market of the euro and more generally as a single financial market. Cross-border activities should only mean exchanges with other economic areas in the world.

Optimal Currency Areas and Implementation of Economic Policies

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Ladies and Gentlemen,

It is a great pleasure for me to speak at this anniversary seminar, not only because of the topic you have chosen – European financial and monetary integration – but also on account of your members. You are contributing to the vitality of SUERF, which is unique in nature: a forum bringing together "practitioner" economists and academics who share one of the most stimulating areas of research: financial and monetary economics in Europe.

I would like to salute the vision of the founders of this association, and its successive Chairmen, who have enabled SUERF, over the past forty years, to elicit research, publications and seminars on essential areas prompted by developments in the European integration process and the financial industry.

In 1997, I had the honour of speaking at the SUERF Lecture held at the University of Copenhagen. I discussed prospects in the run-up to the euro, several months before its introduction. Now that the euro is in circulation, you are affording me the opportunity to further my thoughts. Today, I wish to make a number of comments on the interactions between the degree of optimality of a currency area, and the implementation of economic policies.

I will now discuss three ideas:

1) **The correlation of business cycles between euro area countries reflects both one of the conditions and a consequence of our currency area's "optimality", which must be consistently ensured**

2) **In an evolving environment, fiscal policy must perfectly fulfil its function in the event of asymmetric shocks;**

3) **Structural policies must promote the endogenous forces to strengthen the euro area.**

I – THE CORRELATION OF CYCLES IS ONE OF THE CHARACTERISTICS OF THE "OPTIMALITY" OF OUR CURRENCY AREA, BUT IT IS AN ACHIEVEMENT THAT MUST BE MAINTAINED

Three essential foundations for characterising currency areas were highlighted in studies by Mundell and MacKinnon in the early 1960s: the integration of financial, product and services and labour markets.

The integration of the product market is currently the most apparent foundation of the robustness of our monetary union. **A high degree of trade interdependence links euro area countries to each other. For example, half of the external trade of France and Germany consists of intra-euro area flows[24]; as a weighted average for the euro area this proportion stands at 50%[25].**

Around two-thirds of the imports and exports of Central and Eastern European countries (CEECs) are carried out with the euro area. Forty percent of this is intra-industry trade, compared with 50% for intra-euro area intra-industry trade. These data undeniably confirm the dynamic integration process.

Trade interdependence in the euro area has developed between relatively diversified economies, and in particular in the form of intra-sectoral trade. Consequently, over the past forty years, a tendency towards the specialisation of sites has emerged within each economy, leaving economies with a fairly large degree of sectoral diversification.

We do not have sufficient hindsight to determine the extent to which this model of interdependence via intra-sectoral trade will continue to prevail, or whether increased sectoral specialisation will develop. I tend to believe that the second hypothesis is the most likely. This issue must be borne in mind in all forward-looking studies on the conditions for enhancing the "optimality" of the euro area, and I will come back to this point in my third series of comments.

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[24] 2002 data for France: exports + imports as a % of GDP = 26.3%, of which extra-euro area = 13.2%. Same year for Germany: 34% and 19.6% respectively. Figures from the two previous years are of a similar order of magnitude.

[25] Average over the period January 2002 – August 2003.

In the current environment, the correlation coefficients of the business cycle are high for industry – over 0.8 for France and Germany for example – and the correlation is "contemporaneous". The European services cycle is however less marked and more fragmented between countries. For Central and Eastern European Countries, the coefficient is 0.45 on average for the industrial output index, with a broad dispersion of individual situations.

However, **trade interdependence** is not in itself sufficient to guard a Monetary Union against the asymmetric shocks affecting the area's different economies**. The correlation of cycles also closely depends on the degree of convergence of economic structures and national economic policies**.

This **degree of convergence** may be assessed to a certain extent by taking into account rates of inflation. I wish to stress that euro area monetary policy has a euro-area-wide price stability objective and does not act directly on national inflation differentials. Yet, these inflation differentials may reflect, on the one hand, the degree of homogeneity of economic structures and, on the other, an ability to absorb asymmetric shocks within the area. They therefore constitute a useful indicator. At present, the average annual standard deviation of inflation (measured by the Harmonised Index of Consumer Prices) between euro area Member States is comparable to that prevailing between the 14 main metropolitan statistical areas of the United States. This is a remarkable result considering that monetary union came into force in 1913[26] in the United States. Admittedly, inflation differentials between euro area countries are not negligible, but this is not specific to our currency area.

The homogeneity of the euro area also relies on the similarity of financial structures between countries and the integration of financial markets

The relative homogeneity of **financial structures** – illustrated for example in the "Report on financial structures" published by the European Central Bank in 2002 – shows that the transmission channels of monetary policy are also fairly comparable, with the interest rate channel playing the prominent role in all countries and the bank credit channel a less predominant role [27].

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[26] Actually the Federal Reserve Act of 1913 sets the framework for a single monetary policy. However the founding principle of a monetary union dates back to the Constitution that included a clause forbidding States to coin money and emit Bills of Credit after 1787.

[27] These were the findings of a series of studies coordinated by the Eurosystem Monetary Transmission Network, and published in the ECB Working Paper Series No. 91–114.

As regards **financial markets**, since the introduction of the euro, reforms for completing the integration of infrastructures (trading platforms, delivery-versus-payment systems, central securities depositories), and procedures and standards have been gathering momentum. The “Lamfalussy method”, in application as of 2001, has now been enhanced by the rapid implementation of the European Commission’s Financial Services Action Plan.

In addition to an already highly integrated money market, whose turnover and homogeneity are comparable to those of the US market, – even though the volumes traded within the individual segments are not entirely analogous on these two major markets –, the rapid integration of markets will no doubt foster increased depth and liquidity, which will naturally strengthen the euro area’s capacity to absorb asymmetric shocks: these shocks can be spread over a greater number of counterparties, with a much better exploitation of arbitrage opportunities, in particular intertemporal trades.

HOWEVER, THE DEGREE OF LABOUR MARKET INTEGRATION IS LOW AND LABOUR LAW IS A SOURCE OF RIGIDITY AND HETEROGENEITY

Measuring the integration of the labour market is not an easy task, given the large number of variables to be taken into account. I will cite three considerations:

- first, the dispersion of unemployment rates: different composite dispersion indicators show that there is a higher degree of dispersion in the euro area than in the United States, but the differential is not however very significant[28]. Furthermore, in the United States there is a complex and dynamic economy and, at times, some states may be booming while others are in the process of redevelopment, which temporarily generates substantial unemployment differentials;
- second, differences in labour market structures. For example, according to various estimates by the European Commission, the relative weight of public sector employment is twice as great in some countries as in others: for example, 14% in the Netherlands, 17% in Germany, and over 30% in

[28] Calculations for the 11 countries (excluding Luxembourg) in the euro area and the 52 American states, over the period January 1993-July 2003: average of the standard deviation to average unemployment rate ratios: 0.18 in the United States and 0.20 in the euro area. Min-max difference ratio: 0.4 in the United States, 0.6 in the euro area (and 0.52 excluding Ireland). Taking different reference periods, the dispersion is sometimes lower in the euro area than in the United States, in particular at the period-end. Among other conclusions, it can be deduced from these results that geographical mobility is not yet so developed in the United States as to level out, in the short term, unemployment rate differentials between regions.

France and the Scandinavian countries. According to another indicator, the relative weight of the "informal sector" appears to vary between around 5% in countries where the informal sector is the least developed and 20% in those where it is traditionally the most extensive[29];

– third, institutional obstacles. These include the highly incomplete mutual recognition of diplomas and qualifications, differences between unemployment insurance regimes, and the lack of transferability of rights acquired in national health and pension systems.
– Moreover, the complexity of labour laws in many countries[30] suggests that rapid progress in this area could only be achieved through strong political will. It is this same political will that lent credibility, during the 1990s, to the objective of European Monetary Union. Without doubt, as regards European unification, major labour market reforms are still necessary, and an association such as SUERF could contribute greatly to enhancing and disseminating the economic arguments underlying the importance of this issue.

In sum, the euro area's solidity stems from:

– an already highly integrated product and services market;
– integrating financial markets;
– relatively homogeneous structures – excluding labour markets;
– the combination of these three aspects, which are reflected in the correlation of the business cycle.

The euro area is however still young and its capacity to absorb asymmetric shocks has not yet been fully put to the test. Moreover, the euro area, just like any other currency area, is a permanently evolving entity and vigilance is required with regard to its position in terms of optimal currency area criteria. This leads me to two other series of comments:

– In order to become resilient to such shocks the euro area must adhere to the principles of sound fiscal management ensuring that national budgets have enough flexibility to withstand asymmetric shocks;
– So as to preserve and enhance the optimality of the area regardless of medium-term endogenous developments, appropriate structural policies, in particular concerning the labour market, must be initiated.

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[29] According to a compilation of estimates by the European Commission – 1997

[30] See OECD "labour market regulation indicator": in 2002 the five major euro area countries are ranked between 13th (Netherlands) and 22nd (Spain), the United States and the United Kingdom are in first and second place respectively. (According to this indicator, countries with the least restrictive labour laws rank highest).

II – FISCAL POLICY MUST PERFECTLY FULFIL ITS FUNCTION IN THE EVENT OF ASYMMETRIC SHOCKS

Regarding fiscal policy, the establishment of Monetary Union was accompanied by a very substantial strengthening of governance: the Stability and Growth Pact and the Broad Economic Policy Guidelines.

I believe that the Stability and Growth Pact is an important element in the construction of Economic and Monetary Union.

It satisfies the two questions that were most frequently asked at the outset of Monetary Union, and which remain entirely topical:

- without a single fiscal policy, how can there be a balanced euro area-wide policy mix?
- in the event of a shock affecting one particular economy, what would be the contribution of the fiscal channel without a federal budget?

Indeed, we do not have a federal budget – the level of common resources, standing at around 1% of GDP is clearly not tantamount to a federal budget – but the Stability and Growth Pact makes it possible to keep national fiscal policies balanced within adequate bounds of flexibility in order to preclude any dysfunction of our Economic and Monetary Union.

Naturally, we can question the level at which the criteria established for the euro area are set, such as the 3% of GDP budget deficit limit.

I have had the opportunity on numerous occasions to give my point of view on this 3% limit, introduced in my country in the early 1980s – well before the start of negotiations on the Maastricht Treaty and the Stability and Growth Pact –, on the basis of a well thought-out analysis, according to which unsustainable financial constraints cannot be passed on to future generations.

In the last part of your seminar, you discussed the theoretical analyses solidly underpinning the principle of a fiscal pact in monetary union, so I will refrain from repeating them. But simply allow me to recall that, irrespective of the economy, because of rational expectations there is a level above which the traditional Keynesian effects produced by an increase in public spending and a rise in deficits are more than offset by what I would term Ricardian effects. In other words, you lose more in terms of household and business confidence

– with agents increasing their savings and reducing consumption and business investment – than you gain in terms of "Keynesian spending".

There are therefore limitations to any effective action and these limitations must be subject to an economic assessment and, ultimately, to common sense. In Europe, a 3% margin was chosen, as a margin of a 3% deficit vis-à-vis a balanced budget is sufficient to withstand the vast majority of cyclical downturns.

As regards the second criticism, that levelled at asymmetric shocks, we consider, with the Stability and Growth Pact, that budgets must be balanced or in surplus in normal times, in order to maintain essential reserves for difficult periods. These stabilising reserves may be drawn on either in the event of a slowdown affecting the area's economy as a whole, or for national budgets in the event of a shock impacting on a particular economy. As long as the criteria of the Stability and Growth Pact are met, it is no longer necessary for there to be a federal budget in order to have a consistent "Economic and Monetary Union".

It is worth stressing that the solution put forward in Europe includes a mutual surveillance aspect, which goes far beyond the policy framework implemented in mature federal organisations, such as the United States, Germany and Switzerland. In the American states, the German Länder and the Swiss cantons, fiscal decisions are taken in a more decentralised institutional framework[31].

In addition, the application of the principle of subsidiarity in fiscal matters can promote the emergence and subsequently the generalisation of "good practices". This is an essential process which enables each State to take greater advantage of its euro area membership.

To sum up, we absolutely need a device such as the Stability and Growth Pact, because otherwise, we would be in a fundamentally unstable situation and the criticisms formulated by the Eurosceptics in the 1990s relative to the unlikelihood of the euro area's viability, would be founded.

I would now like to make a few last comments derived from the fact that a monetary union is an evolving organisation underpinned by endogenous

[31] In Germany, an internal stability pact was adopted in March 2002 by the Federal Government and the Länder, which included measures to prevent slippages on the part of the latter in their public finances, but did not formally lay down sanctions.

dynamics. I will refer to the work by Frankel and Rose (2000) on the endogeneity of monetary unions, and to the New Economic Geography models in the wake of Paul Krugman's work (1991).

III – STRUCTURAL POLICIES MUST PROMOTE ENDOGENOUS FORCES TO STRENGTHEN THE EURO AREA

First comment: a monetary union is an evolving organisation underpinned by endogenous dynamics.

Frankel and Rose show that the properties of a monetary union change over time. Monetary union leads to an increase in trade flows between member countries and a greater degree of trade openness (also vis-à-vis the rest of the area), due to the elimination of exchange rate risk and the fall in transaction and information costs. It is therefore expected to generate greater incentives to further specialisation. Economic cycles, which are largely synchronised between countries on account of the relative diversification of euro area economies, could become more divergent. This movement could result in a lower degree of optimality on this specific aspect.

How will this specialisation evolve in the future? The second half of the 20th century was characterised by the development of intra-sectoral specialisation, reflecting, to a large extent, companies' international expansion strategies. Indeed, multinationals sought to raise their industrial efficiency through specialised production sites, which would generate economies of scale. At the same time, their choice of location was essentially determined by the need to be close to their customers. National economies generally retained a relatively sectorally-diversified productive structure, while benefiting from productivity gains.

However, this specialisation pattern could change for a number of reasons:

– the "proximity constraint", which previously governed location choices, is loosened on account of lower transaction costs resulting from monetary union – as well as from economic union. At the same time, heightened competition arising from greater market integration and better price comparability, reinforces the "efficiency constraint" and the incentive to develop economies of scale;
– in a high-tech economy, the unit value of investment projects tends to rise, thereby increasing the necessity of taking advantage of an environment

generating externalities, such as a dense network of sub-contractors, the proximity of research institutes, and more generally, the proximity of all of the services to be found in a complex economy.

These developments suggest that new location strategies are needed and the host of studies on the "agglomeration effects" highlight a striking phenomenon, which deserves to be given greater attention. While complete specialisation is achieved when relative endowments of factors of production are equalised, according to the classical theory of international trade, these agglomeration effects are likely to amplify the concentration dynamics[32]. We should take this element into account when considering the future of EMU.

Second comment: the heightened specialisation and agglomeration dynamics represent more an opportunity than a risk for the euro area.

If these changes take place progressively, Europe might evolve from being a union of rather diversified economies to what would look like a union of specialised regions. At the macroeconomic and monetary levels, economic cycles may differ increasingly between regions. Regions that fail to attract certain activities at the peak of their cycle could witness a decline of their tax base, to the benefit of others. The gap between advanced sectors (which benefit from economic convergence and the spread of knowledge) and traditional sectors is likely to widen.

The concept of "region" used here does not mean that the concept of "State" will become less relevant in the future, especially given the role played by sovereign States, which still underpin the European construction process and define economic policies. It seems more realistic to consider Europe as a combination of two spheres, the first one reflecting the regional economic geography and the second one the national political geography, the interaction of which would influence the pattern of specialisation.

However, in terms of opportunities, increased specialisation would result in productivity gains, and, consequently, in a higher growth potential. Furthermore, the agglomeration dynamics would lead to the clustering of diversified competencies. It might seem anachronistic, in the age of the internet, that geographical proximity represents a clear advantage in terms of spreading knowledge. Yet, this appears to be the case. In particular, "accidental innovations" – innovations which stem from the accidental

[32] According to Krugman's centre-periphery model.

confrontation of ideas from different disciplines – are more likely to occur. It thus seems that developing a knowledge-based economy – one of the objectives of the Lisbon Strategy – will inevitably lead to a strengthening of these agglomeration dynamics.

Third comment: in addition to serving as automatic regulators, structural policies have a major role to play and must, therefore, fit into a European framework.

Of course, agglomeration effects are and will continue to be automatically regulated. Indeed, in regions where such dynamics are at work, costs tend to increase on account of real factors such as pressure on land prices and transport infrastructure bottlenecks, thus enhancing the relative attractiveness of other regions. If the latter are not able to rapidly expand their supply, their window of opportunity might close. A vicious circle of economic degeneration may then be set in motion.

Structural policies can facilitate this automatic regulation. This suggests that we still have to make considerable efforts to improve the coordination of economic policies within the euro area. Indeed, I believe that the single US economic policy also accounts for the fact that specialisation in the United States is widely accepted. In the euro area, the coordination of fiscal policies and structural policies has not yet reached the optimum. This represents a huge project in terms of strengthening the euro area. Although the Treaty itself is not as explicit and exacting regarding structural policies as in the case of Europe's monetary, fiscal, competition and trade policies -which can already be described as "federal" – we need to place greater emphasis on this part of the economic sphere that covers all structural aspects. I here refer to the labour markets, which are, in my opinion, a weak point as regards the euro area's optimality but which are bound to be a more crucial determinant of its degree of optimality in the future.

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I would like to draw **three cautious conclusions** from my previous considerations:

- first, the structural changes that are likely to occur in the medium term will lead businesses, banks, regional authorities and the State to develop **new**

strategies to take advantage of the increased specialisation and agglomeration effects. These strategic orientations will in return shape the structural changes which I believe will be very profound.

- second, by setting a medium and long-term price stability objective, which serves as an anchor for economic agents' price expectations, the monetary policy conducted by the ECB Governing Council creates the appropriate conditions for **making rational economic choices, in the absence of which strategies would lack substance**. Economic policies, in particular, are devised in a stable environment in the medium to long term, conducive to entrepreneurial risk-taking and an optimal use of private and public funds across a very large continental area. In this respect, I would like to point out that the ECB's recent clarification of its monetary policy has highlighted that the euro area's monetary policy is designed to solve problems occurring over an 18 months-two year time horizon but also those occurring over a medium-long term horizon.
- finally – and this remark is at the heart of today's debate – economic and monetary union is a dynamic concept – in the sense that it is underpinned by continuous endogenous structural changes – and not a static one. It is underpinned by profound long-term structural transformations: greater division of labour in a large economy, agglomeration effects and specialisation effects.

The progressive move of every euro area economy towards a possible lesser diversification must gradually go hand in hand with stronger European economic governance, and in particular, with ever closer coordination of structural reform policies. These policies are already required in each individual country, and even more so, for economic reasons, at the level of the euro area and the EU as a whole, comprising 15 members today and 25 very shortly.

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