THE OUTLOOK FOR EMU

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At the start of 1999, eleven members of the European Union (EU) entered the third stage of Economic and Monetary Union (EMU). Their individual currencies became "expressions" of the euro, the single currency of the monetary union, and the new European Central Bank assumed responsibility for monetary policy in the euro zone. The Stability and Growth Pact took full effect, reinforcing the fiscal provisions of the Maastricht Treaty; members that run "excessive" budget deficits are required to reduce them and subject to fines if they fail to comply.

Three of the preceding papers express grave reservations about EMU. Kregel is deeply concerned about the ability of the EU countries to reduce unemployment under existing institutional arrangements and the commitment to a "culture of stability" embodied in the Maastricht Treaty. He advocates a radical reform of wage-setting and labor-market arrangements—that the governments of the euro-zone countries should devise institutional arrangements under which they can function collectively as employer of last resort. A relaxation of the stability pact will not suffice if Germany, the largest euro-zone country, continues to pursue austere wage-setting policies.

The next two papers are even more antagonistic to EMU. Smithin believes that international institutions, ranging from the IMF to the ECB, have achieved global hegemony by propagating a fallacy. The globalization of financial markets does not, in his view, deprive national governments of the ability to pursue independent policies. Adherence to that doctrine, however, has transferred the locus of policy-making authority from national governments to international bureaucracies and substituted market discipline for democratic accountability. By retaining control over its own currency, he argues, a government can pursue an independent monetary policy, because it can manipulate the risk premium. It can therefore pursue its own social and fiscal policies. By implication, EMU is a big step in the wrong direction, away from national autonomy and democratic accountability.

Parguez takes a similar tack but goes further. The Maastricht Treaty, he argues, will make it impossible for governments to finance budget deficits, because the ECB will not buy government bonds, which will then lose their liquidity. The euro, he says, will be a "pure-private" money created at the behest of private agents obliged to comply with the targets set by the ECB and sustained by the expectations of the financial markets. Furthermore, he argues that the euro will be burdened by a logical contra-

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diction. The monetary theory underlying the Maastricht Treaty implies that the euro will derive its value from the willingness of investors to hoard it, not use it, so it will have value only if it is not used as a means of payment. This is a strange doctrine—which may perhaps derive from confusing investors' demand for euro-denominated assets to hold or hoard with their demand for the euro itself as a means of payment. It is difficult, in any case, to understand why the same contradiction does not hold in respect of all other currencies, including the dollar.

The fourth paper, by Lemmen and Goodhart, is far from being antagonistic to EMU, but casts doubt on the forecast by euro enthusiasts that monetary union will bring about the complete integration of markets for government debt within the euro zone. It suggests that cross-country differences in sovereign default risk are apt to persist and that, as a result, the government bonds of the euro-zone countries will be less than perfect substitutes. Hence, euro-zone markets for government debt may continue to be less liquid than the corresponding markets for U.S. government debt. If Lemmen and Goodhart are right, Portes and Rey [1998] may be wrong in predicting that bond-market integration will greatly promote the international use of the euro.

This note will also raise some concerns about EMU. They derive from recent developments and from the risk that some unresolved problems may come to the fore and generate tensions within the European System of Central Banks (ESCB). It will argue, however, that EMU is not likely to collapse, because the costs of exit are very high.

THE GOOD NEWS

Any assessment of the outlook for EMU must start by taking note of a remarkable achievement. EMU has actually happened. Think back to the winter of 1992-93, after the currency crisis that forced Italy and Britain to drop out of the exchange-rate mechanism of the European Monetary System. There was, at that point, profound pessimism about the outlook for EMU. Recall the situation two or three years later, when it seemed impossible for Italy, Portugal, and Spain to meet the so-called convergence criteria and would not be ready for EMU by 1999. Move to the start of last year, when there were still doubts about the way in which the convergence criteria would be applied and thus uncertainty about the initial membership of the monetary union. It is, of course, now clear that Helmut Kohl had decided to back a broad EMU and, therefore, a liberal interpretation of the convergence criteria. A strict interpretation and the resulting exclusion of Italy would have impaired the political cohesion of Europe and made it far harder to reach agreement on the difficult issues that must be resolved to permit the eastward enlargement of the European Union.[1]

At the same summit meeting that resolved the membership question, however, a new problem arose. President Chirac held out obdurately against the appointment of Wim Duisenberg as President of the ECB, and the European Council was forced to adopt an unfortunate compromise, inconsistent with the letter and spirit of the Maastricht Treaty. Duisenberg would serve for only four years, not eight, and would then step down to make way for Jean Claude Trichet, Governor of the Banque de

France. To his credit, Duisenberg himself repudiated this compromise in his appearance before the European Parliament, denying that he is obliged to resign after four years. To its credit, moreover, the French government declined to take notice of Duisenberg's statement. But the issue may still surface four years from now, at the mid-point of Duisenberg's term.

Recall one other issue. At the start of 1998, there was still uncertainty about the way in which the exchange rates connecting the participants' currencies would be fixed and those currencies' values in terms of the euro would be set, given the arcane rules and restrictions set out in the Maastricht Treaty. A number of economists predicted exchange-rate instability during the run-up to EMU. The transition to EMU was seamless, however, and the necessary convergence of short-term interest rates was likewise achieved without financial or economic disruption, despite the concerns of those who believed that it would be extremely difficult, given the prevailing differences in economic conditions within the euro zone, as well as the severe turbulence in international financial markets that followed the collapse of the ruble and suspension of Russian debt payments in August 1998. In short, the euro-zone countries and the ECB itself have been skillful and lucky in managing the transition to EMU.

THE BAD NEWS

The smooth passage to EMU, however, has been accompanied by an unexpected change in the political climate. Social democratic governments have come to power in every major EU country, with the exception of Spain. At first, the shift had little apparent effect on the intellectual consensus embodied in the Maastricht Treaty. The Jospin government in France seemed ready to challenge the stability pact and to press for the creation of a "political counterweight" to the European Central Bank. It did insist on the creation of a new informal body, the Euro-XI council, to facilitate consultation among the finance ministers of the euro-zone countries. But it was unsuccessful in its half-hearted attempts to endow the new body with real authority at the expense of the Ecofin Council, the body officially charged with making and coordinating economic policies within the European Union. But the German election has made more difference than all of the previous changes together. The new German finance minister, Oskar La Fontaine, dared to criticize the Bundesbank and even insisted on attending a meeting of the Bundesbank Council to argue his case for an aggressive easing of monetary policy to stimulate growth and employment. He has endorsed an active exchange-rate policy for the euro and a target-zone regime to manage the exchange rates among the key currencies—the dollar, the euro, and the yen. He has suggested—and emboldened others to suggest—that the stability pact should be interpreted more flexibly. Even Carlo Ciampi, a former central banker and currently Italian finance minister, has endorsed this heresy by drawing attention to an obscure passage in the Maastricht Treaty, which says that judgments about budget deficits should take account of the extent to which they result from spending on public investment rather than public consumption.

Central bankers, including Alan Greenspan, were quick to criticize these heresies. They were particularly critical of La Fontaine's views on exchange-rate policy. A formal commitment to exchange-rate stability of the sort implied by a target-zone regime can require frequent, large-scale intervention on foreign-exchange markets, as well as adjustments in relative interest rates. It is thus potentially inconsistent with the commitment to price stability enshrined in the Maastricht Treaty. Under Article 109 of the treaty, the Ecofin Council may adopt "general orientations" for exchange-rate policy, but these guidelines must not be inconsistent with the pursuit of price stability. In 1998, moreover, at the Amsterdam summit, the EU governments agreed that the Ecofin Council would adopt "general orientations" for exchange-rate policy only in exceptional circumstances (i.e., when key-currency exchange rates were egregiously misaligned).

Although the Japanese finance minister has also expressed interest in more formal exchange-rate arrangements for the key currencies, the proposal is not likely to get very far. The U.S. Treasury is utterly unsympathetic, not because it believes that markets are wiser than governments but because it is convinced that intervention should be used sparing, with careful attention to timing and the conservation of credibility. To make a proposal of this sort, however, is to challenge the economic doctrine on which EMU was based—the belief that monetary policy should focus exclusively on price stability, that fiscal policy can make little, if any, contribution to macroeconomic management, and that unemployment in Europe is due mainly to structural rigidities and can thus be reduced only by making labor markets more flexible and reducing labor costs.[2]

These views need to be challenged. Unfortunately, the challenge was been widely viewed as a frontal attack on the independence of the ECB, and the ECB has made matters worse by confusing independence with immunity from democratic accountability. It has been slow to understand that its legitimacy will depend in the long run on its willingness to explain what it is doing, and why, not on the powers and safeguards provided by the Maastricht Treaty.

THE ECB AND THE NCBS

The legitimacy of the ECB will also depend on its ability to speak and behave as a European institution, not a loose confederation of national institutions, and it may have trouble doing that. The main policy-making body of the ECB, the Governing Council, has two groups of members: the six members of its Executive Board, who manage the institution, and the governors of the eleven national central banks (NCBs). Under its Statute, moreover, the ECB is required to make use of the NCBs insofar as possible to execute its monetary policy—which should come as no surprise, because the Statute was drafted by the governors of the NCBs. The governors have, of course, insisted vigorously on adherence to this requirement. When designing TARGET, the new trans-European large-value payments system, they by-passed the ECB; cross-border transactions are cleared through a network of bilateral accounts on the books of the NCBs, not on the books of the ECB itself. Some of them even tried to prevent the ECB from being directly linked to TARGET, which would have made it cumbersome, if not impossible, for the ECB to conduct open-market and foreign-exchange operations for its own account.

At the next stage, moreover, when the Governing Council began to discuss the actual conduct of monetary policy, individual governors addressed themselves largely to economic conditions in their own countries, not to conditions in the whole euro zone. Their natural inclination to do that was, of course, reinforced by the nature of the very first decision they were required to make—choosing the common short-term interest rate toward which they would steer their own national rates in preparation for the introduction of the single monetary policy. Each governor was understandably concerned about the size of the change in the national rate that would be required to align it with the common rate and the effects of the change on that governor's own country. Wim Duisenberg assures us that the governors are changing—that there has been less talk recently than there was initially about economic conditions in individual countries and more attention to the euro zone as a whole.[3] But that may not last. In the run-up to EMU, conditions in the three largest economies, France, Germany, and Italy, were fairly similar. If and when they come to differ appreciably, attention may turn back to the national economies. Furthermore, the governors continue to insist on exercising firm control over the operations of the ECB. Under the Maastricht Treaty, the Governing Council must meet once each month. The Council has decided, however, that it should meet twice each month. And one of the governors was quoted recently as saying that the NCBs must retain their distinctly independent identities, because the credibility of the ECB derives from the credibility of the NCBs. All of this will change eventually. The next generation of the governors will come to the Governing Council without having served before as the heads of autonomous national institutions. But it will take time.

THE PROBLEM OF INTRA-EMU IMBALANCES

The federal structure of EMU, like that of the Federal Reserve System in the United States, poses a peculiar problem. What will happen when one member country runs the equivalent of a balance-of-payments deficit with another member? When households and firms in one Federal Reserve district in the United States run a payments deficit with those in another district, their Federal Reserve Bank builds up debt to the other Federal Reserve bank. Those debts are settled routinely, however, by transferring assets (gold certificates) on the books of the Interdistrict Settlement Fund—an institution so obscure that few people have ever heard of it. When the same thing happens within the euro zone, one NCB builds up debt to another NCB. To the best of my knowledge, however, there is no agreed way to pay off this debt. True, it is fully collateralized under the rules of TARGET. One can easily conceive of conditions, however, in which one NCB would be reluctant to build up claims indefinitely on some other NCB. In fact, I have been criticized for arguing that the NCBs should be completely indifferent to the sizes of their intra-EMU claims and debts.[4]

THE PROBLEM OF DEFECTION

Could EMU break down completely? History gives little guidance, as there have been very few monetary unions comparable to EMU.[5] Reference are sometimes made to the collapse of the Latin Monetary Union, but it did not have a single currency or single central bank. References are likewise made to the collapse of the Austro-Hungarian empire and the collapse of the ruble zone. In both of those cases, however, monetary unions collapsed when states collapsed. The most durable of modern monetary unions, moreover, those of the CFA franc zone and the one between Belgium and Luxembourg, had very special characteristics. The former are cemented by financial and technical assistance from Paris. The latter involved one rather small country and another very small country. Not at all like EMU.

Those who believe that EMU will not break down frequently remind us that membership in EMU is a concomitant of membership in the European Union. To leave EMU, they argue, would necessarily involve secession from the EU itself, which means, of course, secession from the customs union, the single market, and all that. But Sweden has not joined EMU, although it was not allowed legally to opt out, unlike Denmark and the United Kingdom, which obtained the right to do so when they signed the Maastricht Treaty. It is entirely conceivable, moreover, that an EU member might be allowed to depart peaceably from EMU without being ejected from the EU. The costs to the other members of ejecting a member from the EU would not be negligible.

But the costs of defecting from EMU itself could be very high. The defector would run the risk of financial collapse, and much of its public and private debt would be converted automatically into foreign-currency debt.

Consider, first, the risk of financial collapse. Suppose that a political party opposed to EMU came to power in France and was thought to be serious about leaving EMU, reintroducing the franc, and opting for monetary expansion to reduce unemployment. Expecting the new franc to depreciate, holders of euro-denominated deposits at French banks would shift them immediately to banks in other member countries of the euro zone, and holders of other franc-denominated assets would dump them immediately. There would be a run on French banks, and the prices of all franc-denominated assets would fall precipitously. The Banque de France would presumably come to the aid of the French banks, even though this would involve violating the monetary-policy guidelines laid down by the ECB and running up enormous euro-denominated debts to the other NCBs.

After the defection, moreover, anyone still holding obligations issued by the French government, French banks, or French firms, including French citizens, would be entitled to oppose the redenomination of those obligations into the new franc. Some of the same obligations would have been redenominated once before, at the start of EMU. That conversion, however, was carried out in accordance with European law. The second conversion, back into francs, would be carried out in accordance with French law but in contravention of European law. Hence, any asset holder would be entitled to take the matter to the European Court of Justice. In fact, the European Commission could take the matter to the Court, accusing France of violating European law. If the Court ruled against France, the issuers of all such obligations would be saddled thereafter with foreign-currency debt (i.e., euro-denominated debt), and the cost of servicing that debt would rise enormously if the new franc depreciated sharply in terms of the euro.

Defection is not allowed by the treaty. But the cost of defection would still be governed by the treaty unless France were prepared to leave the EU in order to challenge the applicability of European law and the jurisdiction of the Court. EMU is not forever. Nothing is. But getting out would prove to be more costly than getting in.

NOTES

1. One should, perhaps, have expected this outcome after the adoption of the stability pact, which played down the importance of the debt criterion, which Italy could not possibly meet.
2. For a thoughtful reassessment of this last issue, see Blanchard [1998].
3. See "Builder of the Euro Team Spirit," *Financial Times*, 7 December 1998.
4. See Kenen [1998] and the earlier reference cited there.
5. On the available history and its limited relevance, see Cohen [1993].

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