fondazione Ugo La Malfa

REPORT

ON EUROPEAN MONETARY UNION

Ugo La Malfa Foundation

*REPORT ON THE EUROPEAN MONETARY UNION**

1. *Object of the Report: the European Monetary Union*

The third and final phase of the European Monetary Union (EMU) got under way on 1 January 1999, with the irrevocable setting of exchange rates among the currencies of the participating countries and the transfer of responsibility for monetary policy from the national central banks to the Eurosystem.[1] The treaty signed at Maastricht on 7 February 1992, called for the creation of the European Monetary Union (EMU), a process consisting of three successive phases. For the third and final phase, article 109 j provided for a dual possibility: if, at 31 December 1996, a majority of the member countries had met the criteria for participation in the EMU set in that same article (the so-called Maastricht "parameters"), the European Council would have the power to set the starting date for the third phase, if not, the third phase would in any case begin on 1 January 1999 and would include those countries meeting the established criteria, whatever their number. The European Council would meet by 1 July 1998 to evaluate which and how many members of the European Union (EU) satisfied the conditions for participation.

*** By Enzo Grilli, Giorgio La Malfa, Leonardo Melosi, Laura Ilaria Neri, Chiara Oldani, Mauro Piermarini,and Paolo Savona.***

[1] The Eurosystem consists of the 12 national central banks and the ECB in Frankfurt, whilst the European Central Banks System (ECBS) also includes the central banks of countries not part of the EMU.

Based on this procedure, the European Council, meeting in Brussels on 3 May 1998, decided that 11 of the 15 EU members satisfied the conditions set and, based on article 109 l, then proceeded to appoint the Chairman, Vice Chairman and four other members of the Executive Committee of the European Central Bank (ECB) in Frankfort who, together with the governors of the central banks of the member countries, constitute the Bank's board of directors.

The irrevocable setting of the exchange rates among the participating countries and the transfer of responsibility for guiding monetary policy from the national central banks to the Eurosystem as of 1 January 1999 mark the effective birth date of the single European currency. The actual introduction of the euro into circulation, which took place on 2 January 2002 with the withdrawal from circulation of the currencies of the member countries, which meanwhile had become 12 with Greece's entry into the EMU, was a purely formal event, albeit a symbolically important one.

The single European currency and monetary policy have now been in existence for three and a half years, and it is thus possible to draw up a first balance sheet.

2. *The Report's themes: macroeconomic trends, monetary policy, and institutional architecture*

This *Report on the European Monetary Union* puts forth some considerations of an economic, political and institutional nature on the EMU problems and prospects three years after its creation. It makes use of the data gathered and an examination of some problems of particular significance for the life of the EMU included in the attached *working paper*, but it is the fruit of our observations and those of others, as well as of a specific historic and doctrinal perspective that will emerge clearly as this *Report* continues.[2] An examination of this mass of data and information that emerged over the three-year experiment with the new monetary system makes possible an initial assessment, carried out by us from three points of view.

The *first* is an examination of the economic performance of the area as a whole and of the main countries comprising it, including in relation to the simultaneous evolution of the economies of the United States and the United Kingdom. Reference to this latter country is of a certain interest for purposes of a comparative judgment, inasmuch as it is the largest European Union country to remain outside the EMU area, having exercised its right to *opt out*, as greed upon during the negotiations leading up to the signing of the Maastricht Treaty, despite the fact that its parameters were in order.

The *second* involves the conduct of monetary policies by the ECB and some reflections on the fiscal constraints agreed upon for the Union.

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[2] Cf. *Working paper* on the European economy by Leonardo Melosi, Laura Ilaria Neri, Chiara Oldani and Mauro Piermarini.

The *third* refers to the functionality of the institutional architecture elected for the EMU and set by the Maastricht Treaty.

Although the time that has passed since the start-up of the Monetary Union is too brief to be able to confidently identify basic economic trends, and although we must consider the fact that every new institution requires time to be able to learn how to perform its own functions effectively and to bring to light its own characteristics, it is possible to draw from the complex of available data and from an analysis of the results within the euro area some judgements on the effects of the EMU and examine some problems which the experience of this first phase has brought to light.

Usually, monetary unifications and the creation of central banks have coincided with or followed on the heels of the creation of new national or federal state entities. That is, we go from political union towards monetary unification. The European Community decided to try the opposite approach: it gave life to the monetary union, which should be followed by political unification. Precisely because we are faced here with a new and in many ways unprecedented experience, it becomes necessary to focus the attention of scholars on these new institutions, discussing their functioning and suggesting, where appropriate, modifications in the institutional set-up or in the economic policy guidelines of the Union's government authorities.

That is what this *Report* sets out to do.

3. *Inspiration and purpose of the Report: to revive a serious debate on the future of our country within the EMU*

In preparing the *Report*, the Ugo La Malfa Foundation followed the path blazed by that now far-off experience that saw Enzo Grilli, Giorgio La Malfa, Paolo Savona and other economists directly involved in producing the *Reports on the Italian Economy* that were published annually, from 1974 to 1981, by the CEEP/Centre for Economic Policy Studies.

At the start of that period, there was almost no other research centre outside the public sector involved in studying Italy's economic situation. It seemed useful, then, to attempt to expand the analysis and discussion of problems in the Italian economy and on its prospects to a wider circle of participants.

This initiative proved to be very useful, since it encouraged many others that made it possible to carry the discussion of Italian economic policy problems to a broader university, political and journalistic context.

We believe that there is a similar need today with regard to the European Monetary Union, of which there seems to be, at least for now, a partial vision and inadequate public discussion.

We have noted that the major centre of Italian economic observation, the Banca d'Italia, has not yet introduced into its *Annual Report* a chapter devoted to the economic performance of the European Monetary Union as a whole; nor are there any government documents that specifically examine this issue.

There are some ISAE publications and others of a banking or academic origin, but there are no public opportunities for serious debate on the prospects and problems of the euro area.

This is a gap that we believe needs to be filled quickly.

If this *Report* contributes to increasing attention and stimulating discussion on topics of fundamental importance for the future of Europe that is not limited to sterile polemics on the degree of “Europeanism” of the participants in the debate, it will have served its purpose.

4. *The main macroeconomic trends of the euro area*

An examination of the available economic data reveals the following primary aspects regarding the performance of the EMU in the first three years since its inception.

- For the two-year period 1999-2000, ***growth in real terms*** in national income in the euro area was approximately one-third less than that of the United States (6.1% for the EMU and 8.5% for the USA). The slowdown in 2001 had a greater impact on the American economy (growth of 1.1% compared to the 1.5% for the European economy). Overall, the three-year period saw American growth of 9.7%, about 2 points greater than growth in the euro area. During the same period, the United Kingdom posted an increase of 7.5% in the GDP, in line with the performance of the euro area.
- With regard to ***the situation and prospects for the current year***, Eurostat/EIB data show that growth on an annual basis in the first quarter of 2002 was virtually nil (0.2%) in the euro area, as compared with the 5.6% recorded in the United States. However, the uncertainties surrounding the world economy in this period do not allow us to formulate reliable forecasts on macroeconomic evolution over the coming quarters. The often-announced recovery does not yet seem to have taken hold in the United States, whereas in

the euro area it still appears delayed and weak. In June, the International Monetary Fund "forecast" an average annual growth for this year of 2.3% in the United States, compared with 1.4% in the euro area. The growth forecast for the United Kingdom sits practically in the middle: at 2%.

- Within the euro area, very strong ***differences in income trends*** have been posted: during the three-year period, Ireland grew by more than 30% in real terms, Spain by 11%, France by 8%, Italy by 6.4%, and Germany by only 5.3%. Thus there is a wide dispersion in trends among the various countries, and there appears to be no converging trend towards common growth values.
- ***Inflation*** measured by the consumer price index in the euro area accelerated during the period from 1.1% in 1999 to 2.5% in 2001, as a result of the combined effect of the increase in oil prices and the euro slide. This is still lower than that of the United States, where the total increase for the period was 8.6%, compared with 6% for the euro area. The United Kingdom, perhaps because of the different structure of its oil supply, had a more contained price dynamic than did the two international areas indicated.
- The ***gap in inflation rates*** among the various countries participating in the euro remained high, albeit lower than the gap recorded in the first half of the 1990's. The reduction in inflation is one of the most positive legacies of the EMU preparation phase. Indeed, the effort to meet the Maastricht parameters pushed those countries with the highest inflation to adopt policies aimed at reducing the pace of increases in domestic prices (monetary and fiscal cutbacks, increases in competition, elimination of state

subsidies, knocking down of residual tariff barriers) and promoted downward convergence of price dynamics.

- The ***productivity*** trend shows that in the euro area productivity was two-thirds below that of the United States for the 1999-2001 period. Compared with the United Kingdom, which is close to full employment, productivity performance in the EMU countries was less than half.
- The ***productivity differential*** is thus widening, against Europe, especially vis-à-vis the United States, where productivity's tendency to grow at very high rates continued even more strongly in the first part of 2002, greatly contributing to the acceleration of growth in the U.S. product.
- ***Unemployment*** in the euro area dropped during the first two years, from 9.7% to 8.8%, but it remains especially high in the four major countries (Germany, France, Italy and Spain). On average it is still 50% higher than the U.S. rate, and about one-third above the United Kingdom rate. If income growth rates remain the same as in this first three-year period, it would seem that the prerequisites do not exist even to bring unemployment rates down to the levels prevailing in the other more developed areas.
- The EMU ***balance of payments*** posted the following trends in the three-year period: -18.3 billion euro in 1999, -59.9 billion euro in 2000, coinciding with the hike in oil prices, and –9.3 billion euro in 2001 due to the economic slowdown. For the United States, the current accounts *deficit* in the period exceeded 1300 billion dollars and is expanding in the first half of 2002, confirming that the American recovery is further along with respect to that of the main industrialised areas (Europe and Japan). For the United Kingdom, the balance is negative in the last three years for about 144 billion dollars. In

this period, the current account in the euro area suffered from the exchange rate devaluation and showed a slight negative balance in 1999 and 2000, due to the combined J and absorption effect. In 2001, the balance improved with the weakening of these effects. For the United States, the large deficit in the current account is the effect of the dollar's strength and of an expansion of domestic consumption greater than in the rest of the industrialised world. Thus the balance-of-payments position in the euro area is solid. But this is the foreseeable consequence of a restrictive fiscal policy like the one followed in these years and of a very modest growth in the real absorption of resources.

- The ***exchange rate*** trend between the euro and the dollar was negatively oriented between January 1999 and October 2000, followed first by relative stability and then by a modest correction in trend in the last 4-5 months of 2001 and, finally, by a more recent and significant revaluation still under way. If the current strengthening of the euro continues, it could lead to problems just as serious as those created by the previous phase of weakness. Obviously this would be because of real growth due to less international competitiveness of the euro area. As for inflation, the euro high prices ought to contribute to reducing it.

5. *The main problem arising during the three-year euro experience: the failure to drive European growth*

The whole of the data observed leads us to formulate a certain number of observations on the EMU experience in the first three years.

The modest dynamic of growth rates in the European economy in terms of national production and of labour productivity indicates that the completed union of the economies of the EMU member countries, whilst it is an event of historic significance, and contrary to what some expected, has not yet led to a change for the better in consumer expectations nor to a basic change in the outlook of entrepreneurs. The latter, in fact, have not undertaken an intensive search for resizing their productive activities to a European scale, losing many of the advantages that they could have reaped from the single market with a single currency.

It was believed that the prospect of a large market of more than 300 million consumers would have generated a wave of optimism that would push not only an autonomous expansion of investments by European enterprises but also an influx of new capital from abroad towards the EMU financial markets and productive systems, with positive consequences for employment and consumption.

Neither of the two beneficial effects expected from completion of the single market with the Monetary Union occurred to the extent hoped for.

The setting of the initial euro exchange rate at 1.17 dollars, accompanied by the forecast of a possible revaluation, corresponded to this optimistic vision of the prospects that were opening up for Europe with the birth of the EMU.

As is well known, things have gone quite differently. The drop in the euro exchange rate against the dollar, which began almost the day after the start-up of the EMU, underscores the fact that in this first phase there has been a marked net emigration of capital from the euro area towards the United States.

Obviously it must be kept in mind that most of the EMU countries suffered in these years and in part still suffer the negative effects of the efforts made between 1993 and 1998 to get within the parameters set by the Maastricht Treaty in terms of inflation on the one hand and public-sector needs on the other, and from their continuation even in the most recent three-year period because of the constraints placed on the fiscal policies of the various countries by the conditions of the so-called Stability and Growth Pact.

Even though, for the years following the switch to the euro, it is not proper to speak of restrictive fiscal policies analogous in scope to those of the three-year euro-preparatory period, it can at least be said that these fiscal conditions were unable, except to a very limited extent, to counter the cycle of declining demand within the EMU area.

Once the shock of fast-recovery programmes has passed, and the EMU has been consolidated and the European market expanded by expansion to the East, it is possible that a phase of greater entrepreneurial optimism may set in. What must be noted, however, is that under current political and institutional conditions, this turnaround, if it occurs, will be the fruit of a spontaneous market evolution, in particular in the *animal spirits* of entrepreneurs, and in the confidence of families, since there is no significant economic policy or fiscal tool that can be utilized continuously and effectively to promote the onset of such a development.

A contribution to the growth of investments could come from a policy of low interest rates, which greatly helped the U.S. recovery; but because of the institutionally restrictive orientation of European monetary policy, it does not seem that this can be utilised actively for purposes of supporting levels of productive activity in the euro area. Even if it could, many serious doubts remain about its effectiveness.

Looking at European economic growth in perspective, the most worrisome aspect is the substantial stagnation in productivity which is being recorded in most of the EMU countries and in particular in the largest ones (Italy, France and Germany). To the extent that trends in productivity are connected only with the cycle's trend, it is reasonable to hope for its recovery.

But both the absolute and relative trends in productivity in the EMU presage quite clearly a structurally unsatisfactory trend, and, as we said above, neither the EU nor the EMU has common economic policy tools and strategies capable of working on these factors on the side of supply.

Job market reforms are proceeding slowly, and, as occurred in France with the 35-hour law, even in the wrong direction; the tax system, in turn, yields disincentives to the localisation of new productive activities in the euro area.

In some countries, like Italy, infrastructures are decidedly wanting, and transaction costs are excessively high.

In a situation in which labour costs, transaction and tax costs are too high compared with other areas, and in which there are serious infrastructure shortcomings, the incentives received by companies have the opposite effect of that desired: these factors in fact induce them to invest elsewhere.

This is an phenomenon that touches almost all of the euro area and impacts in a decidedly negative way.

We noted with favour the Lisbon declaration, according to which the EU should be in the vanguard of scientific research and technological innovation by 2010.

We only wonder whether the current tendency of the euro area economy and the absence of specific economic policies in this area are compatible with this expectation and with this commitment in principle.

We are also concerned by the delays leading up to this determination, and the time necessary for the effects of an increase in efforts aimed at improving technological innovation, even if carried out on an adequate scale, to yield concrete and significant results within the time provided.

6. *Our main fear for the EMU future: the tendency to diverge in the main macroeconomic values*

Another consideration arising from data on income and productivity growth is that, within the euro area, there does not seem to be a process of convergence taking place among the member countries towards common growth rates.

Indeed, in some respects the performance gap is increasing.

This is a symptom that, within the EMU and the single market in general, a process of homogenisation of the economies of member countries is not produced endogenously.

The implication of this observation is that the reactions of the various economies to eventual outside shocks differ from one to another. Diverging economic trends in regions belonging to a state, unitary or federal structure can be attenuated or compensated through government policies, and especially through fiscal policies.

In the absence of a European government that can make economic policy decisions, these divergent trends run the risk of not being adequately compensated.

In the long term, the persistence of differing growth rates is destined to nourish dissatisfaction towards the EMU as such.

And this trend would be precisely opposite the expected and desired trend.

If unemployment in the euro area were structurally much greater than in the rest of Europe and the United States, this situation would become grounds for major social and political as well as economic dissatisfaction, and it would be attributed sooner or later to the Monetary Union, which represents the pinnacle of the integration process reached up to now.

In the longer term, failure to achieve significant employment benefits would become a sign of ineffectiveness, if not of failure of the monetary experiment, and a factor for possible self-validation of the assumption that the Union is incapable of creating an "added value" with respect to that which can be achieved autonomously by the individual countries.

The convergence of prices in the EMU area has also been partial, but their trends have stayed at fairly contained values. Leaving out the dynamic of oil prices and the euro exchange rate, so-called *core inflation* has been relatively low and does not show a significant upward trend.

We therefore see no reason for sharing the alarm over prices repeatedly launched by the ECB, convinced as we are that European inflation is suppressed mainly by expanding competition, keeping currency growth stable, and not issuing too many admonishments or brandishing interest rates too often.

Furthermore, we would see no reasons for these concerns if the euro depreciation trend were truly over and its revaluation against the dollar were stabilised.

However, we see in these warnings a proper concern on the part of the European monetary authority (and not only) over the continuing rigidity of the labour market and little competition in markets that can spark inflation in the presence of a strong and sustained recovery. But we wonder whether the monetary restriction towards which the ECB currently seems disposed is an adequate response to this delay in promoting flexibility.

Implicit in this situation are both a possible effect of relaxation of certain structural constraints that restrictive monetary policies carry with them and the risk of combining two negative effects – that of little flexibility in the labour market with a higher cost of money – in the event that reforms are not perceived as being indispensable or are ignored by national governments.

We note instead a rather broad dispersion among inflation trends in the various countries around the mean.

This too is a symptom of a weak tendency towards convergence among the various member countries, which we have already noted.

7. *Our reservations about European monetary policy*

we have serious reservations about the formulation of the European Central Bank's duties contained in the Maastricht Treaty, and hence in the ECB charter, which we believe are at the origin of one of its inadequate contributions to achieving the political design of unification and of its performance in the first three years of its life.

Even ignoring these reservations, which are perspective in nature, or *de jure condendo* (if we may say), it is possible to criticize the ECB policy with respect to the interpretation it gave to its mandate and to the situation it has had to deal with.

The ECB has repeatedly declared that it wanted to faithfully follow the mandate set by article 105 of the Treaty that established it, i.e., to pursue the sole objective of keeping inflation under control, and, only secondarily, to take charge of real growth.

Having set the inflation target at 2% and the intermediate M3 objective at 4.5%, and with neither of these two variables ever having met the performance levels set during the entire three-year period, the consequent criticism is that the ECB should have set a stronger policy than it did, if it wanted to pursue the production of the "public good," which is more important for a society like Europe's which is in the process of being formed and is desirous of development: the credibility of its central bank.

The worst thing for a monetary authority is to declare a policy and not follow it. This sends conflicting signals to operators, hindering the formation of correct and stable expectations.

We think that the ECB did not focus on certain aspects of the environment in which it was operating and that it had some hesitation in its actions.

First of all, it underestimated its dependency on the conditions inherited from the past in terms of structure and trends (the *path dependence* always invoked by economists). Indeed, it should have taken into account that it had to operate in a non-optimal monetary area, lacking compensatory fiscal instruments, and that it was guided by the inspiring principles of the European treaties imposed by a pessimistic vision of national behaviours, which it was wished to discourage with restrictive clauses rather than clauses encouraging growth. It was also inspired with regard to the euro exchange rate by an excessively theoretical vision of the relevance of this variable on inflation and growth, for the objective difficulties of operating in the currency market under its current conditions of freedom and global complexity, for the conviction that the exchange rate is chosen by the market and not by its own policies, and for not having eased reservations about the *export-led* or *consumption-driven* nature of the growth mechanism to be governed, which requires resorting to different monetary policies depending on the nature of the growth mechanism.

In addition, since its inception the ECB has attempted to take into account the strong political pressure to reconcile its primary mission (containing inflation) with the secondary one (growth) without managing to fully achieve either one. In this action, the lack of a proper understanding of the quantitative relationships between its monetary action and the effects of this on the economic system as a whole and on its national components has played an important role.

On the exchange rate, upstream there was an overestimation of the euro acceptability as an international currency and of its relative value, which led to its initial value being set at levels too high with respect to the dollar. This quickly led to a drop in euro/dollar exchange rates, subsequently aggravated by the effects of monetary creation within the EMU area sanctioned by the ECB. This policy is partly responsible for the exchange rate values and the inflation, both of which alarmed the European monetary authority, albeit at different times, and induced it to drastically raise short-term interest rates, blocking the economic recovery of 2000 and limiting its consolidation, without however significantly influencing, in the opposite direction, the euro depreciation with respect to the dollar.

Reading the declarations of the ECB directors, we note further that it is not clear what the reference model was that the Bank used to interpret the trends and tendencies of the European economy.

Some publications indicate that the ECB made use of the Basel BIS model developed in 1995 and of models available from the national central banks. Despite this, it is striking that it recently reported that it had commissioned four universities to prepare an econometric model of the European economy.

We note however that recently the ECB has also introduced an unusual statistical revision that artificially reduces the M3 dynamic, regarding which see the technical note in the attached *Working Paper*.

According to some, the reference set-up of the ECB monetary policy should be radically changed. We believe that at least its apparent duality should be reviewed, reduced and reconciled, so as to make it more comprehensible to the markets and more capable of guiding expectations.

8. *The current characteristics of public finance in the European Union*

The trend in public finance in the euro area tends to violate the commitments made following application of the Stability Pact, especially in this latter phase when the drop in productive activity is reflected in a decline in tax revenues compared to forecasts.

The situation appears especially serious in Germany and France, but even in Italy there are difficulties arising in keeping public financing on the tracks set by the Pact.

As with monetary policy, so too for fiscal policy: the euro countries must take on a clear strategy regarding both *ex-ante* and *ex-post* coordination.

The worst choice is to announce a course and then give the impression of not being able to follow it indeed.

On *ex-ante* coordination, if the Union's members do not decide to formulate the Stability Pact's commitments differently to take into account the cyclical trend in tax revenues, and hence in needs, they must have the courage to follow through to the end the original set-up and impose it on all the member countries, including the larger ones.

This is because the efficacy of a coordinating mechanism for tax policies that operates *ex-ante*, like the Stability Pact, is crucially dependent on the existence of credible commitments.

On *ex-post* coordination, which is made necessary to deal with contingent situations (shocks), either it is agreed that there is no need for it since an efficient assignment of objectives and responsibilities mostly replaces the need for coordinated national fiscal policies (once the German position), or the circumstances must be defined in which such coordination is effective and desirable (e.g., in the presence of real shocks of asymmetrical supply and demand, or that strike Union members in significantly different ways) and what the procedures are to implement this coordination.

In these cases of likely EC passivity, given the limited range of influence of its instruments in these circumstances, the risks of counterproductive interactions between fiscal adjustments and monetary adjustments would also diminish.

During the first three years of the EMU, the action of the so-called Euro-12 Committee seems not to have attracted any attention: in the intentions of its proponents, the committee should have been the place where the EMU economic policy guidelines, and potentially also coordination in fiscal policies, deemed desirable and efficacious, would have been developed in a meeting of the finance ministers of the member countries, the European Commission and ECB representatives.

All available information indicates that the work of this Committee is basically irrelevant, both in terms of formulating the EMU economic policy and of *ex-post* coordination of fiscal policies.

9. *The cause of divergences: the failure to create an endogenous stimulus for the construction of an optimal monetary area*

One basic problem with the EMU, which was brought to light by numerous economists during the preparatory phase, is that the European area does not have the characteristics of an optimal monetary area in the sense illustrated and analysed in depth over the years by Robert Mundell, Nobel prize winner in economics.

It was correctly noted that the euro area lacked and still lacks that flexibility of markets and in particular of the labour market that would make it possible to spread homogeneously over a vast geographic area, and hence to absorb shocks that particularly strike certain regions of that area.

In addition, it also lacked – and still lacks – a common or highly coordinated fiscal policy among the Union’s members that could under these circumstances facilitate a rebalancing among the various zones.

These conditions were well known in economic literature in this regard and are confirmed as well by the more recent analysis of the efficacy of fiscal policy coordination.

This serious institutional-constitutional shortcoming was the main reason for the perplexity expressed by major economists, especially American, and from major international monetary institutions like the IMF, on the functionality of the European Monetary Union.

As is known, the reasons that it was decided within the European Union to create a monetary union were not exclusively and perhaps not even primarily of an economic character. These are political and economic reasons, which we fully agree with. Thus the decisions taken did not depend on the strict and conditioning assessment of whether in the European area proposed as the monetary union the conditions for an optimal monetary area were already present and operating.

The prevailing economic reasons had to do with concern for preventing the instability of international exchange markets, mirroring the relations among the currencies of the European Union's member countries, from making it more difficult to create a single great European market, and with the extreme difficulty, which the European countries had experienced in managing the European Monetary System, of maintaining over time a system of fixed exchange rates within the European Union, once the movement of capital had been fully liberalised.

In the choice between renouncing fixed exchange rates in relations among the Union's countries and adopting a single monetary policy and hence, *de facto* and as of right, a single currency, the choice fell on the second option, partly because of the symbolic value that such an epoch-making change assumed.

Alongside these reasons of an economic character, which however left out any assessment of the pre-existence of conditions of monetary optimality identified by Mundell, also weighing on the decision to proceed was the political need to visibly underscore the close bonds that united the Community's countries at a time when international events were changing the European panorama, permitting the reunification of Germany and opening the path to an expansion of the Union towards the countries of Central and Eastern Europe.

This said, we must make an observation that we consider to be of great importance: the fact that the reasons that led to establishing the EMU overlooked the existence in Europe of the conditions for an optimal monetary area does not mean however that these reasons can and especially will be able to be overlooked for an indefinite period of time in the life of the EMU.

Indeed, the possibility of maintaining a monetary union over time presupposes that the area to which it is applied has within it, or manages to develop rapidly, the characteristics of an at least sustainable if not optimal monetary area, i.e., an area that enjoys adequate flexibility in the markets of consumer goods and production factors and that is also able to utilise fiscal-policy instruments capable of blunting and compensating for the asymmetrical effects of significant shocks coming from outside the area, over which the common monetary instruments controlled by the ECB do not exert effective influence (like the shock from prices of imported products like oil, from demand for specific goods like steel and automobiles, or from demand in general).

The great gamble that was opened up by the birth of the EMU is thus that the euro area can be transformed progressively and endogenously into an optimal monetary area. In the economic trends of the first three years we have identified no signs that lead us to believe that this endogenous process has been put in gear.

Alternatively, it can be hoped that such a transformation of the EMU will occur as a consequence of decisions wisely taken by the member countries to complete and reinforce it. It is in this sense that we should interpret the repeated calls from many parties for the adoption of labour market reforms aimed at introducing into it sufficient degrees of flexibility – with the understanding that this flexibility is still estimated at one-fourth that which the United States enjoys – and completion of an effective competitive orientation that improves the function of consumer markets.

The question that must be asked is whether, beyond these appeals, the functioning of the EMU contains some economic element that pushes towards promotion from within and automatically of those conditions of structural conformity that are currently missing.

As can be seen from the data presented in the preceding paragraphs, and as can be found by examining the political and legislative events of the euro countries in which problems of insufficient market flexibility exist, progress on these fronts has been very modest.

However, seeking to push this analysis further, it should be noted that the creation of divergences in economic trends in different areas may induce political authorities to introduce the necessary corrections.

It is possible that this will happen, but it is in no way certain that this result will come about. In our view, it would not be very wise to trust in it.

In connection with what has been said, there is another problem that needs to be pointed out, and which does not seem to us to get sufficient attention.

With the decision to move on to the Monetary Union, the member countries agreed to introduce a constraint on the exchange rate that in the past had been used in most of them as one of the tools for reconstructing economic balances in the presence of dissimilar trends in the fundamental variables: income, productivity, inflation, wages, interest rates, balance of payments.

When the exchange rate ceases to be a factor for flexibility, the role it plays as rebalancer must be played by other variables.

The natural candidate for this role is the labour market, and the variable on which the greatest adjustment burden falls is wages, especially in the presence of relatively rigid consumer prices.

This is what economic theory tells us.

But if it is not politically possible to modify the institutional rules on the labour market, as seems to be the case today in many of the larger European countries (although this condition remains to be verified), the need for flexibility would again present itself and could lead to other changes that have equivalent effects.

In particular, we might face the eventuality that difficulty in adapting the labour markets leads to consequences in the field of public finance.

This happens in federal systems like the United States, but in that system the relationship between the federal budget and the states' budgets is very different from Europe.

In the latter, the budget that can be defined as federal, i.e., the resources assigned to the European Commission, is very limited. It does not reach 2% of the area GDP and is in large part absorbed by the common agricultural policy.

The bulk of public budgets is still in the hands of the states.

Thus it might happen that the public treasury of an individual country might be called on to compensate for the rigidity of the exchange rate by its own performance.

Whilst it is realistic to foresee such an effect, in those countries belonging to the monetary union in which the labour market remained highly rigid, public finance might tend to take on highly divergent trends.

As is documented in the *Working Paper* attached to this *Report*, this is what emerges from an examination of the fiscal policy indicators of the member countries.

There are obvious deviations in the trends expected from revenues and expenditures, and hence from public budget balances, with respect to the common commitments made by the governments of the EMU countries. There are also indications of "competition in the tax rates" to be applied to various activities. The national governments have a *de facto* incentive to reduce taxation on movable factors (like capital) in order to attract them into their country and thereby support economic activity and employment. And they are doing this.

These considerations contribute to explaining the difficulties encountered on the one hand by the fiscal harmonisation process within the E.U. and on the other by compliance with the rules of the Stability Pact by the larger European countries: Germany's resistance to balancing the public budget, France's request for a delay in balancing the budget from 2004 to 2007, and Italy's resistance and problems on this point are clear and well-known examples.

In particular, it is obvious that governments are uneasy in dealing with balancing public budgets because this involves overall disagreeable political decisions, consisting of increasing the fiscal take or further reducing public expenditures which are often considered, rightly or wrongly, to be already at the limits of tolerability in some social circles.

But it is clear that a policy of reducing public deficits is more acceptable in the presence of homogeneous (and favourable) trends in the European economy, whereas it presents more and more serious problems when countries undergo the particularly negative effects of the international situation, as is happening today in the larger EMU countries, and they undergo them in differing ways.

Ultimately, this is the most worrisome prospect: if, given diverging economic trends, the euro countries were induced to compete stably on the fiscal level, conditions of political conflict would inevitably result that could not be easily resolved or borne.

10. *What principal corrections are required by the EMU institutional architecture*

In response to the objection that a monetary union without a political union – i.e., without a common or better-coordinated fiscal policy than it now has – is in itself a very fragile construction, Maastricht's defenders ask what the possible alternative would be.

Was it necessary – they argue – to give up the idea of forming a monetary union while awaiting the "mythical" day when all the conditions for political union, and hence also for monetary union, are present?

They add that the monetary union now exists, with the rules established by the Maastricht Treaty.

So what matters is not to make recriminations on what should have been done and to concentrate instead on working to get the Union functioning better.

Precisely because it is right to take a positive view, it is well – and in our view absolutely necessary – to deal with the problem of modifications to the EMU so as to ensure that it functions better and to secure for Europe sufficiently ample and common economic benefits that will encourage the European peoples to continue along the road towards integration.

In our view, there are at least three essential and urgent modifications to be made in the Monetary Union's rules:

A *Revision of the Stability Pact.* The Pact must be modified in two points:

- in calculating acceptable public-budget deficits, to always take into account the cyclical component of economic trends, so as to prevent, in a phase of economic downturn, the lesser tax revenues that follow the slowdown from imposing further restrictive measures that will aggravate the negative trend of the cycle, or long negotiations, like those concluded in Seville, to reach the same goal, leaving open controversies and interpretative uncertainties.
- to exclude from deficit calculations relevant for purposes of the Pact those infrastructure investment expenditures for which there is no reason whatsoever to set the same restrictions that it is reasonable to apply to current spending. Consequently, the structural constraint on the public budget's balance should be applied to the current part of the budget.

B *The functions of the Euro-12 Committee.* This Committee's functions should be formally defined and provide for:

- the power to give national governments binding macroeconomic guidelines with regard to trends in public budget balances so as to achieve an opportune trend throughout the euro area;
- responsibility to examine the euro area economic framework and its consequent economic policy orientations, and in particular responsibility for *ex-post* coordination of EMU countries' fiscal policies, including the ways to achieve this coordination, the rules to be followed and the reporting mechanisms to be followed.

C *Redefinition of the ECB functions and introduction of greater transparency in the Bank's choices.* These should proceed along the following lines:

- the task assigned to the ECB should be less limited than that indicated by article 105 of the Maastricht Treaty. This new definition could essentially be copied from the formulation of the *Humphrey-Hawkins Act*, which assigns to the Federal Reserve the task of "maintaining the long-term growth of monetary and credit aggregates in line with the long-term potential for growth in production, so as to effectively promote the objectives of maximum employment, price stability, and the maintenance of moderate long-term interest rates;”[3]

- it is also necessary to introduce the obligation to publish the minutes of the Bank’s board of directors meetings, again on the model of the American Fed’s operating rules, so that the motivations for decisions and the line-ups that supported or opposed them can be known.

The Union’s proposed competent budgetary authority has the scope of a reformulation of some of the EMU inspirational principles and key rules that takes into account the political anomalies of monetary construction (absence of a democratic state) and of the more than satisfactory experimentation with the same institutions in other countries.

It is not easy for this to happen, but it is not impossible.

On some of these revisions, especially those relating to the Stability Pact’s rules, there is potentially a very broad agreement in Europe. Some steps were taken in this direction at the Seville summit. On others, for example on the functions to be assigned to the Euro-12 Committee and on redefinition of the ECB functions, it is likely that there will be strong opposition.

However, if the wait-and-see attitude prevails, the risk is that very substantial potential discontent may pile up regarding the EMU performance. at that point, it will not be just the prospect of political union risking a crisis, but the Monetary Union itself.

11. *Additional institutional modifications required by the EU expansion to the countries of the East*

Finally, the problem consisting of the implications of the EU now imminent expansion for the EMU needs to be pointed out.

The consideration that the candidate countries have economic conditions and banking and financial structures that are too far from those of the EU countries to be able to participate in the single currency was cast aside by the EMU countries and by the candidate countries.

The prevailing view is that, as soon as they become EU members, the candidate countries will take the steps necessary for membership, which is mandatory as soon as the preliminary conditions are satisfied, for all countries that did not negotiate an opt-out clause, as the United Kingdom and Denmark did.

Consequently, imagining – as was hypothesised at the Laeken summit – that an initial group of countries can complete the negotiations before the end of 2002 and enter the EU in 2004, if one or more of these countries decided to sign on to the EMS 2 agreement, i.e., if they declared an official exchange rate parity with the euro (with an allowed fluctuation of 15% around that) and kept it unchanged for two years, and if, meanwhile, they met the convergence conditions set by article 109 j of the Maastricht Treaty, these countries could enter the EMU as of 2006.

The prospect of an increase in the number of EMU member countries requires that we consider some modifications to the ECB charter.

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[3] *United States Code*, Title 12, Chapter 3, Section 225 A, Us Government Printing Office, Washington D.C..

In particular, it would be necessary to limit the number of members on the board of directors so as to avoid a body with too many members and in which, by virtue of the one-vote-per-country system, unexpected majorities could be formed, with unexpected consequences.

As is well known, for this very purpose the Treaty of Nice provided for a simplified procedure that would make it possible for not all the national parliaments to have to follow the established ratification procedures for Treaties.

However, it happens that no steps were taken in this direction, and there is no emerging common opinion on the way in which the matter should be handled.

Finally, we should mention a problem that strays from this treatment concentrating on macroeconomic problems but that will take on significant relevance in the debate in coming years: that relating to the most opportune placement between the European level and the national level of prudent oversight over the banking system.

This is a matter destined to take on increasing importance as economic integration takes concrete steps forward. On this occasion, we shall limit ourselves to pointing out the existence of the problem.

12. *Summary and conclusion*

The conclusion of our *Report* is that, beyond the rhetoric that has accompanied the euro entry into the daily life of the 12 European countries that adopted it, things are not going well in the European Monetary Union.

The euro area growth performance has been less than expected (as well as below that of the United States), with unsatisfactory repercussions in terms of employment.

The performances of the individual countries that make up the EMU remain wide apart, despite positive signs of convergence preceding the euro introduction.

The performance of prices and productivity continues to point to the existence of structural knots that have not been undone. The functioning of the labour market and subtle restrictions on competition are the presumable causes of this.

The euro negative performance has undermined the credibility of the euro system, although it should be kept in mind that the lack of history of the new monetary institutions and the anomaly of a currency without a state may have had an impact on this. Time will attenuate the consequences of the first of these two aspects. But it is very unlikely that there will be a sort-term solution to the second problem.

Contributing to these unsatisfactory results are the difficulties in monetary administration experienced by the ECB, some of them structural (existence of a non-optimal monetary area and weakness of the endogenous pushes that were expected to have materialised following the creation of a common currency) and some relating to the administration of the monetary policy (the “original sin” of the highly monetarist mandate of Maastricht, the lack of a reference model for the existing growth mechanism), over-reliance on M3 control, soft reactions to pressures on the political body beforehand, and fears arising from the loss of control over the euro exchange rate afterward.

Given these conditions, any manifestation of satisfaction with the "brilliant" recovery of the euro value seems to us out of place, both because of the effects that this will have on the euro area growth performance, which is already unsatisfactory in and of itself, and because the euro recovery risks relieving the ECB and government authorities from seeking a stable solution consistent with their policies, putting off any decision on reform, because the "danger of inflation" has gone away.

The risks we see emerging are due to:

- the weak impetus to reform the labour market in many countries, partly because of the rejection of a "unified vision" essential for a single market with a single currency;
- efforts to get around the Stability Pact rather than reformulating it to orient it towards true stability, which must be seen as part of non-inflationary growth;
- underhanded competition inside and outside the euro area, through tax discrimination.

We are convinced that the EMU can not be completed by itself, especially in a global context that is not favourable to it.

We do not think that its components can converge rapidly and significantly without help from political choices.

We do not think that social conditions strengthen its sustainability.

Improving the EMU chances involves the creation of a common fiscal policy, as well as a less dogmatic use of monetary policy.

This requires that political union be completed.

Otherwise, we must prepare ourselves for a rude awakening.

We had hoped and had deluded ourselves thinking that we could skirt the rocky shoals, but now the time has come to get back on the right course.

As we await this important event, the following are possible steps to improve the European institutional framework:

- a revision of the Stability Pact to take into account the cyclical component of the public deficit and to exclude infrastructure investments;
- assigning to the Euro-12 Committee some *ex-post* macroeconomic guideline and coordination powers over fiscal policies;
- reformulation of the ECB mandate along the lines of the Fed, investing it with responsibility for growth as well as for inflation.

The Monetary Union creation and the euro introduction are facts of historical importance destined to affect the economic performance of all European countries and the very future of European political integration.

Precisely because we favour this, we fear that this construction is still fragile overall, that too little attention has been paid to perfecting its functioning, and that, conversely, it has been too much hoped that things might adjust themselves.

Maastricht's "healthy criteria" have turned into taboos, and Europe is growing too little even with the single market and single currency.

The benefits once pointed to in the Cecchini Report seem distant and not easily achievable.

If Europe is growing little and, hence, many of the available resources in it remain unutilised or underutilised (think of the young people and the women who are not entering the workforce), discontent is destined to increase and spread.

If she grows unevenly, internal reactions risk being even more destabilising both politically and socially.

In the end, discontent deriving from an economic performance that is below the area potential and citizens' expectations could turn against the European institutions and nationalism could once again flare up in old and new forms.

That is why we must have the courage to reform and to believe that reform can find the necessary consensus, if the need for reform and its benefits are argued with determination, calm and good sense.

There is no economic subject that can remain immutable in a world that requires constant change.

Our *Report* seeks to aid this discussion and to contribute to a better future for Europe.