Institutions and Politics

This afternoon we heard some fascinating economic debate. Tonight I will talk of institutions and of politics. In fact, I am sceptical of the facile division of policy issues into the economic and the political. Of the ten Chancellors of the Exchequer and the three Prime Ministers for whom I have directly worked, none have had on their desks one intray labelled “economic problems” and another labelled “political problems”. Life is not like that. There is much more to welfare than the numerics of the GNP figures. And there is more to the EMU story than the story of exchange rates, budget deficits and inflation rates. But more of that anon.

EMU – what has been done?

In 1999 eleven countries, soon to become twelve, created a monetary area, virtually at the stroke of a pen, with 307 million people, compared to the United States 287 million – though with a GNP appreciably lower at some US$ 7100 billion compared to that of the United States of US$ 9,300 billion. History has never seen such a venture. No wonder the pundits said that it would not happen. If it did, it would break apart in its first few years. But it did happen and in four weeks time, the euro will be five years old.

Why, what and where next?

So in my remarks tonight, I want to
Explain why the twelve countries set out on this unique initiative

Evaluate the experience of the last five years

Set out some issues for the future.

Let me set my own cards out on the table. I speak as a supporter of the euro; someone who would like to see his country join but who sees no prospect of that eventuality in the near future.

I give you one reason for my support of the euro. A member state that excludes itself on a long-term basis from the monetary union deprives its people of an essential ingredient of economic progress – the spur from working in a highly competitive single currency area. But that is a personal judgement and not one to debate tonight.

The EMU

First, a point of terminology. For me, EMU stands not for European Monetary Union, but for Economic and Monetary Union. This is not a semantic point. To harvest the full benefits of the monetary union requires an effective economic union and vice versa. Economic and monetary union are mutually reinforcing. But again, more of that later.

EMU was a surprise

For most of the academic and political community in the United States, EMU was an unexpected and strange development. But no one would have been surprised if they had read modern European history. The Single Currency was on the Community’s agenda from the time the representatives of the original six member states met in June 1955 at Messina to agree the Resolution that laid the basis for the Treaty of Rome. In that Resolution we read of:

The adoption of methods designed to make possible an adequate co-ordination of the monetary policies of the member countries so as to permit the creation and development of a common market.

There, back in 1955 is the Single Currency in embryo. And the European Community was scarcely a dozen years old before the Werner Committee was established in 1969
to come up with the eventually ill fated blueprint for the Single Currency.

The next decade saw the fundamentals laid for the euro – the establishment of the Exchange Rate Mechanism in 1978, the liberalisation of capital movements and the Single Market. And the irony is that each of these developments owed much to British initiative.

So what happened in 1999 was the culmination of a project started some 45 years before and twenty years of detailed planning and hard political decisions spanning the last twenty years or so.

**The impulse to monetary union - political**

So what was it that gave the impulse towards monetary union?

For the original Six member states of the European Community, the move to EMU represented the final commitment to the European Union project, the point from which there would be no turning back.

The political motivation of the New Six members was different. For Spain, Greece and Portugal, EMU membership signified their arrival as full members of the democratic community of nations in Western Europe, in the mainstream of European political development, after decades of totalitarian rule. For Ireland, membership was further demonstration of its independence from Britain, a sentiment totally understandable in the context of Irish history. In short, the motive for joining EMU flowed directly from each member’s need as a nation state.

**The impulse to monetary union - economic**

There was another strand in the development of EMU. Recall the language of the Messina Resolution, which linked monetary policy to the creation of a common market. During the eighties and nineties, unsurprisingly it proved impossible to maintain freedom of capital movements, the single market in goods and services and pegged exchange rates. Dr Tomaso Padoa-Schioppa set this out in his elegant exposition of the so-called “inconsistent trinity”.


The single currency was the most satisfactory solution for the preservation of the Single Market. I would go further and here I trespass on my evaluation of the success of the monetary union. If the single currency, or its prospect, had not existed over the last decade, the Single Market, a jewel in the European Union’s crown, would have been at grave risk. The reason was the extreme volatility of the dollar/euro exchange rate.

The evidence shows that in the late eighties and early nineties, swings in the dollar against the European currencies put pressure on the so-called peripheral currencies, the Spanish peseta, the Portuguese escudo, the Greek drachma, the Irish punt and the Italian lira. At a time of dollar strength they tended to depreciate more than the core currencies, especially the German mark.

The result was bouts of exchange rate turmoil and trade frictions within the Single Market. We saw that in 1992 when the pound and the lira fell out of the Exchange Rate Mechanism. I remember particularly Irish mushroom farmers whose business of supplying British supermarkets was virtually wiped out overnight as the pound plummeted. Certainly in the Irish case the European Commission had to tolerate some state subsidies to affected industries, even though such subsidies were against the spirit of the Treaty of Rome.

Without the exchange rate stability provided by the euro, dollar strength around the turn of the millennium would have caused turbulence among European currencies and pressures for trade protection, especially at a time of high unemployment. The Single Market would have been put under real strain.

So much for the history.

Evaluating EMU

How has Economic and Monetary Union worked? Compared to the US wonder economy, statistics for the euro area disappoint. Even so, I assert that the monetary union is working.
A central bank that works

I do so because the Bank’s Governors have created a central bank that works. And a central bank which is truly independent, thanks in large part to the steadfastness of its first President.

Communication

But there is one area where the Bank has been less than successful. Certainly in the early years, there has been a lack of clarity of the Bank’s communication – to the markets and to the wider political community.

I am not so concerned with the absence of published minutes, nor with secrecy with individual Governors’ votes, nor with the unfortunate exchange rate statements in the early days. My concern is that there is still no precise, symmetrical formulation of the inflation objective, or more properly the price stability, objective.

Last May the Bank introduced greater clarity when the inflation objective was defined as close to two per cent over the medium term. Yet even that formulation lacks precision. That statement removed some uncertainty about the role of money in the Bank’s decision-making analysis. Monetary analysis, we are told, is now no more than a crosscheck, providing a reference value.

The outcome

Whatever the early deficiencies in communication, the monetary union deserves to be judged by the test set out for the Bank in the Treaty – price stability.

In terms of the outcome, euro-area inflation has consistently been slightly above the two per cent upper limit of the inflation objective. But that is not ground for significant criticism. Nor is there a strong argument that the Bank has been unduly dilatory in cutting interest rates. Timing of such decisions is always a matter of fine judgement and there is no evidence of egregious failure here.

So all in all, I believe that a virgin central bank has operated the M element in EMU as well as could reasonably be expected.
The Stability and Growth Pact

But it is in the E element of EMU, the economic union, wherein lies the reason for a lagging economic performance.

In my view the Stability and Growth Pact is not the root cause of this lagging performance. In fact, the Stability and Growth Pact arrested the upward trend of debt burdens and the spend and borrow mentality to which many governments succumbed in the nineteen eighties and nineties. Even so, three euro area countries still have levels of debt to GDP in excess of 100 per cent.

A Pact to constrain fiscal policy is still needed. The linkages between fiscal and monetary policy are uncertain and complex. But linkages there are, though I recognise that that is a controversial statement in the United States. The free rider problem is a real one.

Today, Germany and France, with budget deficits above three per cent, are to a large extent are paying for failure to carry out the necessary budget consolidation in the economic upswing. That is not new in Europe. There is an unfortunate pro-cyclical tendency to fiscal expansion in the good times, followed by consolidation in periods of low growth. I do, however, confess to some sympathy with Germany, who is still burdened with the costs of reunification.

The Commission was absolutely right in its statement at last week’s meeting of Finance Ministers.

*Only a rule-based system can guarantee that commitments are enforced and that all Member States are treated equally.*

The Pact now needs a make over, with some hard thinking which takes account of the economic cycle, the structural budget deficit, the level of debt and of a member state’s willingness to address its budgetary challenges. The credibility of the Economic and Monetary Union will be undermined if the Commission is again given cause to state that it
... deeply regrets that the Council has not followed the spirit and the rules of the Treaty and the Stability Pact that were agreed unanimously by all Member States.¹

Even so, I do not believe that the fundamental reason for the euro area’s growth performance lies in the budgetary constraints of the Stability and Growth Pact.

**Micro-economic inefficiencies**

More important are the micro economic inefficiencies in some of the euro area’s economies. An effective economic union requires, to use the fine words of the Treaty, that

> The Member States and the Community shall act in accordance with the principle of an open market economy with free competition, favouring an efficient allocation of resources...²

To create that “open market economy”, the Lisbon European Council in the year 2000 set out an ambitious programme of action. Progress has not lived up to the fine words of the Lisbon Council, especially in the essential labour market reforms.

It is this failure to carry through the structural reforms envisioned at the Lisbon Council that is holding back growth in the euro area. So it is heartening to see that at last there is a pick up in the pace of reform in some countries, notably Germany with their Agenda 2010.

**The Future – four points to watch for**

First, it will take the euro area many years to adjust to the rigours of the single interest rate, to the necessary budgetary discipline and to the competition induced by the Single Market.

The inevitable pressures of adjustment will generate from time to time loud, and healthy, political hubbub. The point to watch – that political hubbub does not detract from the efficient running of EMU.

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² Article 98, consolidated version of the Treaty establishing the European Community
The Euro Group

Second point to watch: Institutional development.

Hitherto, according to the existing Treaty, the formal forum for debate and decision has been the Council of Economic and Financial Affairs, or ECOFIN for short.

But discussion of euro area matters takes place in the informal Euro Group of the twelve euro finance ministers, the relevant Commissioner and the President of the ECB. The draft Union Constitution gives legal recognition to the Euro Group, though its formal powers would be restricted. The Euro Group would elect its own president – for a period of two and half years – who need not be the President of the Finance Ministers Council.

Of course, the draft Constitution, which of course is not a constitution in the real sense of that term, has still to be ratified by the member states. Yet these provisions will probably remain. So watch to see whether the Euro Group becomes the crucible for deciding the Union’s economic policy, with states outside the euro area excluded.

Expansion of the euro area

Third point to watch: Will there soon be new members of the euro area?

Of the ten prospective entrants in Central Europe and elsewhere, a few may be ready to join in the next few years. But for the remainder of the new entrants, early membership would be risky. For them, the competitive rigour of EU membership will impose challenges best met outside a single currency.

In Britain, I see no prospect any time this decade of persuading a majority of the British people to vote in a referendum in favour of entry. Probably the same is true for Sweden and Denmark.

Euro area financial diplomacy

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1 EU Draft Constitution, Protocol on the Euro Group
Fourth point to watch: It is a truism that the European Union is a giant in the global economy, but a pygmy in international diplomacy. There is one aspect of international diplomacy where the pygmy may grow a bit in the next few years.

Over the next few years, international financial diplomacy may prove an exception to this truism, notably the Union’s representation at the international financial institutions.

At the IMF for example, after the accession of the ten new members, EU member states will control almost one third of the votes of the Fund and contribute roughly the same amount to the Fund’s resources. Yet member state Executive Directors are spread among nine of the Fund’s twenty-four constituencies.

The result – a muted European Union’s voice at the conference tables of the international financial institutions.

Before too long I expect to see the consolidation of the scattered EU representation in the international financial institutions into fewer constituencies, with the ultimate aim of one euro area representative.

Watch too to see whether the President of the Euro Group adopts a higher profile in forums, such as the G7 and the International Monetary and Financial Committee, and becomes global political spokesman for the euro.

**Concluding remarks**

Let me conclude with something of a paradox. The key to improved performance of the euro area economy lies in improving the working of the economic union – creating that open market economy with free competition, favouring an efficient allocation of resources. But the member states should do that even if there was no Economic and Monetary Union.

Thank you.