# Two Years in the Euro:

# The Next Step for Europe

By

Stephen Colligon

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# Two years into the Euro: the next step for Europe

**Stefan Collignon**

European Monetary Union (EMU) has been good for Europe. Two years after it started, the economy of Euroland is in better shape with economic growth at 3.5 percent in 2000, the highest in over a decade, unemployment down, and price stability assured. However, contrary to previous expectations, the exchange rate has depreciated from its initial high level and although it recently seems to have turned around, public opinion often remains sceptical. Ultimately, this gap between reality and perception needs to be closed, if European integration and therefore EMU is to be sustained. In this paper, I will first review the economic arguments that led to the creation of EMU and match them against the results. I will then analyse policy making in Euroland and put forward some recommendations for improvement.

## I - Kept Promises.

The economic debate prior to the introduction of the Euro had focused on two main points: microeconomic benefits for the private sector operating in the single market and macroeconomic improvements in the management of Europe's economy.

*Microeconomic benefits.*

Although European Monetary Union has ultimately been an eminently political project, the process to get there was to a large degree driven by private companies. Elected politicians would hardly have had the courage to delegate sovereignty over monetary policy to an independent European Central Bank, had they not had the support of the business community who felt the limitations of a single market without a single currency. When former chancellor Helmut Schmidt and president Giscard d'Estaing turned to leading European businessmen in 1987 asking for their support to create a European currency and to form the Association for the Monetary Union of Europe, it was out of an understanding that the private and public sector had a common interest in monetary stability.

The theoretical foundations were two-fold. With the European community agreeing on the Single Market Program, lifting all obstacles to the free flow of goods, services and capital between member states, it quickly became apparent that European economic policy suffered from inconsistencies. Padoa-Schioppa (1988, p.373) pointed out that "the community will be seeking to achieve the impossible task of reconciling (1) free trade, (2) full capital mobility, (3) fixed (or at any rate managed) exchange rates and (4) national autonomy in the conduct of monetary policy. […] These four elements cannot coexist, and at least one has to give way."

From a business point of view, the appropriate way to resolve this "inconsistent quartet" was to overcome national autonomy of monetary policy by delegating it to a European institution, for all the other measures would have put the single market into question. If proof was needed, it came in the form of the ERM-crisis in 1992-93 when distortions in the exchange rate levels (before and after the crisis!) did not only disturb capital markets, but also led to public protest against the free circulation of goods in the single market. In fact, the elimination of exchange risk was a necessary condition for a fully integrated, competitive market economy where firms compete for the quality of their products and the efficiency of production. Otherwise macroeconomic policy would always distort companies' level playing field in one way or another: exchange rate levels would bias relative prices for goods, services or in labour markets; exchange rate volatility and divergent monetary policy would prevent the effectiveness of the law of one price in capital markets.

A second element in the commercial strategy of firms was the reduction of transaction costs. In particular, companies in smaller countries considered the transaction costs related to exchange risk hedging and transborder payments as a disadvantage compared to their competitors from larger countries. These transaction costs, estimated to amount to up to 1 percent of EU-GDP[1], reduced the potential for reaping the economics of scale that the single market promised.

Since 1999, Euroland has made good progress in overcoming these obstacles. By definition, EMU has eliminated all exchange risk between Euroland members. The single market has now been completed by a unified monetary payment system. Thus, Euroland has effectively become a unified "European economy" with participating member states as "regional economies." In fact, as Eucken (1989, p 120-127) has pointed out, a market economy consists of *many* markets which are linked and constrained by money. For this reason the co-ordination of individual economic plans and actions depends on the structure of the monetary system that establishes the coherence of economic decisions. However, as we will discuss below, the coexistence of a unified monetary authority and several autonomous national governments poses the question of optimal policy coordination.

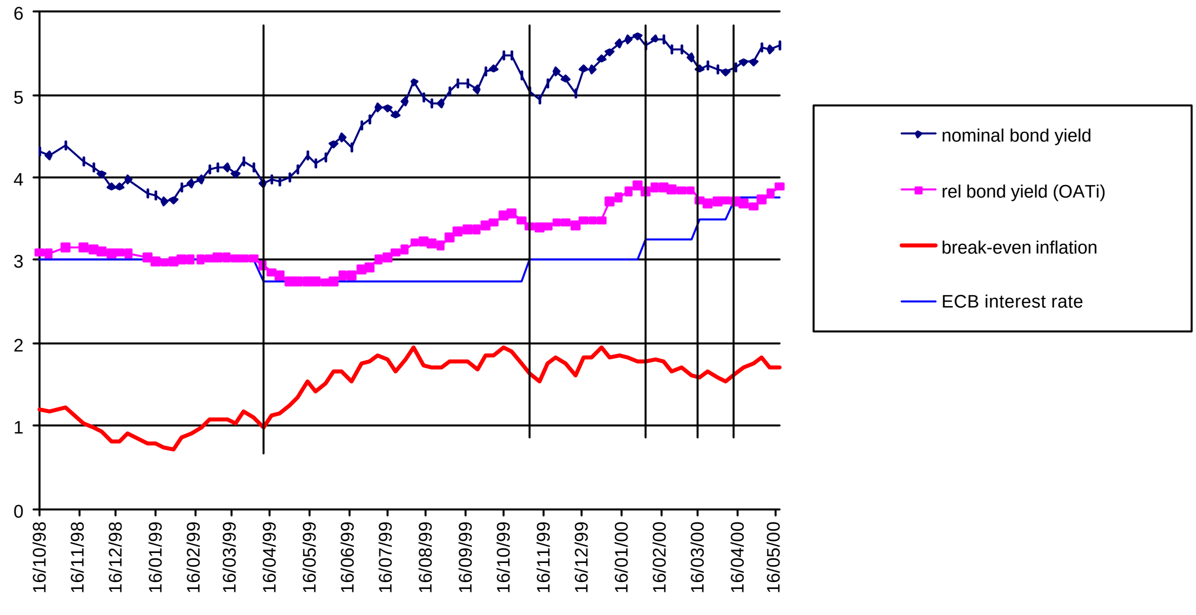
One area where the reduction of transaction costs still remains insufficient is the retail transborder payment system. While the wholesale TARGET-system set up by the European System of Central Banks is cost-efficient and competitive, ordinary customers still find that payments for small purchases and transactions across Europe are more expensive than at home. While the banking system is primarily responsible for this failure to pass cost efficiencies on the customers, public authorities could and should do more, in order to create a level playing field in Europe. With the introduction of notes and coins, this will hopefully become a reality, but national governments must follow up on the initiatives by the European Parliament.

1 For a full discussion of the costs and benefits of EMU including data see Collignon, 1999 (a), OCA.

*The macroeconomic management of Euroland*

"In all beginnings there is magic" said Hermann Hesse. Indeed, the first two years of EMU have been surprisingly good: domestic price stability has been maintained. The ECB's inflation target, a range between 0 and 2 percent, has been achieved by the core inflation rate which excludes energy and fuel costs. With respect to the official HICP, consumer prices started to overshoot the 2 percent mark only in the second half of 2000 when the oil price exploded. However, GDP-deflator inflation has remained below 1.7 percent in every quarter since EMU started. More important even is the management of inflation expectations – a crucial element in the ECB's strategy.[2] Figure 1 shows the expectations of future inflation, derived from the French indexed government bond (OATi); they remain below the 2 percent target. This degree of price stability contrasts favourably with the USA, where inflation fluctuated in a 2-4 percent range. It also documents the advantages of a unified monetary policy in periods of economic shocks: while flexible exchange rates after the demise of Bretton Woods and the oil shock led to widely diverging policy responses in Europe in the 1970's, this time monetary policy was by definition coherent and aimed at preserving price stability.

**Figure1: Euro-inflation expectation**[3]




Partly, as a consequence, economic growth has stayed up. In fact, I would argue that the highest European (and German) growth since the mid 1980's is a direct consequence of EMU. This is not only because the elimination of all exchange risk in the single market and the establishment of a monetary framework of stability was in itself an enormous structural reform, but also because it

[2] See: ECB Monthly Bulletin, May 2000

changed the conduct of economic policy in the EU. The reasons for Europe's growth-slowdown and high unemployment in the 1980s and '90s have been subject to heated debates. Conservative orthodoxy claims that it is all due to Europe's high regulations, rigid labour market, an out-dated welfare system and an over-dimensioned public sector – in short, it is all about supply side economics. EMU was supposed to be a vehicle to impose the "necessary structural reforms" on an unwilling population and policy. However, a closer look shows that the facts do not always coincide with the theory[4]: The costs of regulation are not as high as they appear and the structure of unemployment, the patterns of worker and job turnover and the behaviour of wages in Europe is not so different from the USA as has often been assumed. It has also been noticed that Europe's supply side structures have not changed significantly between periods of high and low growth.

The alternative explanation centred around the suboptional policy mix and insufficient demand. Monetary policy was seen as the culprit (Modigliani, 1997). Clearly, macroeconomic management must have an important role in explaining Europe's performance lagging behind the United States. While the distribution of years with positive and negative output gaps was always fairly balanced in the USA, it dramatically deteriorated in Europe in the 1980s (see table 1).

**Table 1: Ratio of Number of Years with Positive to Negative Output Gaps**

| | **1960-81** | **1982-99** |
|---|---|---|
| **EU 15** | 5.0 | 0.29 |
| **Germany** | 2.0 | 0.20 |
| **France** | 1.0 | 0.50 |
| **Netherlands** | 2.0 | 0.50 |
| **Belgium** | 1.3 | 0.29 |
| **Spain** | 1.4 | 0.38 |
| **Portugal** | 0.8 | 1.0 |
| **USA[5]** | 1.0 | 1.0 |

Source: European Commission, AMECO; OECD .

Thus, an important difference in the macroeconomic management between Europe and America consists in the degree to which the output potential is actually realised. Economic theory readily recognises the crucial role of monetary policy in this context. Europe suffered from a double asymmetry: within the European Monetary system, the Bundesbank was the dominant authority and this implied higher interest rates for most other ERM-countries. Secondly, Frankfurt's monetary policy was overly restrictive, even for German consumption. Figures 2a and 2b show that the Bundesbank frequently kept interest rates higher than output considerations under the *Taylor-rule*,

[3] Source: Bundesministerium der Finanzen, Berlin
[4] See for example: Alogoskoufis et alt., 1995
[5] USA: 1964-81

which was followed by the American Fed, would have suggested. This overtightness bias explains a good part of the excessive accumulation of negative output gaps.[6]

**Figure 2a: Taylor rule and Bundesbank**[7]

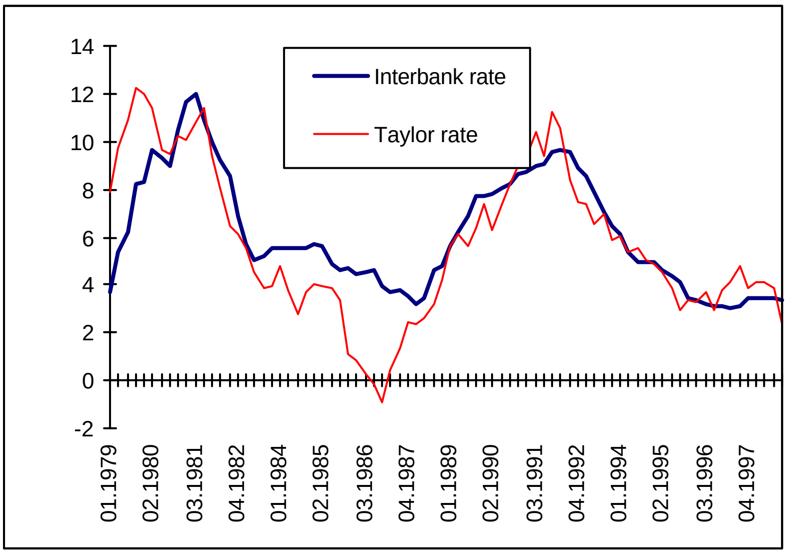
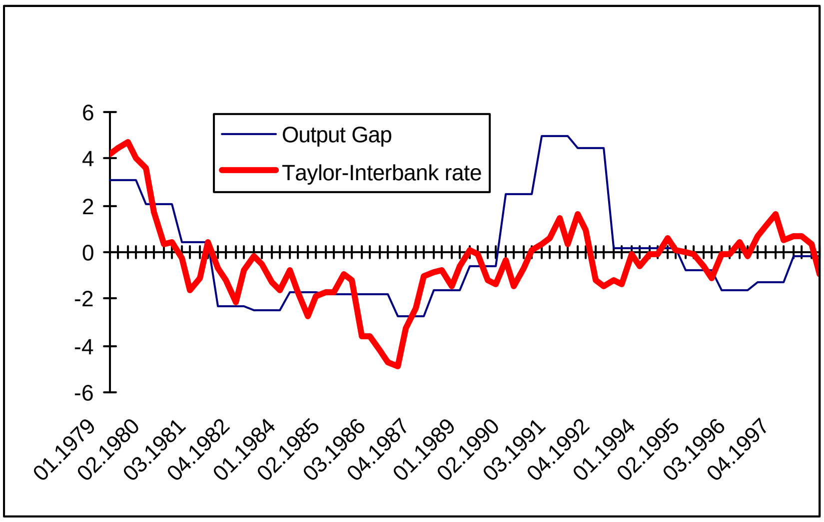



**Figure 2b: Output gap and deviation from Taylor rule**[8]




The restrictive bias also intensified Europe's budgetary pressures. For higher interest rates and lower growth increased the tax burden of debt service and required extra fiscal consolidation in order to keep public debt sustainable (Collignon, 1999 b). These macroeconomic problems could only have been solved by structural reforms at great social costs, for this implied a need to adapt output to insufficient demand, while under welfare considerations supply side reforms should be aimed at *improving the potential*. With this fact in mind, the Portuguese EU-presidency, in spring

[6] On the asymmetric behaviour of the Bundesbank see also Clarida, R. and M. Gertler (1997).
[7] Source: Deutsche Bundesbank
[8] Source: Deutsche Bundesbank and OECD

2000, put forward an ambitious program of structural reforms to create a "European new economy". This so-called Lisbon-Strategy gave new zest and direction to the structural reform processes, which were previously agreed in Cardiff (completing the single market for products and capital) and Luxembourg (improving the quality and flexibility of Europe's labour force).

The effects of this modernisation policy will only become manifest in the future. But the closing of the output gap and the higher GDP-growth rate that created new jobs all over Europe since 1999, can only be due to an improved policy mix in Euroland (which, incidentally, has also supported growth in the non-Euro member states). Dominique Strauss-Kahn, who was a leading voice in the intimate Euro-group of Finance Ministers, has characterised the optimal combination of monetary and fiscal policy as the "Clinton-Greenspan mix", which he contrasted with the "Reagan-Volcker mix" of the 1980's. It implied a relatively loose monetary policy stance with strict control of public *expenditure* (rather than deficits). Low interest rates would then lead to a virtuous circle of renewed growth, extra revenue, and therefore shrinking public deficits. This is exactly what happened in Euroland after the ECB lowered interest rates in April 1999. The Tietmeyer-Waigel policy mix of tight money/tight fiscal stance, which had been imposed on the rest of Europe, was broken and with exchange risk in Euroland abolished, economic growth returned quickly. Subsequent interest rate hikes by the ECB remained in the neutral range, at least until the end of 2000.[9]

However, in order to ensure the long-term sustainability of this positive policy orientation, a third element had to be integrated into the policy mix: wage developments. For the relatively accommodating monetary policy stance is dependent on price stability. This requires, given the sound fiscal policy stance, that unit labour costs are stabilised, i.e. that *nominal* wage cost increases do not exceed aggregate labour productivity improvements.[10] The new German government that came into office at the end of 1998 quickly adopted this philosophy.[11] Under the German EU presidency it introduced the *Macroeconomic Dialogue* at the Cologne summit as an instrument to integrate Europe's social partners into the formulation of an optimal policy mix. This is a rather weak form of policy coordination, but the underlying philosophy was to structure a debate in Europe where relevant policy information could be shared in a consensus building way. So far, the experience has been positive, as most partners would agree.

Thus, introducing the Euro has improved the economic environment in Europe and has also brought about structural reforms. Why then, has the Euro fared so badly on foreign exchange market? Most

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[9] This is what both the so-called Taylor rule of setting interest rates with respect to inflation and output gap or the Ramsey rule of comparing real interest and growth rates would teach us.
[10] See Collignon, 1999(c) and (d) for the underlying theory.
[11] See Jahreswirtschaftsbericht (Economic Report) der Bundesregierung for 1999 and 2000.

analysts agree that this was largely due to the extremely buoyant perspectives of the US economy. Even before 1999, many international fund managers had already taken large positions in Euro-denominated paper. Few of them have subsequently shifted their portfolio in a significant way into dollar assets, despite the Euro depreciation. This is a sign of confidence. However, new investment seemed to yield a significantly higher return in the US, at least in the short and medium term. In addition, the deeper Euro-capital market did now offer borrowers more favourable conditions, even if the funds were used outside Euroland. Finally, the still significant cost of German unification, with the related tax burden, led to an outflow of capital not only from Germany, but also the Euro area. In fact, the persistent volume of DM 200bn (Euro 100bn) *gross* transfers[12] p.a. into East Germany (6 percent of GDP) must imply significant distortions in the return on the German capital stock. In 1998, East German GDP was DM 436bn, but absorption was DM 655bn or 50 percent more. Excess absorption in the new states was mostly financed by public transfers, only one third by private capital flows. The share of labour cost in total value added was roughly two thirds in the West and over 95 percent in the East. Thus, the aggregate profit share fell by nearly 4 percentage points. However, gross transfers amounted to 21 percent of West German profits, therefore reducing Western profit margins after transfers by nearly 7 percentage points. At a capital-output ratio of 3.7, this implies a reduction in the post transfer return on the West German capital stock of 190 base points from 9.0 to 7.1 percent. In terms of net transfers, the reduction of the profit share is by 15.5 percent and the return on capital by 140 base points. By contrast, the return on capital before transfers would have been 1.1 percent in the East and 13.5 (respectively net 10.4) percent after transfers (assuming the same capital-output ratio).[13] These distortions must have led to a significant reallocation of West German capital – but in a globalized economy not necessarily in favour of East Germany.[14] Given this background, the evolution of the Euro exchange rate appears somewhat less surprising, although few observers had anticipated it.

To summarise, the Euro has largely fulfilled the hopes and expectations that its founders had raised. If the exchange rate has been disappointing so far, it is likely to improve in the future, especially as US growth cools down. But the recent experience of exchange rate management does teach us that more stability in the transatlantic monetary relation would benefit the world economy.

## II. Political uncertainties

[12] Net transfers amounted to DM 150bn, which is the more frequently quoted figure. However, with respect to the burden of unification on the productive economy and the distortions it has caused, gross transfers seem more relevant. For example Sinn (2000) shows that the cost of capital in East Germany became negative because of tax incentives.

[13] I have used figures from Sinn (2000), DIW and Bundesministerium der Finanzen for these calculations.

[14] The burden of unification transfers may also explain why the German economy did not respond with the same vigor to the interest rate cuts by the ECB in 1999 as other Euroland economies.

If the start of the new currency has been positive, is it likely to last? This is much more uncertain. For Europe's good performance has benefited from the favourable international environment: low inflation world-wide, a strong US economy, but also renewed growth in Asia, Russia and Latin America. Under these circumstances it was relatively easy to continue the consolidation of public finance, to keep monetary policy from turning restrictive or to prevent unit labour costs from rising. However, what will happen when the going gets tough? Does Euroland have the institutions to design and implement a coherent policy strategy in a more adverse climate? Unfortunately, a positive answer is doubtful. We will first look at the faultlines in the present setup and then suggest some alternatives.

*Instruments of policy co-ordination*

There is no institution clearly in charge of formulating coherent economic policies in Euroland. The Treaty establishes the Broad Economic Guidelines as a coordination instrument. However, in reality this is an indigestible policy document where hordes of bureaucrats from national finance ministries re-write the original draft made by the European Commission. Their prime objective is to prune it of all aspects that could constrain their national governments. Once it has solemnly been adopted by the European Council (the heads of state and governments) it rests in peace on the cemetery of most official policy declarations. Nevertheless, occasionally a new idea gets introduced into the policy debate, for example when the Commission raised the issue of the quality of public finances and its impact on economic growth.

Of greater usefulness is the so-called Euro-group, the regular meeting (10 times per year) of finance ministers with the ECB president and the commissioner. Due to its informal character, the small number of participants, and the confidential nature of the debates, this forum has helped to speed up the formation of common views and consensus between the participants. Discussions are very frank, often with a lead speaker and a discussant. The European Commission usually prepares policy-relevant analysis and the quality of these papers has greatly improved over the last two years. The following debate is often dominated by the brightest and best-trained ministers. The dreary reading of prepared speaking notes is less common in the Euro-group than in Ecofin meetings where ministers speak under the scrutinising eyes of their top civil servants.

Unfortunately, due to its informal nature, the emerging political consensus of the Euro-group also lacks commitment. Thus, when the French finance minister Ch. Sauter wanted to use windfall revenue from economic growth ("cagnotte") in order to pay back public debt, he was overruled by his Prime Minister. And when the German government announced a major tax reform in 2000, it did not even brief its partners in advance – not to mention taking any advice about its appropriateness in terms of the aggregate policy mix. Hence, in the last resort fiscal policy in Euroland is still guided by the principle "*chacun pour soi*" and not by "common concern" as postulated by the Treaty. In fair weather periods, this may be sufficient. In a storm it is not. Instead, it is likely that national policy makers will respond to a crisis in ways that keep their immediate national objectives in focus, ignoring the spill-over effects and externalities that isolated policies will have within an integrated monetary economy. A preview of what is to come was given in summer 2000, when member States reacted in an uncoordinated way to the tax implications of the oil price shock.

It has been claimed that fiscal policy is co-ordinated by the Stability and Growth Pact. Yet this is only true with respect to the stipulated maximum budget deficit limit. In the medium term, i.e. over the business cycle, national budgets are supposed to be "in balance or surplus". Hence, once this has been achieved, as it is now in the case for more than half of the 12 Euro-countries, national fiscal policy is unconstrained. Although each member state submits a pluri-annual Stability Program, their aggregate effect is never seriously assessed. Hence the fiscal policy stance in Europe's unified monetary economy is a random event. As a policy instrument it is non-existent. And still - fiscal policy matters for growth, employment and the developments in capital markets. In a crisis, this policy hole may become a considerable handicap. What is needed is a stronger commitment to policy co-ordination or even a common policy design.

*The next step in building Europe*

The need to improve economic policy co-ordination has been apparent for a long time. When President of the Bundesbank, H. Tietmeyer frequently emphasised the need of complementing monetary union by political union. Yet, when the French government called for a *gouvernement économique*, their German friends were quick to reject it, instead of using the proposal as a stepping-stone for their own declared objective. This may be due to the clumsiness of *neo-wilhelminian* diplomacy, but more profoundly it reflects resistance to restrict their capacity to act and to surrender areas of national sovereignty.

Policy co-ordination can take different degrees of commitment. In its weakest form it comes as the result of "free choice" after "insight into necessity" (to use Hegel's formulation). The macro-economic dialogue is an example of this practice. This mode of co-ordination can be strengthened by agreeing on common rules. That is the essence of the intergovernmental *modus operandi* in the EU.

Some have argued that this is the appropriate method to deal with economic policies in Euroland.[15] However, apart from the uncertainties how this approach will work in a crisis, the growing public disenchantment with European integration hints at an ultimately fatal flaw in the intergovernmental co-ordination method: the growing democratic deficit. The more areas of competences fall into the domain of European policy-making - and the scope increases with externalities from integration and their spill-over effects - the larger is the legitimacy gap in policy decisions. The problem results from the fact, that in a democratic system collective preferences are translated into government policy through the constitutional mechanism. If the public's preferences change, governments and policies will (eventually) adapt. Hence, democratic decisions remain potentially reversible and therefore open. Intergovernmental agreements have a different character. Here, each government enters negotiations with pre-established preferences (interests), which, in principle, reflect the preferences of its own constituency. During the negotiation, governments trade off some of their interests without any feed-back to their constituency. As a consequence, public opinion in the national environment does not necessarily consent to the negotiated outcome. Furthermore, an iron rule of international relations is: *pacta sunt servanda*. Hence, intergovernmental choice can only be reversed when a qualified majority of *countries* decides to do so, but not necessarily the majority of *people*. This form of gerrymandering makes policy changes much more cumbersome and re-enforces the feeling of democratic frustration.

There are two ways to overcome this problem: one is to revert back to nation-state politics, thereby undoing the benefits of integration. This is not unusual. History has seen many cases where regional co-operation disintegrated. Some of the overtones in the debate about subsidiarity and the redefinition of competences between the EU, national and regional authorities could ultimately lead to Europe' demise, especially after the intake of a large number of new countries. The alternative is to delegate more competences to community institutions. This process has been at the core of European integration over the last 50 years, particularly in the field of agricultural policy, competition policy, and foreign trade. With the creation of the European Central Bank it has taken a new qualitative leap, for the coherence of the monetary foundations of Europe are now in one hand. It is only logical to give aggregate fiscal policy a similar degree of coherence. There are, however, two difficulties. First of all, nobody would like to create a large Union-budget. If anything, fiscal pressure should be reduced in Europe. Therefore, budgetary policy will continue to depend on national budgets, which are established - and voted - by independent actors. However, it is conceivable to establish a binding commitment toward defining a coherent aggregate policy stance. For example in France, parliament first approves a macroeconomic policy stance (total planned income, total expenditure and deficit); only in a second step will it then vote on individual titles

[15] See P. Jacquet et J. Pisani-Ferry, 2000

which will have to respect overall budget coherence. This prevents inconsistent budget decisions which hampered the IV. Republic. Along similar lines, one could imagine that national Governments delegate the formulation of the fiscal policy stance in Euroland to a Community institution, presumably the Commission. After due debate and final approval by the legitimating instances (Parliament and Council), national governments, in a second step, implement the so defined aggregate fiscal policy stance through their national budgets. Here they would have the freedom to set priorities in line with local preferences. This leads , of course, to the second difficulty. Further delegation of national sovereignty requires greater democratic legitimacy for the decisions to be taken at the Union level. It does not necessarily require a fully blown federal state, but the European *res publica* will need the involvement of its citizens. Only a democratic debate across borders about the right options for Europe's economy could create the necessary consensus around decisions, which the single currency will make unavoidable. The debate launched by the German Foreign Minister J. Fischer has opened new perspectives. Bringing them into concrete form is the next step for Europe.

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Stefan Collignon is Professor of European Political Economy at the London School of Economics and Political Science. He was previously Director of Research of the Association for the Monetary Union of Europe and from 1999-2000 Deputy Director for Europe at the German Ministry of Finance.