FRBSF Weekly Letter

Number 92-23, June 5, 1992

EMU and the ECB

The accord reached at Maastricht in southern Holland last December moved the European Community significantly closer to the creation of a European Monetary Union (EMU) and a common European Central Bank (ECB). When the EMU is established, exchange rates among participating countries will be permanently fixed, resulting in essentially a single currency for Europe, and participating countries will surrender control of monetary policy to a common European monetary authority.The movement towards the establishment of a common currency and a single European central bank represents one of the most important developments in Western Europe in the postwar era.

In this *Weekly Letter*, the proposed stages in the process leading to monetary union are described, the nature of the proposed common European central bank is discussed, and some of the criticisms that have been made of the transition to monetary union are evaluated.

1989: The Delors Report

The Delors Report in 1989 established the goal of a European Monetary Union that would include complete convertibility of all member currencies, full liberalization and integration of capital markets, and the permanent fixing of exchange rate parities. In order to maintain the credibility of permanently fixed exchange rates, the Report also envisioned a Europe in which the authority for the conduct of monetary policy resided not in the central banks of the individual member countries, but in a common European central bank. Without a single monetary policy, member countries could have different inflation rates. The combination of fixed nominal exchange rates and different inflation rates would lead to real exchange rate movements that would diminish the relative competitiveness of the countries with higher than average inflation. Such a situation would eventually force a realignment of exchange rates, so the claim that exchange rates would be permanently fixed would not be credible.

The transition from a system of separate currencies and central banks to a single currency economy was to proceed in gradual stages. While realignments of exchange rates would be allowed during the transition, the maintenance of fixed exchange rates became an important political symbol of each nation's commitment to the whole process leading to EMU. Only in the final stage, however, would exchange rates among the member countries become "irrevocably locked." In that stage, monetary policy authority would be transferred from the national central banks to the ECB, and member countries would be subject to constraints on the conduct of fiscal policy, such as binding limits on budget deficits in the individual countries.

This transition process has been criticized for its emphasis on fixing exchange rates even though policy convergence would not be achieved until the final stages of monetary union. Maintenance of fixed exchange rates in the absence of inflation convergence may require that capital controls be reintroduced. In that case, interest rates could continue to incorporate a risk premium to compensate for the eventuality of controls. As a result, interest rates could differ across countries, leading to economic inefficiencies (Giovannini 1990; Fratianni, von Hagen, and Waller 1992).

1991: The Maastricht Accord

The agreement reached at Maastricht in December 1991 accepted the Delors Committee's strategy of a gradual approach to monetary union, but altered the stages by which EMU is to be achieved. Most importantly, capital and exchange controls were no longer viewed as acceptable tools of national policy. In order to prevent the potential instability that would arise with fixed exchange rates and no capital controls, the Maastricht agreement calls for early convergence by the individual countries in achieving price stability and fiscal balance, specifically by January 1, 1994. Unlike the strategy outlined in the Delors Report, therefore, the Maastricht Accord envisions the achievement of financial and economic integration, including the permanent elimination of capital controls, before monetary union is established, with greater convergence required to ensure exchange rate stability during the process.

To facilitate the necessary policy coordination, the Maastricht Accord establishes a new European Monetary Institute designed to coordinate national monetary policies and prepare the way for the ECB. Finally, the Accord sets a timetable for monetary union and establishes four requirements for countries to enter the union. First, a country's inflation rate must be no more than 1.5 percentage points above the average rate of the three EC countries with the lowest rates of inflation. Second, its long-term government bond interest rate must not exceed by more than 2 percentage points the rates of the three lowest inflation countries. Third, the total government deficit must be 3 percent or less of GDP. Fourth, outstanding government debt must be no more than 60 percent of GDP. These preconditions for entry require inflation convergence, capital market integration, and fiscal budgetary control.

The Maastricht Accord calls for final monetary union no later than January 1, 1999 and as early as the end of 1996 if seven EC members (that is, a majority) have met the entry conditions. Currently, only Germany, France, Denmark, and Luxembourg qualify, and the only other country that seems likely to qualify by 1996 is the Netherlands. Consequently, monetary union probably will be delayed until 1999 and, even then, will include only a minority of EC countries.

The Accord continues the strategy of the Delors Report in using exchange rate policy as a signal of commitment to the EMU and to policies of price stability. In fact, the current exchange rate system in the EC has been described as ". . .an arrangement for France and Italy to purchase a commitment to low inflation by accepting German monetary policy" (Giavazzi and Giovannini, 1989, p. 85).

According to one view, however, this strategy is both unnecessary and costly. An alternative approach to monetary union could allow exchange rates to remain flexible while completing the process of economic and financial integration, at which point policy coordination could be enforced, followed by the complete fixing of exchange rates. In this scenario, the gains of economic integration could be realized even if individual countries were still following inconsistent inflation policies. Exchange rates would be allowed to adjust to reflect differing inflation rates or regional economic disturbances.

As an example of the costs of making fixed parities a symbol of commitment to the process of eventual monetary union, EC countries were forced to raise interest rates in line with the rise in German interest rates that occurred at the time of German unification, leading to a widespread slowdown in economic activity. The alternative of allowing the DM to appreciate relative to other European currencies would have helped to cushion the impact of German unification on the economies of the other European countries.

Some economists have argued that a more satisfactory way to gain credibility for a low inflation policy, while not losing the ability to adjust exchange rates if necessary during the transition to EMU, would be to increase the independence from political control of the individual national central banks (Fratianni, von Hagen, and Waller 1992).

This argument is based on the observation that countries with legally independent central banks tend, on average, to experience lower inflation (see *Weekly Letter* Dec. 13, 1991). Independent central banks are believed to be less likely to sacrifice long-term price stability than are elected governments who might try to use monetary policy to achieve short-term economic expansions for political reasons. While a government's decision to realign its exchange rate might call into question its commitment to low inflation and eventual monetary union, such a realignment made while monetary policy is conducted by an independent central bank would be less likely to raise doubts about the commitment to low inflation.

The Maastricht Accord calls on EC countries to modify their central banking legislation to ensure their own central banks have a degree of independence consistent with that proposed for the

ECB. This requirement need only be met, however, by the time complete monetary union actually begins.

The ECB: Another Bundesbank?

Membership in the EMU requires participating countries to surrender control over monetary policy. Once monetary union is established, with exchange rates of the participating countries permanently locked, monetary policy authority will be vested in the new ECB; countries in the EMU will no longer be free to set their own monetary policies. The explicit policy objective of the ECB is to be price stability, so it is not surprising that the ECB is being closely modeled on the European central bank that has been most successful in achieving low inflation, Germany's Bundesbank.

Like the Bundesbank, the ECB will have an Executive Board (appointed by the European Council in consultation with the ECB Council and the European Parliament) that will carry out the policy guidelines established by a central bank Council in which regional interests are represented. The ECB Council will consist of the six members of the ECB Executive Board plus the central bank Governors from those countries that have met the requirements for entry into the EMU. Fratianni, von Hagen and Waller (1992) argue that the Governors from the national central banks will be stronger supporters of price stability than the members of the Executive Board who will represent EC-wide political interests. This is similar to the argument that regional Federal Reserve Bank presidents are more disposed towards low inflation policy than are members of the Board of Governors. Tootell (1991), however, finds no discernable difference in voting behavior by Federal Reserve Bank Presidents and the Board of Governors, suggesting that the inclusion of regional representation on the ECB Council may make little difference.

To maintain the ECB's independence, its statute says that neither the ECB nor the national central banks are to take instructions from member governments or from EC institutions. Members of the ECB's Board will be appointed for eight-year nonrenewable terms in order to ensure their political independence.

Political and legal independence of the ECB is unlikely to shield its decisions from political controversy. If individual countries evaluate the short-run tradeoff between unemployment and inflation differently, there will be conflict over the policy the ECB should follow in the face of economic disturbances that have differential impacts on the nations in the union. The unification of Germany provides a vivid example in which the "independent" Bundesbank was forced to accede to decisions reached by the government that had monetary implications. Such developments are likely to test the true independence of the future ECB and its ability to sustain price stability as the sole objective of monetary policy.

Carl W. Walsh
Professor of Economics
Univ. of California, Santa Cruz
and
Visiting Scholar
Federal Reserve Bank of
San Francisco

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Research Department
Federal Reserve
Bank of
San Francisco

P.O. Box 7702
San Francisco, CA 94120

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The *FRBSF Weekly Letter* appears on an abbreviated schedule in June, July, August, and December.