Challenges to Central Banking from Globalized Financial Systems

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Regional monetary arrangements
– lessons from the euro area

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Introductory remarks

Ladies and gentlemen,

I am very happy to have been invited to this conference on the prerequisites for establishing currency unions and to share some of my thoughts with you. It will certainly not come as a surprise that my remarks draw heavily on the experience accumulated by Europe over a number of decades on its way to completing monetary integration. I should perhaps also emphasise that, from the outset, a common European currency was not a goal in itself but an outcome of European history, and largely grounded in the political ideals that Europe finally embraced after two disastrous wars. Bearing this in mind, I nevertheless believe that the experience of the 12 European countries in the euro area can be of relevance for countries of other continents, at different latitudes and with different historical backgrounds.

[*] I should like to thank Claus Brand for his valuable contribution.

In my talk I shall give a brief overview of the historical process leading to EMU, highlighting how economic, political and monetary integration has proceeded in Europe. This integration process has required that a number of economic and institutional preconditions be met. In this context, I must also consider what can be said, in the light of the optimum currency area (OCA) literature, in relation to the economic preconditions for creating a single currency area in Europe. As a major challenge on the road to monetary union I will focus on the thorough reshaping of economic institutions, which in many respects is still ongoing and which has proven to be indispensable for the success of Europe's monetary policy. I will also touch on the issue of whether a "one size fits all" approach to policy, implicit in a monetary union, would be appropriate in a diverse economic context such as the euro area.

1. Major economic challenges on the road to monetary union

Looking at the chronology of European integration, it is apparent that the creation of Economic and Monetary Union (EMU) marks the crowning piece of a historical process which after WW II went on for decades and in many dimensions, including politically, economically and geographically.

Although monetary unions among independent states have been seen in history before, the EMU is particular in a number of respects. It has a population of no less than 300 million people and an economic area comparable in size to that of the United States. In fact, its share of world exports and imports of goods and services – which are of an order of magnitude of about 19% – makes it the most prominent exporter and importer on our planet. So, even though the launch of the single currency has made the currency area as a whole less open – and thus less exposed to exchange rate volatility – than any of its constituent countries, the euro area remains a primary trading partner for the rest of the world.

What is today the euro area represents a highly advanced institutional construction combining both supranational and intergovernmental elements. It is the outcome of a highly complex and long historical process which has been underway for more than half a century and has been driven by the ideal to establish and safeguard peace and economic prosperity in Europe through increased political, economic and monetary integration.

The sequence of events that led to full monetary union is unique in the sense that it is deeply rooted in European history. Nevertheless, the thread which guided each step to ever-closer forms of integration may be of more than a historical interest for a wider group of observers. Let me give a brief overview of this process. After centuries of continental wars, enduring fragmentation and political and economic disasters, the main emphasis was initially on *political*, and not so much economic, integration.

However, after the founding of the European Coal and Steel Community in 1952 and the establishment of the European Economic Community (EEC) with the Treaty of Rome (1957), it became evident that the process of economic and monetary integration was moving ahead faster than that of political unification. The developments in the 1970s showed that there was a need for deeper monetary integration. The collapse of the Bretton Woods system created the desire for exchange rate stability needed to minimise the risk of trade tensions within the European Customs Union launched in 1968. This resulted in the European currency "snake" (1972-78), resulting from the Werner Report (1970) and the Exchange Rate Mechanism (ERM) of the European Monetary System (EMS) in 1979.

The need for exchange rate stability became even more acute from 1986 onwards with the move towards the creation of the single market for goods, services, capital and labour. Following the Single European Act, which came into force in 1987, and the Single Market Programme, of 1992, the process of economic integration was largely complete: it established the free circulation of goods, persons, services and capital across European Union (EU) countries. This helped lead to a tremendous expansion of intra-European trade, a significant rise in foreign direct investment, but also to a gradual geographical enlargement from the original six founding members of the EEC to the current 15 members of the EU, and the many applications to join. The Maastricht Treaty, finally, which was agreed on in 1991, provided the legal and institutional framework for the launch of EMU and led to the establishment of the EU.

Economic integration acted as a spur to monetary integration. As EU members became more interdependent, it became apparent that spillovers from national policies could be significant and currency fluctuations could hamper trade and cross-border investment. Capital liberalisation, combined with the tight exchange rate commitments entered into by individual countries within the context of the EMS, would always expose them to the impending risk of exchange rate crises.

Indeed, the 1992 crisis was a case in point. It brought about a huge shock to nominal and real exchange rates as well as interest rates, a swing in intra-European relative prices, and it had tremendous consequences for trade flows within Europe. The Maastricht Treaty – signed less than a year before – had designed a medium-term time path whereby the nominal exchange rates were to be irrevocably fixed with the aim of achieving and maintaining a truly unified Single European Market. In this respect, the goal to establish a common currency reflected the desire to preserve and strengthen the degree of economic integration that had been achieved at the time.

Indeed, the prospect of a common currency being established as the crowning piece of an ambitious convergence process was a vital component in re-establishing confidence and exchange rate stability

in the context of the ERM for the remainder of the 1990s. Without such prospects, the economic history of Europe – certainly that of the ERM and intra-European trade links – would certainly have been different.

The economics profession has elaborated a number of general structural criteria to judge whether a set of countries forms an OCA. In this respect, without going into too many details, I would even go so far as to say that the euro area satisfies many of these well-known criteria. Trade flows within the euro area are extensive and much more important than trade with the rest of the world. In such an area, eliminating transaction costs and uncertainties relating to exchange rate movements is an obvious advantage measured in terms of enhanced cross-border price transparency and trade opportunities. In addition, the euro area countries are typically highly diversified in production and consumption. They are, therefore, generally less likely to be affected by asymmetric disturbances. Moreover, if intra-industry trade accounts for most of the trade – as is the case within the euro area – and the partner countries are all affected by some major external shocks (for example oil price shocks), then business cycles may be expected to be reasonably synchronised.

It is certainly fair to say that the euro area cannot be unequivocally identified as an OCA in all respects. For example, a lack, or shortage, of some OCA properties – such as the degree of flexibility of prices and wages and/or the mobility of labour which would be required to fully absorb localised shocks without major macroeconomic imbalances – are undeniable. Some observers have also suggested that the sustainability of EMU hinges on the existence of an area-wide fiscal transfer mechanism to function as an absorber to regional shocks. However, a high degree of capital mobility is expected to produce highly diversified financial portfolios which, in this case, could act as shock absorbers.

Another dimension in which the countries that now form the euro area may have been seen to differ a great deal from one another, particularly at the start of the 1990s when the Maastricht Treaty was signed, was that of productivity and price differentials. I shall return to this issue later in my remarks.

The countries that signed the Treaty took a dynamic view on the issue of real convergence. They realised that static thinking in terms of costs and benefits as measured at a certain moment in time is probably misleading when it comes to taking a decision the consequences of which will last forever. They rightly concluded that some of the OCA properties, which the area may not have satisfied ex ante, would turn out to be satisfied ex post, by virtue of EMU itself and the monumental regime change that it would bring for all participating economies. In any case, the benefits are never guaranteed and will crucially depend on national economic policies.

The latter considerations led to the choice of a selected number of macroeconomic criteria which then acted as preconditions for the successful launch of a sound currency.

In 1991, at the European Council meeting in Maastricht, a set of nominal and practically applicable criteria was agreed upon, which would be applied to select those countries which would become members of the single currency area. These economic convergence criteria, relating to price stability, public finances, exchange rate stability and long-term interest rates, while also taking into account a few other factors such as the results of the integration of markets, were designed in a way to act as indicators of the extent to which the prospective member countries were able to comply with stability-oriented economic policies. A further criterion is linked to legal convergence providing independence for national central banks. The philosophy which dictated the selection of the macroeconomic criteria was that countries that are able to maintain stability-oriented policies of low inflation and sound public finances in a sustainable way are less likely to experience substantial internal economic problems, which in a single currency area could have negative spillover effects to other countries. Exchange rate stability and low long-term interest rates have been serving as a market test for the success in achieving stability-oriented policies.

The convergence criteria were thus formulated in a very clear way. They were needed for the credibility of the monetary integration process. The criteria served well as a target and as a disciplining device for economic policies in EU Member States throughout the 1990s. With the benefit of hindsight, it is difficult to imagine how the process of disinflation and fiscal consolidation in Europe in the 1990s would have been possible without the clarity of the convergence criteria or the prospects of monetary union. As many as 11 countries were able to fulfil the criteria ahead of the start of Stage Three of EMU in 1999, something which had not been expected only a few years previously, while Greece was able to join in 2001.

As I have already mentioned, the process of European integration is something gradual and ongoing. It does not only have the dimension of a sustained reinforcement of the economic and political relationships among those European countries which initiated convergence in the aftermath of the Second World War. It is also an attempt to integrate a large portion of Europe – its eastern part – which the dramatic events of the last century have kept separated and divided from the rest of the continent. The enlargement of the EU eastward and the prospective adoption of the euro by the accession countries constitutes a further step on the road to European integration.

2. Institutional arrangements for the functioning of EMU

Before turning to the institutional arrangements that today ensure the functioning of a monetary union, let me briefly turn to an issue which frequently tends to be neglected when thinking about preconditions for the formation of currency unions. Monetary policy can only be successful if it is able to stabilise long-term expectations of economic actors. On the road to monetary union it seems vital to build a common view among prospective participants of the key features of the way the economy and society in general should be shaped and evolve in a common environment. The emergence of such a "political consensus" among countries that today form the euro area has been gradual but sustained. The political consensus which has emerged in Europe is based on the principles of political and economic freedom and on a stability culture, expressed as a desire to achieve, maintain and reinforce monetary stability.

Launching a single currency entails a large-scale institutional transformation. This primarily involves creating a new monetary authority that, by definition, has no established track record. In order for this process to be successful, it must be irrevocable. Furthermore, there must also be a credible framework for the central bank. On these grounds, the ECB has received a clear mandate to maintain price stability and a high degree of independence to pursue this mandate free of external interference. Credibility has been reinforced by the principle of fiscal discipline enshrined in the Treaty and the Stability and Growth Pact.

Fiscal discipline is a key element in promoting a proper functioning of a monetary union like EMU. Disciplined fiscal policy can help to maintain stable prices, while unduly lax fiscal policies can make it more difficult for a monetary authority to achieve its goal of price stability. High public debt can be perceived as a standing threat that inflation may be used as a quick cure to fiscal imbalances and the burden that these impose on the economy at large. In order to do away with this perception, the Maastricht Treaty prohibits the monetary financing of public deficits and bans the privileged access of governments to financial institutions. These are fundamental principles of modern monetary governance and key factors in establishing central bank credibility.

History is full of episodes of high inflation or even hyperinflation that were related to a mismanagement of public finances combined with an accommodative monetary stance. The absence of legal clauses prohibiting the monetary financing of public deficits and governments' privileged access to financial institutions have the potential to jeopardise a central bank's record of maintaining price stability. Instead of enhancing collective prosperity, fiscal laxity tends to make endeavours by central banks to preserve price stability more costly and painful. Even worse, accommodative monetary policy in these circumstances will lead to sustained rises in inflation and finally result in

even greater welfare costs. Fiscal laxity also tends to undermine the stabilising role of public finances and instead reinforce economic instability. History has made it clear that, apart from central bank independence, fiscal discipline is necessary to achieve price stability. Disciplined and sound fiscal policies, as well as structural reforms, also support a central bank's stability-oriented policy by reducing inflation expectations and supporting potential economic growth.

In the case of the euro area, with centralised monetary policy-making but decentralised fiscal policy-setting, the free-riding behaviour of governments could become a problem, as fiscal restraint and/or budgetary consolidation become a public good which all participating countries can share without paying the cost. The importance of rules for fiscal discipline for individual member countries is reflected in the above-mentioned budgetary convergence criteria. Countries need to avoid a deficit above 3% of GDP, and reduce debt significantly if it is above 60% of GDP. In case a country were to exceed the 3% limit on the deficit ratio, a procedure is set in motion that requires budgetary adjustment measures and which can ultimately lead to sanctions.

Furthermore, Member States agreed in 1997 to introduce the goal of budgetary positions of close to balance or in surplus as a medium-term objective. A budget in balance or in surplus over the business cycle allows countries to let the automatic budgetary stabilisers operate freely, thus contributing to macroeconomic stability, without considerable risks that deficits may exceed the 3% limit. Furthermore, such budgetary balances allow for a gradual reduction of the public debt ratio, thus preparing for the financial consequences of ageing populations.

These commitments have been key to achieving sounder public finances in the euro area, and this is meant to be a lasting beneficial arrangement, not just a criterion for entry into EMU.

Another fundamental institutional factor, in particular in a newly-established monetary union, is the existence of a credible and predictable central bank strategy. In the euro area, the Governing Council of the ECB has quantified the ECB's mandate as laid down in the Treaty by announcing a numerical definition of price stability. In this way, it has anchored expectations in the area and has made the new policy framework transparent and predictable.

The Governing Council has also announced the strategic framework to be used to guide its actions. This has been designed to address – in a transparent way – the uncertainties that monetary authorities face in discharging their duties and, in particular, to deal appropriately with episodes of heightened uncertainty which are recurrent in central banking. Uncertainty was particularly acute following the introduction of the euro, when the ECB was facing the challenge of having to conduct monetary policy for the newly-created economic area. In those circumstances, the ECB chose to design its monetary

policy strategy in such a way as to ensure a firm hand management of policy, and to make its policy framework robust enough to withstand the events that were unfolding.

Finally, the launch of a single currency required the creation of a set of financial and statistical infrastructures: notably a large value payments system, which allows for the establishment of a fully integrated area-wide money market, and the compilation of area-wide statistics. The latter are extremely important for the successful conduct of monetary policy in a unified currency area. Indeed, a major challenge on the path towards the launch of the euro was the issue of harmonising statistical series across member countries and ensuring the timely availability of reliable euro area-wide statistics to monitor and assess the euro area economy in all its facets. Many achievements have been made during Stage Two of the EMU project, and many efforts have gone into the design and implementation of Stage Three, but the process is still ongoing.

In this context, let me say that EMU was launched in three stages, which allowed for an orderly process of reshaping institutions and building the necessary infrastructure. Stage One was mainly characterised by a complete liberalisation of capital movements. As a precursor of the ECB, in 1994 the European Monetary Institute (EMI) was established, marking Stage Two. From this time on central bank credit to the public sector was banned and a process was started leading to the required independence of national central banks. The EMI had the task of carrying out the preparatory work necessary for the launch of the single currency in Europe. It contributed to the strengthening of co-operation between the national central banks and the examination of the convergence process. It developed the technical and organisational infrastructure of the ECB. In particular, the EMI carried out the preparatory work for the conduct of the single monetary policy, such as devising a monetary policy strategy and the appropriate set of monetary policy instruments and promoting the harmonisation of statistics. The ECB itself, as the centre of the European System of Central Banks, was established in mid-1998 and finalised the preparations. 1 January 1999 finally marked Stage Three, comprising the irrevocable fixing of exchange rates, the introduction of the euro and the transfer of national sovereignty in monetary policy to the ECB.

3. A single monetary policy for many nations

Ever since the project of economic and monetary union in Europe moved into its decisive phase there has been an intense debate on the viability of a single monetary policy in an area with potentially diverging economic developments and structures across regions and countries. For the launch of the single currency a reduction in inflation rates among the participating countries was seen as vital. This is why it constituted a convergence criterion. However, it was clear to all that there was – and there is – no inherent mechanism which could guarantee further convergence of inflation rates within EMU

once monetary union had been established. In that respect, researchers and policy-makers alike have long questioned whether a "one size fits all" approach to policy, implicit in a monetary union, is appropriate in a diverse economic context such as the euro area. At the heart of this debate lies the notion that large and persistent cross-country inflation differentials would complicate the conduct of a single monetary policy in Europe. Under certain circumstances inflation differentials affect the competitiveness of countries participating in a currency union, in a context in which exchange rate adjustments can no longer be used to compensate for potential losses in competitiveness. Neither can a single, common monetary policy do anything about this.

To facilitate the conduct of a single monetary policy it seems crucial to carefully consider the sources of potential inflation differentials across nations forming a single currency area and to identify national remedies for this kind of regional dispersion. Inflation differentials in currency unions may be caused by several factors. They may be caused by differences in cyclical developments, possibly caused, or exacerbated, by differences in the fiscal policy stance. They may equally be caused by differences in relative prices that are, for example, due to misalignment of the exchange rate at which a country may have joined monetary union. Therefore, whether inflation differentials are a concern for policy depends crucially on the factors causing them.

The literature has also pointed to intrinsic factors causing divergences in inflation rates, such as the fact that some countries catch up with others in terms of real per capita income. What has become known as the Balassa-Samuelson effect explains inflation differentials as being caused by catching-up effects in economies with productivity differentials between the tradable and non-tradable goods sectors. Wage rises caused by productivity increases in the tradable goods sector spill over into other sectors, leading to an overall rise in inflation.

With respect to the euro area, we see no evidence that this effect could be relevant for the countries that currently form the euro area, not least because it may be blurred by structural distortions such as protective regulations in specific sectors or government-induced growth in public-sector employment. Should such distortions indeed be relevant, this would, of course, call for national solutions.

As it seems important to acknowledge that catching-up effects may in general be relevant for countries with widely different levels of per capita income, it should be clear that in a currency union, inflation differentials may well be a perfectly normal phenomenon. In integrated markets and economies, inflation rates cannot be expected to be identical as they may reflect an equilibrium process of convergence in national price levels, which may begin at different levels. In some sectors and regions prices may even have to fall. This is normal and is no cause for concern as long as this process does

not spill over into area-wide deflationary expectations. However, with increased market integration and the progressive levelling of productivity standards across the participating countries, differences in inflation rates should diminish over time, although they would normally not disappear completely, as the experience of mature currency unions such as the United States shows. Here, I should perhaps remark that, indeed, our experience is that in the run-up to EMU, and also as a direct result of the Single Market, in the euro area we have seen a remarkable convergence in price levels and inflation rates in the participating countries.

Inflation differentials may also be due to asymmetrical shocks or to regional differences in the propagation of symmetrical shocks because of deep structural features, such as demography, market regulations and the degree of competition. Again, monetary policy cannot do anything about these phenomena. In contrast, it is often the case that national economic policies are in a position to counter these processes and can thus effectively help to avoid the adverse effects of such processes. A good example of this is the establishment of mechanisms which can act as shock absorbers in the face of regional shocks. We have always made it clear that the onus is on national governments to create structures in labour, product and capital markets that increase the overall flexibility of the economy.

Very similar considerations hold for possible differences in the mechanisms by which the effect of monetary policy is transmitted in the various countries. Such differences may be the reflection of different structures in the banking system and in financial markets, or different degrees of market imperfections such as wage and price rigidities. The integration of the financial sector and the markets for goods, labour and capital should help to alleviate such asymmetries over time. And it is certainly true that financial integration is an endogenous process which is accelerated by monetary union itself. As in the case of prices and productivity standards, it is important that the process of convergence in the financial structure and in the way capital markets operate is well on its way *before* a single currency is launched.

Differences in the nature of the monetary policy transmission mechanism in the euro area have been the subject of intensive research, both inside and outside the ECB and the national central banks. Of course, most of this research is done on the basis of pre-1999 data, where no single monetary authority existed and where most of the economic convergence was still to be achieved. Drawing conclusions on the likely differences in the effects of the single monetary policy is therefore a potentially hazardous exercise. As these effects crucially depend on the private sector's expectations about the central bank's objectives and actions, they also depend, to a large extent, on the monetary policy regime itself. The change to the new EMU regime may well invalidate part of the inference drawn on the basis of historical data.

Despite these caveats the fairly extensive literature on the transmission mechanism in individual countries finds little evidence for discernible differences in policy effects across countries. In particular, differences in the estimated impact of monetary policy on key macroeconomic variables like money, prices and output do not seem to be robust enough to withstand the use of different methodologies, models and data series. In any case, it seems plausible to assume that there is no clear-cut evidence of systematic differences in monetary policy transmission in the euro area.

The acknowledgement of the fact that a single monetary policy cannot address regional economic divergences is fundamental and is firmly anchored in the institutional set-up on which the ECB has been established. Economic divergences in different regions or possible differences in the effects of monetary policy cannot serve as considerations in policy setting. The price-stability mandate has been defined in terms of a *euro area-wide* aggregate measure of consumer price inflation, and monetary policy decisions are geared towards the maintenance of price stability for the euro area as a whole.

4. What can be learnt from a European perspective?

To conclude, let me perhaps mention that the way the common currency in Europe was launched and the form that monetary integration took in our continent were greatly influenced by the particular historical context that marked Europe's experience in the course of the last century. The political dimension – that is, the need to create durable links among countries that had been enemies for much of their past – clearly dominated over economic considerations. The currency union is one important building block of European integration, along with economic and political integration, and the process of this integration in Europe has been driven by the ideal to establish and safeguard peace and economic prosperity. Historically, it turned out that economic integration acted as a spur to monetary integration: the launch of a single currency seemed vital to safeguard deeper market integration and capital liberalisation achieved earlier on. New policy requirements arose from the so-called "inconsistent trinity", which implies that autonomous national monetary policies are incompatible with fixed exchange rate objectives in an environment of free capital movements. As a result, national authorities participating in EMS/ERM had to subordinate monetary and, to a large extent, fiscal policy to the achievement of exchange rate stability. This led logically to monetary union, with the creation of the ECB as a supranational institution, and to the introduction of the euro. Now, as a result, economic and monetary integration is much more advanced than political integration in Europe.

It is important to acknowledge that there is a body of fundamental economic principles and institutional arrangements that have proven to be indispensable in establishing and managing a sound

single currency and which seem to be independent of the particular historical context in which Europe pursued its own agenda. Let me summarise the lessons that are readily exportable to other continents and other contexts. The most obvious technical precondition for a viable currency union is certainly the establishment of a single market for goods, capital, money and labour among the participating countries. Financial market integration, the harmonisation of legal systems, the creation of area-wide large value payment systems and security settlement systems, as well as the availability of area-wide statistics, have proven to be the other key building blocks for the infrastructure necessary to launch Europe's common currency.

Furthermore, the launch of a sound currency requires a far-reaching and long-lasting process of institutional and political reshaping in addition to economic integration. It seems inconceivable that an Economic and Monetary Union of the sort which was created in Europe could have been achieved without relying on a common political consensus solidly wedded to the principles of democracy and free market and on a stability culture, expressed as a desire to achieve, maintain and reinforce monetary stability.

Transparent and compelling economic criteria are of great help, both in fostering commitment to the project of integration by prospective members and in facilitating necessary and beneficial policy reform within individual countries. The chosen convergence criteria for membership in the EMU were crucial for the process of disinflation and fiscal consolidation which took place in the EU in the 1990s. These achievements have generated stability and welfare gains and have thus created lasting economic benefits. The convergence criteria were formulated in a very clear way and have served as a very transparent basis on which to form a judgement about whether countries are able to join.

However, let me emphasise that beyond the fulfilment of convergence criteria further tasks have to be accomplished by national economic policies to safeguard economic and political benefits from EMU. Regarding fiscal consolidation, in order to support the stability-oriented monetary policy of the ECB, some member countries must undertake further efforts to be able to comply with their commitment to achieve budgets close to balance or in surplus in the coming years. In addition, to enhance the growth potential of the euro area economy as a whole, it would be necessary for countries to continue with the implementation of structural reforms in the goods and labour markets. This will also strengthen the ability of national economies to absorb economic shocks, thus contributing to a smooth conduct of monetary policy in the euro area.

Finally, and perhaps most importantly, let me say that, from a European perspective, in order to launch a sound currency it was crucial to rely on the principle of central bank independence, the need to

assign an unambiguous mandate for price stability to the central bank and to set up a framework that guarantees a sound management of public finances to safeguard a central bank's mission of preserving price stability.