The Political Economy of Common Monetary Arrangements. Lessons from the European Experience

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ABSTRACT

This paper analyses the preconditions and procedures that have led to the introduction of a common currency in Europe and draws lessons for monetary arrangements in other parts of the world. Based on a detailed analysis of the European experience before the introduction of the Euro, the paper addresses the need for stable exchange rates as a precondition for the deepening of economic integration. It is pointed out that stable exchange rate conditions require not only economic and financial convergence but also most of all the political will to harmonize economic policy, which goes beyond monetary and fiscal policies and includes transfer and regional policies. Analysing the experience since the introduction of the Euro, it is pointed out that even if institutional arrangements are well conceived, any ‘new currency’ is burdened with the difficult task of establishing its reputation involving additional policy measures which require a high degree of consensus especially in the area of fiscal policies. The major conclusion of the paper is that while the preconditions for a monetary union are extremely difficult to achieve, finding a way to stabilize exchange rates within an area which wants to achieve deeper economic integration or even an economic union, is also a necessity.

I. The Problem of Sequence

Macroeconomic convergence is generally considered as being an essential precondition for the establishment of monetary arrangements that imply stable exchange rates.[1] An even stricter proposition is held by the theory of optimum currency areas that postulates additional requirements ranging from factor mobility to various structural features of the economy, which would guarantee that economic policy would be capable of managing external shocks.[2] More recently, even political union or the existence of a 'political identity' is being discussed as an essential pre-requisite for a functioning common currency[3] while in the new theory of an optimum currency area the requirements are less strict.[4]

But economic convergence in the European Union, rather than being a precondition has been the result and the consequence of specific monetary arrangements. Mutual agreement on the degree of inflation tolerance and a consensus on monetary policy as to its indicators and instruments have grown out of the existence of currency systems aimed at stabilizing the exchange rates.[5] The European experience demonstrates that there is also a sequence that does not go from macroeconomic convergence to stable exchange rates, but begins with stabilising exchange rates, proceeds to harmonizing monetary policy, and goes on from there to fiscal adjustment. Although it is often the case that monetary arrangements aimed at achieving stable exchange rates are deficient as long as the consensus on monetary and fiscal policies is lacking, the European experience suggests that once when stable exchange rates have gained supreme policy status, monetary and financial convergence results more or less naturally when this precondition is established.

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[1] Cf. McCauley, R. N., and R. W. White, The Euro and European Financial Markets, in: P. R. Masson, et al. (eds), EMU and the International Financial System, IMF, Washington, D.C. 1997

[2] Cf. Mundell, Robert A., A Theory of Optimum Currency Areas, in: American Economic Review, Vol. 51, 1961, pp. 657

[3] Holtfrerich, Carl-Ludwig: Did Monetary Unification Precede or Follow Political Unification in the 19th Century?, in: European Economic Review 37 (1993), pp. 518-524

[4] Melitz, Jacques, The Current Impasse in Research on Optimum Currency Areas, in: American Economic Review, Vol. 39, 1995, pp. 492 and Tavlas, George S., The 'New' Theory of Optimum Currency Areas, in: The World Economy, Vol. 16, No. 6, 1993, pp. 663

[5] Cf. De Grauwe, Paul, The Economics of Convergence: Towards Monetary Union in Europe, in: Weltwirtschaftliches Archiv, 132(1), 1996

Theoretically, the "European sequence" is borne out as well. Firstly, if a region composed of different countries with individual currencies should already possess the features of an 'optimum currency area', the introduction of a common currency were not necessary as exchange rate would be stable anyway due to factor movement and other price adaptations.[6] Secondly, the analyses of so-called asymmetric shocks are based on the idea that these can and should be countered by fiscal and monetary policy responses in combination with exchange rate variations. But external shocks usually have specific micro-economic impacts while the effects of monetary policy and exchange rate changes cannot be adequately specified in relation to the micro-level. If, however, the effects of an external shock are of a general macroeconomic nature, most likely the monetary authorities of the unified currency area could also apply adequate measures. Thirdly, serious external shocks are relatively rare cases.[7] However, if events like unexpected interest rate or price movements are included, it is unlikely that these will affect homogenously specific economies but would be highly heterogeneous across a regional group of countries.[8] In addition, external shocks, which potentially affect the exchange rate, will be more pronounced when market liquidity is small, while the existence of a larger currency area dampens the effects as it facilitates microeconomic adaptation.[9] Constancy of monetary policy is usually more helpful for the adaptation process as it assists in stabilizing expectations on the micro-level and avoids the additional factor of uncertainty that comes along with economic policy activism. Economic policy makers hardly possess the prognostic capacity in order to correctly assess the severity and the duration of shocks, and there is no reliable economic model that could prescribe the correct dosage of policy measures.

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[6] For the application of this criterion to the stability of currency union see Vaubel, Roland, Real Exchange-Rate Changes in the European Community: The Empirical Evidence and it Implications for European Currency Unification, in: Weltwirtschaftliches Archiv, Vol., 112 (3), 1976, pp. 429 and Hagen, Jürgen v./Manfred J. M. Neumann, Real Exchange Rates within and Between Currency Areas: How Far Away is EMU? In: Review of Economics and Statistics, Vol. 5, No. 2, 1994, pp. 236

[7] Funke, M., S. Hall and R. Ruhwedel, Shock-Hunting: The Relative Importance of Industry-Specific, Region-Specific and Aggregate Shocks in OECD countries, Centre of Economic Forecasting, Discussion Paper No. 14-97, London Business School, London 1997

[8] Fatas, A., EMU: Countries or Regions? Lessons from the EMS Experience, European Economic Review, Vol. 41(3-5) 1997

[9] For a cost-benefit analysis of a monetary union see Robert Grassinger, Nutzen und Kosten einer Währungsunion. Wohlfahrtseffekte eines gemeinsamen Geldes, Baden-Baden 1998

The heart of the matter is not monetary union per se but what kind of common monetary policy will be conducted.[10] Focusing on the problem of optimality distracts the focus from the more central problem of monetary stability and fiscal adjustment.

II. European Economic Integration and Exchange Rate Systems

A common currency is not a new event in European history. For about half a century until the outbreak of World War I, the gold standard had provided a common currency system. While the period of the gold standard is still generally associated with prosperity, the interwar period of the 1920s and 1930s with their lack of a functioning common currency system continues to be remembered as a period of instability, economic decline and political conflict. At the Bretton Woods conference in 1944, John Maynard Keynes represented the consensus opinion among economists when he suggested the construction of a system that would offer the stability of the gold standard without the limitations inherent to a metal standard.[11] When the modern process of European economic integration began in an institutionalised form, all joining states (Belgium, France, Germany, Italy, Luxembourg and The Netherlands) were members of the Bretton Woods fixed exchange rate system. When later on in 1957, the European Economic Community (EEC) was founded, this exchange rate system was well established and delivered – at least until the late sixties – a fairly stable framework shared by all EEC members. As soon as this system began to crumble the need arose to find alternatives as currency fluctuations caused internal disputes ranging from conflicts on how to manage the common agricultural policy to the problem of how to calculate contributions and funding. When the Bretton Woods System finally broke down in the early 1970s, there was little doubt that the integration process in Europe was at stake threatening to bring the integration process to a standstill and even provoke its retrogression.

As early as in 1970, when a detailed plan was launched which called for the establishment of a common currency for the Community by the end to the 1980s, a pre-course to the current debate occurred between the so-called "economists" who called for the integration of the real

[10] Cf. Collignon, S., P. Bofinger, C. Johnson and B. De Maigret, Europe's Monetary Future, New Jersey 1994

[11] For the historical analysis see Bordo, Michael D., and Forrest Capie (eds), Monetary Regimes in Transition, Cambridge 1993

economy before the introduction of a common currency, and the so-called "monetarists" who claimed that a common currency was necessary in order to achieve the integration of the real economy.[12] But practical necessity overruled both opinions as it became clear during the instabilities of the 1970s that neither freely floating exchange rates nor demand side policies are compatible with a deeper integration. The turbulences caused by the breakdown of the Bretton Woods system, the two oil price shocks, and the futile attempts to apply deficit spending as a means of overcoming the slump, led to a fundamental change as to what economic policy can and should do. Misunderstanding the role of fiscal and monetary policy by ignoring the lessons learned still seems to guide many analyses.[13]

In Europe, the two major lessons that were drawn from the experience during this period said, firstly, that practical experience did not confirm the expectations about the automatic stabilization of freely floating exchange rates, and, secondly, that demand management theories did not fulfil their promises. Some governments were more prepared to accept these lessons but step-by-step during the 1980s a new consensus emerged among European policy makers.[14] A pioneer in this process of re-orientation was the German central bank that never had quite accepted the idea that monetary policy could foresee economic cycles in a timely manner in order to overcome the time lags when implementing its instruments. The German central bank was one of the first to use its newly gained monetary autonomy after the breakdown of the Bretton Woods System in order to pursue a strategy of stable monetary growth.[15]

The European consensus[16] on economic policy, which was about to emerge, can be summarized in the following statements:

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[12] See Krägenau, Henry and Wolfgang Wetter, Europäische Wirtschafts- und Währungsunion. Vom Werner-Plan zum Vertrag von Maastricht. Analysen und Dokumentation, Baden-Baden 1993

[13] Typically represented by the analytical perspective in: OECD, EMU. Facts, Challenges and Policies, Paris 1999

[14] Cf. Eichengreen, Barry, Jeffrey Frieden and Jürgen von Hagen (eds.) Monetary and Fiscal Policy in an Integrated Europe, Heidelberg 1995

[15] See Deutsche Bundesbank, The Monetary Policy of the Bundesbank, Frankfurt a. M., 1995 and Issing, O., Theoretical and Empirical Foundations of the Bundesbank's Monetary Targeting, in: Intereconomics, November/December 1992

[16] The term 'consensus' as used in the context here refers mainly to the European Council as the prime decision making body of the European Union and the Commission as the executive branch. It includes

- The process of integration requires a stable currency system
- Monetary policy should primarily be oriented towards price stability
- Deficit spending policies are incompatible with exchange rate stability.

III. From EMS Towards a Single Currency

The European Monetary Systems (EMS) of 1979 which replaced the ‘snake system’ which was introduced in 1972, initiated the synthetic currency ECU (European Currency Unit). This basket currency system, based on the relative shares of all members of the Community including the currencies of those countries that would not participate in the Exchange Rate Mechanism (ERM), was aimed at overcoming the asymmetry associated with the priority of a single national currency, as it was the case with the role of the U.S. dollar in the Bretton Woods Systems. As the decline of the Bretton Woods System had demonstrated, an international monetary system, which exclusively depends on one national currency, is exposed to the disruptions due to national priorities of the leading currency. After a period of realignments, the EMS stabilized in the second half of 1980s and its existence was accompanied by falling inflation rates and solid growth[17] providing the basis to initiate new steps forward in the integration process with the single market initiative.[18]

During the period of the 1980s, earlier lessons were re-enforced while others were refined. The new consensus on economic policy that had emerged went deeper and was at the same

to a lesser extent the relevant political groups within the individual countries but does not refer to public opinion or academia.

[17] See Gros, Daniel and Niels Thygesen, The EMS: Achievements, Current Issues and Directions for the Future, in: CEPS (Centre for European Policy Studies), Paper No. 35, Brussels 1988

[18] Emerson, M. et al., The Economics of 1992: An Assessment of the Potential Economic Effects of Completing the Internal Market of the European Community, in: European Economy, No. 35 (Commission of the European Communities), Brussels 1988

time more pronounced than earlier.[19] Hypotheses had turned into convictions that were supported by a wide majority of member states.[20]

- Stable exchange rates are highly beneficial for deepening economic integration
- Monetary policy should be confined to guaranteeing a stable price level
- Fiscal adjustment is a prerequisite for stable internal and external monetary conditions.

But as the exchange rate crisis of 1992 and 1993 demonstrated, even sophisticated multi-currency systems such as the ERM do not offer the degree of stability, which would be compatible with the deeper integration that had been achieved.[21] Political considerations and economic necessities worked together in establishing the additional pillar of consensus among the majority of EU members that only a common currency could provide the stability needed in order to maintain and deepen the integration process. Since the early 1990s, economic policy in the EU increasingly operated under the guidelines set by the criteria of the plan to achieve a common currency until the end of the decade. This regime of convergence worked within the framework of the loosened ERM while the convergence criteria on price stability and fiscal adjustment were aimed at eliminating the roots of currency instability. By adopting a common standard for economic policy, most member states experienced a period of relatively stable exchange rates in the absence of a strict formal system. In certain respects the plan to achieve a common currency worked as if a common currency was already established. This, however, was only the case due to the earlier consensus that had emerged in the past decades and had become an integral part of the European Union Treaty of 1992 (Maastricht Treaty).

The European integration process and the experimentation with different kinds of monetary arrangements had brought forth a broad consensus not just on the usefulness of stable currencies but on stable monetary and fiscal policy as well. When Europe began the introductory phase of installing a common currency, fiscal and monetary policy and the use of

[19] European Commission, Commission's Recommendation for the Broad Guidelines of the Economic Policies of member States and the Community, Brussels, May 1998

[20] Although some modifications are under way, the principle of decision-making at the EC is unanimity. In practice, France and Germany *together* form the basis for new initiatives, i.e. while individually France and Germany have an informal 'veto'-right, with very few exceptions (most prominently the United Kingdom) other members usually follow the consensus when these two countries give unanimously strong support to a proposition.

[21] See Fratianni, Michele and Jürgen von Hagen, The European Monetary System Ten Years After, in: Carnegie-Rochester Conference Series on Public Policy 32 (1990) pp. 173-242

exchange rate variations for short-term policy purposes had lost their appeal of the past. This, however, does not imply that alternative policy instruments such as deregulation and making labour market more flexible are generally embraced.[22] It remains to be seen whether the historical logic of the European integration also applies coercively to labour markets and thus the single currency will force the individual countries to deregulate their internal markets due to the fact that other policy measures are no longer available.[23]

IV. Are there Lessons for other Regions?

Among the numerous endeavours of economic integration in the world, the EU represents the most advanced system. European economic integration serves as a model for a number of other regional blocs while its attractiveness in Europe is shown by the fact that beginning with six member states in the early 1950s, it will most likely have 20 or even more members within the next decade. It is still too early to assess the effect of the Euro on Europe's future economic integration. However, by analysing the monetary integration process a number of lessons can be drawn for those regions that intend to work towards deeper integration.

The European process of integration offers an ample field of experiments with different kinds of currency systems. When analysing these under the aspect of 'lessons learned' one has to take into account that the European integration is peculiar in the respect that it represents primarily a political endeavour.[24] By having a well-established and largely undisputed

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[22] Cf. Bean, C., European Unemployment: A Survey, in: Journal of Economic Literature, Vol. 32 (2), 1994

[23] It should be noted, however, that in the end the burden of adaptation must always be borne at the micro level. Even assuming that short term economic policy *may* alleviate the burden in the short run, there is rarely an escape in the long run. On the contrary, short-term macroeconomic management may rather contribute to a postponement of necessary adaptation measures – paying a higher price later on.

[24] See Lindberg, L. N., The Political Dynamics of European Economic Integration, Stanford 1963

political goal[25], the integration process gained constancy. To overcome the various impasses, political stamina was required which resulted from a constant source of political energy directed towards this goal. Only by taking into account that European integration is primarily politically motivated, and economic integration serves as a means to obtain this objective[26], the major features of the European integration process can be adequately evaluated:

- It has been the deeply rooted political will towards integration which was essential for overcoming disputes, obstacles, and setbacks which by necessity accompany an integration process
- From the beginning, political union was supposed to include monetary union
- As the political union served as the premier aim, matters of economic integration and later on the way how common monetary arrangements should be handled, became largely technocratic matters, and as such could be assigned to bureaucracies and the experts.

While working with various forms of monetary arrangements and later on when following the guidelines set by the aim of introducing a common currency, it became clear that finding a consensus about what monetary policy should and can do, and, more technically, which aims, indicators, and instruments should be used in conducting monetary policy is of primary importance. In addition, the European experience includes the lesson that stable common monetary arrangements need internal monetary stabilization and fiscal adjustment. When these conditions are fulfilled, market integration follows in a natural way.

Applying these lessons to the integration process in other areas, it becomes obvious that almost all of the elements which lie at the basis of the European process of integration are not present or of a very different nature. In more general terms and limited to economic policy, however, five aspects result as the primary guidelines:

[25] In contrast to the ‘consensus’ on economic policy, which is mainly confined to the prime decision making bodies of the EU, the political consensus on European integration runs deep among most nations with few exceptions.

[26] Here, too, as with the economic sequence, the record needs to be set straight as it is not so that political unification was imposed upon a mere economic community.

- Without constancy and an unwavering adherence to the goal of economic integration, the process will likely encounter abortion due to a standstill and neglect;
- If deeper integration such as a single market is wanted, common monetary arrangements aimed at stable exchange rates are one of the major preconditions for achieving this aim;
- Stable common monetary arrangements require the formation of a consensus on rules for monetary and fiscal policy;
- Applying fiscal and monetary policy for short-term purposes is incompatible with stable currencies;
- Stable exchange rates require stability of economic policies.

As a tentative outlook for other regions that aim at integration, the European experience would suggest a strategy of an early adoption of common monetary arrangements and to work towards consensus on monetary policy that implies fiscal restraint.

V. Is there a Future for Regional Integration?

Any deeper regional economic integration is severely hampered when stable currencies are lacking. In this respect common monetary arrangements that would stabilize exchange rates are a necessity. On the other hand, the European experience demonstrates that maintaining stable currencies is difficult to achieve as currency stability does not only require a functioning formal system but also a profound consensus on monetary policy and the role of fiscal policy. Such a consensus cannot be gained in a purely theoretical way but requires active experience guided by strongly felt political convictions.

The major lesson to derive from the European experience thus is taking into account the highly political character of forming a regional union. As to the technical aspects of the process, the important lessons appear to be that common monetary arrangements are necessary to induce the convergence process in the first place. Even lose systems which leave room for realignments seem to do the job as long as there is the political will involved to seriously work towards tighter systems.

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