



EUROPEAN CENTRAL BANK

EUROSYSTEM

PROGRESS THROUGH CRISIS? PROCEEDINGS OF THE CONFERENCE FOR THE 20TH ANNIVERSARY OF THE ESTABLISHMENT OF THE EUROPEAN MONETARY INSTITUTE

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Ivo Maes and
Frank Moss (eds.)



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FOREWORD

January 2014 marked the 20th anniversary of the establishment of the European Monetary Institute, the predecessor of the European Central Bank. On 12 February 2014, the European Central Bank and the National Bank of Belgium co-hosted a conference in Brussels to commemorate this key milestone on the way to Economic and Monetary Union.

This book brings together the papers presented at the conference which was entitled “*Progress through crisis? Conference for the 20th anniversary of the establishment of the European Monetary Institute*”. The aim of both the conference and this volume was not only to celebrate the anniversary and honour Alexandre Lamfalussy, the first President of the EMI. It was also intended to draw parallels between how the lessons from the crisis of the 1990s had influenced the progress towards EMU and how the recent euro area crisis was holding lessons for the future functioning of EMU. As such, it offered an occasion to assess how some of the past experiences remained relevant for the future, very much in the spirit of Alexandre Lamfalussy, the prototype of the forward-looking central banker.

Naturally, we would like to thank all the persons who contributed to the successful conclusion of this project, both for the organisation of the conference and the preparation of this volume.

Ivo Maes
Frank Moss

July 2014

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Marco Buti, educated at the Universities of Florence and Oxford, joined the European Commission in 1987. He was economic advisor of the Commission President until 2003; from September 2003 to August 2006 he was Director of Economies of Member States at the Directorate-General for Economic and Financial Affairs where, as from 1 September 2006, he has been appointed Deputy Director General and, since December 2008, Director General. He has been visiting professor at the Université Libre de Bruxelles, the University of Florence and at the European University Institute. He has published extensively on EMU, macroeconomic policies, welfare state reforms, European unemployment.

Luc Coene

Since 1 April 2011, Luc Coene has been governor of the National Bank of Belgium, as well as a member of the Governing Council and the General Council of the European Central Bank. He is also a director at the Bank for International Settlements and has a seat on the G10 Board of Governors. He has been a Minister of State since 2003.

Mr. Coene obtained a degree in Economics at the Rijksuniversiteit Gent and a post-graduate diploma in European economic integration at the College of Europe in Bruges. He began his career in 1973 at the National Bank of Belgium, where he worked successively in the Research and Foreign Departments. In 1979, he became the assistant of the Belgian Administrator at the International Monetary Fund. He came back to Belgium in 1985, first as deputy chef de cabinet to the Minister of Finance, and then as chef de cabinet of the Deputy Prime Minister and Budget Minister. He was an Economic Adviser at the European Commission (DGII) from 1989 to 1992. In 1995, he became a senator and, in 1999, the Prime Minister's chef de cabinet and Secretary to the Council of Ministers. In 2003, he was appointed vice-governor of the NBB.

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In his capacity as President, Mario Draghi chairs the Executive Board, the Governing Council and General Council of the European Central Bank, and is

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From 2006 to October 2011 he served as Governor of the Banca d'Italia. In April 2006 he was elected Chairman of the Financial Stability Forum (later the Financial Stability Board), and served in that function until November 2011.

He graduated from the Sapienza University of Rome in 1970 and received his PhD in Economics from the Massachusetts Institute of Technology in 1977. Between 1975 and 1981, he was Professor of Economics at the universities of Trento, Padua and Venice, and from 1981 to 1991 he served as Professor of Economics at the University of Florence.

Prior to taking the helm of the Banca d'Italia, he was Vice Chairman and Managing Director at Goldman Sachs International, and a member of the firm-wide Management Committee (2002-2005). He was Director General of the Italian Treasury (1991-2001), Chairman of the European Economic and Financial Committee (2000-2001), and Chairman of the OECD's Working Party No 3 (1999-2001). In 1993 he was appointed Chairman of the Italian Committee for Privatisations and from 1984 to 1990 he was an Executive Director of the World Bank.

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Wim Haine holds master degrees in Business Engineering (1997) and Economics (1998) from the University of Leuven (Belgium), where he also worked for a few years as a research assistant before joining the Department of Commerce section of the United States Embassy in Brussels. Since 2002, he works for the European Central Bank from where he is currently seconded to the 'Secretariat of the Eurogroup and the Eurogroup Working Group' at the European Commission's DG ECFIN. In that capacity, he provides analytical support to the Eurogroup and EWG Presidents on a wide range of dossiers related to the functioning and deepening of EMU.

Alexandre Lamfalussy

Alexandre Lamfalussy was born in Hungary in 1929. He left his native country in 1949. After he studied at the Catholic University of Louvain in Belgium, he spent two years on post-graduate studies at Nuffield College, Oxford, where he obtained a doctorate (D. Phil.) in economics. He was visiting lecturer at Yale University in 1961 and 1962. From 1955 to 1975 Mr. Lamfalussy worked with Banque de Bruxelles, becoming Chairman of the Executive Board in 1971. In 1975 he became Executive Director of Banque Bruxelles Lambert. Mr. Lamfalussy joined the Bank for International Settlements in Basle in 1976 as Economic Adviser and Head of the Monetary and Economic Department.

Between 1981 and 1985 he served as Assistant General Manager, before being appointed General Manager of the BIS, in May 1985. He held this post until the end of 1993. From 1st January 1994 until 30th June 1997, Mr. Lamfalussy was President of the European Monetary Institute in Frankfurt. Mr. Lamfalussy was also a professor at the Catholic University Louvain in Belgium. In 2001-2002, he was Chairman of the Committee of Wise Men on the Regulation of European Securities Markets, set up by the European Council.

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Hanspeter K. Scheller

After graduating in economics and law at the University of Cologne in Germany, Hanspeter K. Scheller joined the Deutsche Bundesbank in 1969 and subsequently, in 1973, the Bank for International Settlements in Basel where he held advisory and managerial positions. As a member and, as from 1992, Head of the Secretariat of the Committee of Governors of the central banks of the Member States of the European Community, he was involved in monetary cooperation among central banks in Europe. In 1994, he became Secretary General of the European Monetary Institute in Frankfurt where he was in particular responsible for the organisation and coordination of preparatory work for Stage Three of EMU within the EMI as well as with the relevant EU institutions. Following the establishment of the European Central Bank in June 1998, he served as Director General Administration until January 2003 and subsequently as Special Advisor to the Executive Board until end-2004. He has published several articles on European monetary cooperation and integration and has been the author of the "History, role and function of the European Central Bank".

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Born in Lyon in 1942, Jean-Claude Trichet is an honorary Inspecteur général des Finances and Ingénieur civil des Mines (Nancy). He is a graduate of the Institut d'études politiques de Paris, of the Université de Paris (in economics) and of the École nationale d'administration. Jean-Claude Trichet has been awarded honorary doctorates by several universities.

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INTRODUCTION

LUC COENE

It would be wrong to consider the history of European integration as a smooth process. On the contrary, it has gone through several crises right from the start. Jean Monnet observed long ago that crises can act as a catalyst: “Les hommes n’acceptent le changement que dans la nécessité et ils ne voient la nécessité que dans la crise”.¹ It should not be forgotten that European integration is basically a political process, which has its roots in the crises of the two world wars. The memory of the wars made for a very strong political will to drive European integration forward.

While the start of the European integration process dates back to the 1950s, economic and monetary union (EMU) only arrived on the agenda with the December 1969 Hague Summit and the Werner Report, but, initially, without much success.² In 1988 the monetary union project was relaunched, with the establishment of the Delors Committee, of which Alexandre Lamfalussy was a member. It provided a blueprint for economic and monetary union, which was taken up in the Maastricht Treaty. Despite heavy monetary thunderstorms, the European Monetary Institute was established in January 1994. It played a crucial role in the preparations for the euro, especially the elaboration of the changeover scenario. The European Monetary System (EMS) crises in 1992 and 1993, with exchange rate turmoil and high interest rates in many countries, could have dealt the EMU project a fatal blow, showing that EMU was not inevitable.

Why then did Europe succeed in establishing EMU, notwithstanding this looming crisis? I would put forward three factors: first, stability-oriented policies were pursued, which provided for sound economic fundamentals; second, the changeover scenario, in which the EMI played a crucial role, provided a credible and robust framework for the introduction of the euro; and, third, the strong political will of Europe’s leaders, who adopted difficult measures in order to establish EMU.

European Economic and Monetary Union, with a single currency but no political union, was, to use an expression coined by Alexandre Lamfalussy, “navigating in uncharted waters”. However, the first decade of the euro went smoothly, even too smoothly. The sovereign debt crisis, which started in October 2009 after new Greek budget data were released, revealed the flaws in the structure of European Economic and Monetary Union. It demonstrated that membership of a single currency in a single economic and financial market creates extremely strong and complex interdependencies. That is why much stronger integration of economic

1 Monnet (1976).

2 Maes (2002).

policy is absolutely vital. Furthermore, this poses fundamental questions of democratic legitimacy and accountability. Deepening EMU should go together with significant progress towards a political union. This should also enhance “national ownership” of policies agreed at the European level.

Progress towards economic policy integration is all the more necessary as one cannot trust markets to impose sound economic policies. Indeed, the history of the euro highlights the limits and excesses of market forces. In the first ten years markets hardly responded to the growing macroeconomic imbalances. Their subsequent reaction was too late and overblown, further disrupting the economy. The contagion sweeping through European financial markets in 2011 and 2012 was unprecedented. It is noteworthy that Alexandre Lamfalussy, as a member of the Delors Committee, had already been warning about these issues. He strongly questioned whether “it would be wise to rely principally on the free functioning of financial markets to iron out the differences in fiscal behaviour between member countries: (a) the interest premium to be paid by a high-deficit member country would be unlikely to be very large ... and (b) to the extent that there was a premium, I doubt whether it would be large enough to reduce significantly the deficit country’s propensity to borrow”.³ Lamfalussy consequently argued for a “Centre for Economic Policy Coordination”, an idea which, however, was not taken up in the Delors Report.

The sovereign debt crisis became a watershed in the process of European integration. European economic policy-makers responded with a range of measures, not just emergency assistance and fiscal consolidation programmes, but also substantial reforms in European economic governance.

In the first instance, a substantial strengthening of fiscal sustainability was realised. The “six pack”, “two pack” and the new “fiscal compact” are particularly important. A primary aim is to tighten fiscal discipline by reinforcing the Stability and Growth Pact. The Treaty on Stability, Coordination and Governance implies further a significant revision of the fiscal rules and new commitments by the euro area countries in the fiscal policy sphere. Moreover, with the Macroeconomic Imbalances Procedure, there is now a system of ex ante surveillance of macroeconomic risks and competitiveness positions. The European Union has also set up new financial stabilisation mechanisms to provide for financial solidarity, especially the European Stability Mechanism. However, further reforms, especially a functioning banking union and greater political integration are necessary. Of fundamental importance is also a resolute and ambitious programme of structural reforms, to enhance the competitiveness and growth potential of the euro area.

In line with its mandate, the Eurosystem kept watch over the anchoring of inflation expectations, in order to avoid both inflation and deflation. For that purpose, the central policy rate was cut several times and forward guidance was introduced. To safeguard the transmission mechanism of monetary policy,

3 As quoted in James (2012), p. 249.

which was threatened by the fragmentation of European financial markets and the risk of a break-up of the euro area, the Eurosystem set up a major series of non-conventional measures. These comprised three-year refinancing operations and the Outright Monetary Transactions. However, one has to bear in mind that monetary policy can only buy time. It is for governments to make fundamental reforms, both in terms of economic policy and in strengthening the governance framework of Europe's EMU.

The fragmentation of Europe's financial markets, especially the vicious nexus between banks and sovereigns, made clear that further progress in European financial integration, a real banking union, was needed. This was certainly no surprise for Alexandre Lamfalussy. As far back as the discussions on the Delors Report, he had argued in favour of giving the European Central Bank a role in the area of banking supervision.⁴ In 2004, Alexandre Lamfalussy focused further on the organisation of prudential supervision in the European Union, which he described as a “mind-boggling patchwork”. He stressed that central banks had a crucial role in the management of financial crises, especially in “preventing a potential crisis from turning into a real one”.⁵ For him, the crucial issue was to give the ECB responsibility for the supervision of the large, systemically important banks.

A genuine EMU, then, should not only include a fiscal union and an economic union, but also a banking and political union. The road map to get there was drawn up by the President of the European Council, Herman van Rompuy, in close collaboration with the Presidents of the European Commission, the Eurogroup and the European Central Bank, in the report “Towards a genuine Economic and Monetary Union”.

A crucial task for Europe's policy-makers now is to create a genuine banking union, with two essential pillars: supervision and resolution. Setting up the Single Supervisory Mechanism is a significant step in the European integration process, probably the most important one since the introduction of the euro. The Eurosystem is working to have the Single Supervisory Mechanism fully up and running in November 2014. A major task, in cooperation with the European Banking Authority, is a comprehensive assessment of banks' balance sheets, the so-called Asset Quality Review. However, integrating supervision is not enough in itself. An appropriate resolution framework is essential to deal with banks that are failing or likely to fail. The agreement reached by the European Parliament and the Council on the Bank Recovery and Resolution Directive is an important step in this direction. We now need to have an agreement on an effective Single Resolution Mechanism and Single Resolution Fund. We should be mindful to avoid another, to use Alexandre Lamfalussy's terminology, “mind-boggling patchwork”. The Single Resolution Mechanism needs lean decision-making, particularly in emergency situations.

4 ECB Archives.

5 Lamfalussy (2004), p. 7.

So, to conclude, the experience of the 1990s clearly showed that a crisis can act as a catalyst for progress. To make progress now, just as in the 1990s, three elements are crucial: first, structural reforms to strengthen the competitiveness and growth potential of the European economy, while budgetary consolidation should become more growth-friendly; second, a robust framework of European economic governance, including a true banking union; and third, a political union, expressing the strong commitment of Europe's political leaders to European integration.

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I THE TURBULENT 1990S: LESSONS FOR THE PRESENT?

MAASTRICHT AND THE CRISIS IN EUROPE: WHERE WE'VE BEEN AND WHAT WE'VE LEARNED

REZA MOGHADAM

Everywhere, but especially in Europe, the crisis has exposed gaps in our beliefs, systems and institutions. This symposium on Maastricht and the road ahead is an opportunity to take stock of the presuppositions about what it takes to deliver financial stability and an enduring EMU. In this talk, I will advance the following line of argument:

- The Maastricht mindset saw fiscal indiscipline as the primary risk to the viability of the euro. Hence, its pre-occupation with fiscal rules and no bailout clauses.
- But the pernicious forces at work before the crisis were not just about fiscal indiscipline, but more so, financial market indiscipline which priced risk more or less uniformly across the euro area and allowed, via banks, the build-up of large cross-border debts.
- When the crisis hit, the unsustainability of these private sector imbalances became apparent, threatening to bring down the banking system. It was assumed that private imbalances would remain a private sector problem, but instead some of this became public sector debt.
- The reality of the crisis has realigned the mindset. An explicit regime for bailout using ESM was invented. Fiscal rules were adapted and recast in structural terms. The need to monitor current account imbalances and other balance sheet weaknesses was recognized.
- Most importantly, rules are being developed to instill financial market discipline and ensure adequate burden sharing between the public and private sectors. Unified supervision, a resolution mechanism, clear bail-in rules, and a common backstop for bank resolution are critical elements.
- Progress has certainly been made, but Europe still has much work to do on some of these post-Maastricht adaptations if it is to lay the basis for stability and growth.

I MAASTRICHT'S FISCAL FOCUS

Maastricht's promise was that by giving up monetary autonomy, members of EMU would see their incomes rise with increases in trade and the free flow of labor and capital. By eliminating exchange rate uncertainty and lowering

borrowing and transactions costs, members would receive large benefits for a small loss of sovereignty.

But it was understood that the centralization of monetary policy could carry some risks: country specific shocks could go unaddressed, while fiscal profligacy by members could lead to pressures for monetary financing. To address these risks, some kind of fiscal coordination and integration would have needed to accompany the monetary union, as recognized in the MacDougall and Delors reports. The consequences of country-specific shocks could have been reduced by fiscal risk-sharing across members. But to ensure that it would not be abused, members would have had to cede some of their fiscal autonomy to the center.

However, when Maastricht was being drawn up, such a loss of sovereignty was not politically feasible. A compromise was needed, one that would mitigate the risks, while at the same time preserving a large degree of members' fiscal autonomy. As a result, the Maastricht framework and its implementing agreements, like the Stability and Growth Pact, tried to resolve these tensions by putting in place strict fiscal rules for members:

- Countries would maintain their fiscal independence, but would respect limits on the size of public debt and deficits.
- The “no bailout” clause meant that no country participating in EMU could expect another country to bail it out.

The fiscal targets were thought to be generous enough that they would enable countries to respond effectively to shocks, while being restrictive enough to ensure that countries debt and deficits could not spiral out-of-control or diverge too much. The “no bailout” clause was supposed to encourage markets to discipline sovereigns, by pricing their debt according to their credit risks. Taken together with the assumption that the framework would be self-enforcing, Maastricht seemingly addressed the tradeoff between sovereignty and solidarity.

2 MAASTRICHT MEETS REALITY

From the start though, practice was different from theory. Countries (e.g., Greece and Italy) were allowed to enter EMU, despite failing to satisfy the original criteria for public debt. Adherence to the fiscal rules was spotty (Table 1 and 2), with countries moving in and out of compliance. When the sanctions prescribed by the fiscal rules were suspended after France and Germany fell into non-compliance, the markets and government understood them to be guidelines at best, rather than binding rules.

Even without fiscal rules, market discipline was supposed to be a failsafe, reinforced by the “no bailout” clause. But government debt that was treated differently before the euro area, as seen in the cross-country dispersion of bond yields, came to be treated nearly identically after its inception. While some interest rate convergence was expected, these nearly identical low rates came despite

Table 1 Fiscal rules key, but also ambitious – General Government Balance														
(percentage of GDP)														
Country	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013
Austria	-1.8	-0.2	-0.9	-1.7	-4.6	-1.8	-1.7	-1.0	-1.0	-4.1	-4.5	-2.5	-2.5	-1.9
Belgium	-0.1	0.4	-0.2	-0.2	-0.2	-2.6	0.3	-0.1	-1.1	-5.6	-3.9	-3.9	-4.1	-2.8
Cyprus	-2.4	-2.3	-4.5	-6.6	-4.2	-2.5	-1.2	3.5	0.9	-6.1	-5.3	-6.3	-6.4	-5.9
Estonia	-0.2	-0.1	0.3	1.7	1.6	1.6	2.5	2.4	-2.9	-2.0	0.2	1.2	-0.2	-0.3
Finland	6.9	5.1	4.1	2.4	2.2	2.7	4.1	5.3	4.3	-2.7	-2.8	-1.0	-2.2	-2.6
France	-1.5	-1.7	-3.3	-4.1	-3.6	-3.0	-2.4	-2.8	-3.3	-7.6	-7.1	-5.3	-4.9	-4.2
Germany	1.1	-3.1	-3.8	-4.2	-3.8	-3.3	-1.7	0.2	-0.1	-3.1	-4.2	-0.8	0.1	-0.1
Greece	-3.7	-4.4	-4.8	-5.7	-7.4	-5.6	-6.0	-6.8	-9.9	-15.6	-10.8	-9.6	-6.3	-3.4
Ireland	4.7	0.9	-0.4	0.4	1.4	1.7	2.9	0.1	-7.3	-13.8	-30.5	-13.1	-8.2	-7.3
Italy	-0.9	-3.2	-3.2	-3.6	-3.6	-4.5	-3.4	-1.6	-2.7	-5.4	-4.3	-3.7	-2.9	-3.1
Luxembourg	6.0	6.1	2.1	0.5	-1.1	0.0	1.4	3.7	3.2	-0.7	-0.8	0.0	-0.6	0.1
Malta	-5.7	-6.3	-5.7	-9.0	-4.6	-2.9	-2.7	-2.3	-4.6	-3.7	-3.5	-2.8	-3.3	-3.5
Netherlands	2.0	-0.3	-2.1	-3.2	-1.8	-0.3	0.5	0.2	0.5	-5.6	-5.1	-4.4	-4.1	-3.2
Portugal	-3.3	-4.8	-3.4	-3.7	-4.0	-6.5	-3.8	-3.2	-3.7	-10.2	-9.9	-4.3	-6.5	-5.9
Slovakia	-8.7	-4.5	-5.8	-2.0	-1.8	-2.2	-2.6	-1.6	-2.0	-8.0	-7.7	-5.1	-4.5	-3.1
Slovenia	-1.2	-1.3	-1.4	-1.3	-1.3	-1.0	-0.8	0.3	-0.3	-5.5	-5.4	-5.6	-3.2	-5.7
Spain	-1.0	-0.6	-0.3	-0.3	-0.1	1.3	2.4	2.0	-4.5	-11.1	-9.6	-9.6	-10.6	-7.2

Sources: IMF and WEO database.

■ lower than the limit set by the Stability and Growth Pact (-3% of GDP)

■ higher than the limit set by the Stability and Growth Pact (-3% of GDP)

growing differences in net foreign asset positions of the euro area economies (Chart 1). These largely reflected private sector debts, part of which ultimately was assumed by governments. So market discipline seemingly broke down.

Or did it? Perhaps markets understood that the economic and financial integration of the euro area made it “too-big-to-fail”, so that the “no bailout” clause was not

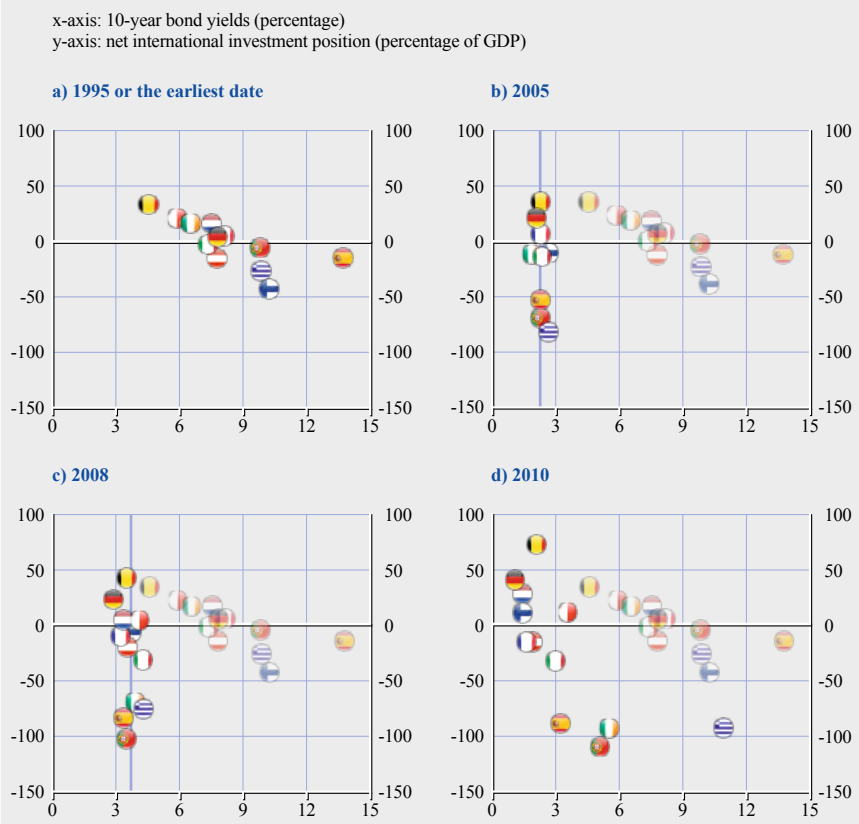
Table 2 Fiscal rules key, but also ambitious – General Government Structural Balance													
(percentage of potential GDP)													
Country	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012
Austria	-3.6	-0.9	-0.9	-0.8	-1.7	-1.7	-2.5	-2.7	-2.5	-3.0	-3.1	-2.2	-1.4
Belgium	-0.6	0.0	0.0	-1.0	-1.3	-0.8	-1.3	-1.3	-2.2	-4.2	-3.6	-3.7	-3.4
Cyprus	-2.4	-2.4	-4.1	-6.4	-4.1	-2.6	-2.6	-1.4	-1.9	-5.1	-4.5	-4.0	-4.8
Finland	5.7	4.4	4.0	2.6	1.6	2.0	2.4	2.2	1.9	-0.1	-1.7	-1.1	-1.3
France	-3.2	-3.3	-4.2	-4.3	-4.1	-3.9	-3.4	-4.2	-4.1	-5.7	-5.7	-4.6	-3.5
Germany	-1.8	-3.0	-3.3	-3.2	-3.3	-2.6	-2.3	-1.1	-0.9	-1.1	-2.3	-1.0	0.1
Greece	-2.1	-3.1	-3.6	-6.1	-8.4	-6.7	-8.7	-10.8	-14.3	-19.1	-12.3	-8.3	-2.6
Ireland	2.3	-1.4	-1.0	-0.2	-1.2	-2.6	-4.2	-8.7	-11.9	-9.9	-8.3	-7.0	-6.1
Italy	-3.2	-5.0	-5.1	-5.5	-5.2	-5.4	-4.3	-3.5	-3.8	-4.1	-3.6	-3.7	-1.3
Malta				-8.4	-3.6	-3.4	-2.8	-3.5	-6.2	-3.7	-4.8	-3.7	-4.2
Netherlands	1.0	-1.2	-1.8	-2.3	-1.1	0.2	-0.1	-1.4	-1.1	-4.8	-4.4	-3.7	-2.3
Portugal	-4.2	-5.0	-5.2	-5.5	-5.8	-6.1	-3.8	-4.2	-5.4	-9.2	-9.0	-6.6	-4.1
Slovakia	-3.1	-4.8	-4.4	-0.6	-1.7	-1.0	-2.2	-3.2	-2.8	-6.3	-7.2	-4.3	-3.9
Slovenia	-1.1	-0.7	-0.9	-0.5	-0.9	-1.1	-2.0	-2.5	-3.4	-4.5	-4.8	-4.1	-2.3
Spain	-1.1	-1.3	-0.7	-0.6	-0.4	0.7	1.2	0.5	-5.7	-10.0	-8.4	-7.9	-5.7

Sources: IMF and WEO database.

■ lower than the limit set by the Stability and Growth Pact (-3% of GDP)

■ higher than the limit set by the Stability and Growth Pact (-3% of GDP)

Chart I “Boom & bust” followed the euro – 10-year bond yields and international investment position



Sources: Bloomberg, IMF and WEO database.

credible. At the height of the crisis in 2011, when there were real doubts about whether or not the euro area would survive, the dispersion of cross-country bond yields reemerged. But with this existential threat, the authorities acted to keep the currency union intact—the assessment that the euro area was “too-big-to-fail” was right.

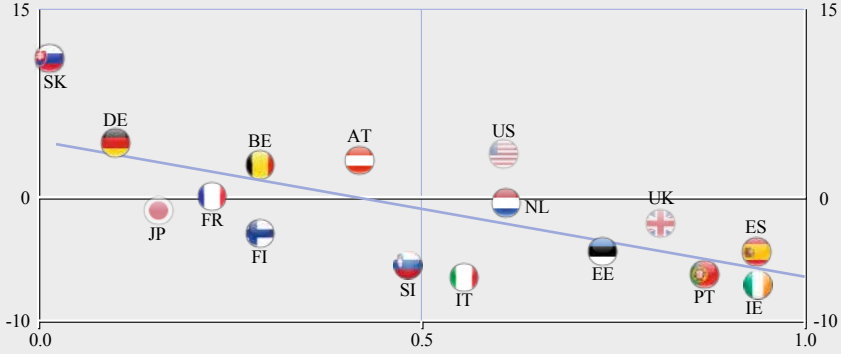
3 BEHIND THE SCENES, THE BUILD-UP OF PRIVATE IMBALANCES

Given the political constraints and the risks as they were perceived at the time, Maastricht’s focus on the sustainability of the public sector and reliance on market discipline is understandable. But with the benefit of hindsight, it is clear that the framework neglected the risks associated with excess private sector leverage and divergence of competitiveness. The means to identify and address financial stability risks were not directly built in to Maastricht’s design.

Chart 2 Are balance sheets original sin? – Effect of balance sheet stress on growth, consumption and investment

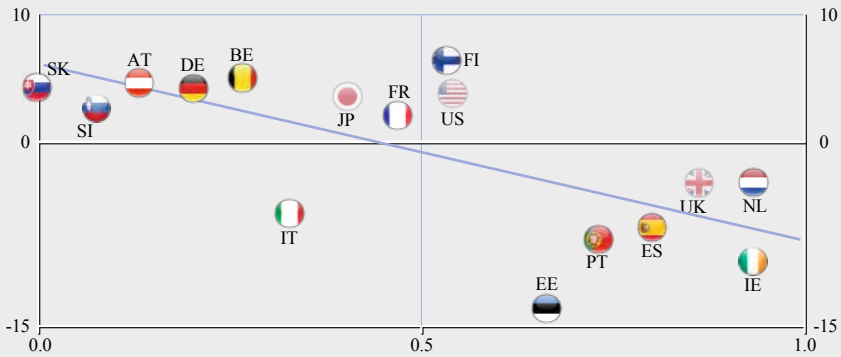
a) Growth and balance sheet stress index

x-axis: private sector balance sheet stress index, 2007
y-axis: cumulative GDP growth 2008-2012



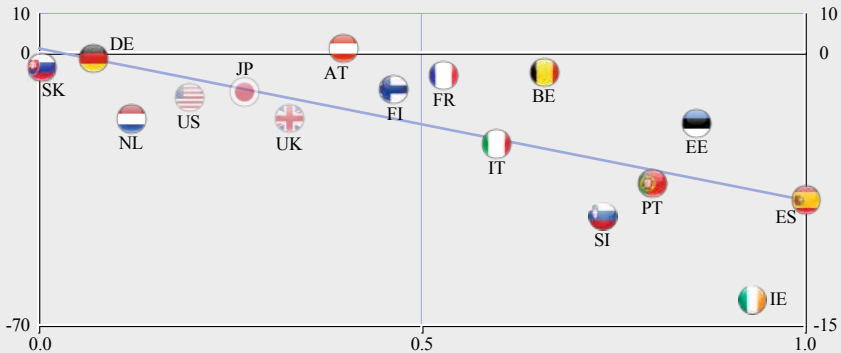
b) Consumption and balance sheet stress index

x-axis: household balance sheet stress index, 2007
y-axis: cumulative consumption growth 2008-2012



c) Investment and balance sheet stress index

x-axis: corporates balance sheet stress index, 2007
y-axis: cumulative investment growth 2008-2012



Sources: IMF, WEO database and OECD.

Looking back at the crisis, the role of private sector leverage has been significant. We know that countries with the greatest pre-crisis private balance sheet vulnerabilities have been the ones with the weakest post-crisis growth (Chart 2a). Persistent current account imbalances were a signal of these vulnerabilities and underlying competitiveness concerns.

For example, the higher the pre-crisis leverage of a country's household sector, the lower the growth in consumption following the crisis (Chart 2b). The story for corporates is similar, where there is a striking negative correlation between corporate leverage and future investment growth (Chart 2c). And for banks, we know that those with high pre-crisis leverage have had to shrink their balance sheets.

What's more, we've learned that there is no simple separation between private and public sector balance sheets: private imbalances can eventually end up as public sector imbalances. This can happen either through a direct bailout of the banking system (Ireland) or the lost revenue and increased spending necessitated by deep and prolonged declines in output (Spain).

4 DID MAASTRICHT ENCOURAGE PRIVATE IMBALANCES, MAKING THE CRISIS WORSE?

Similar to fiscal policy, supervision of the financial sector and resolution of financial institutions under Maastricht, including lender-of-last-resort facilities, were kept in the hands of national authorities. However, unlike fiscal policy, there was no set of rules embedded in Maastricht to ensure a minimum degree of harmonization in the financial sector. Unsurprisingly then, financial regulations and market practices varied substantially across member countries. At the same time, the introduction of the single currency facilitated rapid financial integration, as reflected by a large rise in cross-border capital flows (Chart 3).

So when the crisis happened and the financial stability risks materialized, the result was pervasive and persistent financial market fragmentation in the euro area. This has led to unhealthy bank-sovereign links and an impaired transmission of monetary policy. All of this has weighed on the pace and strength of the recovery.

Viewed from this angle, Maastricht's preeminent focus on fiscal policy has been limiting, both in the identification of risks and the effectiveness of the policy responses.

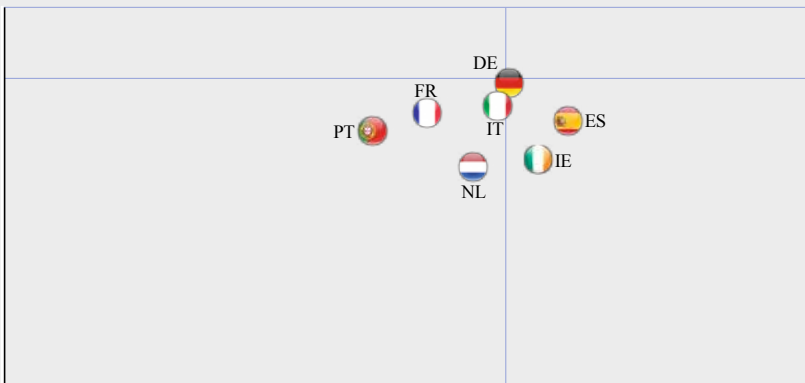
Chart 3 Why is it happening? – Change in cross-border financial linkages

a) Cross-border financial linkages



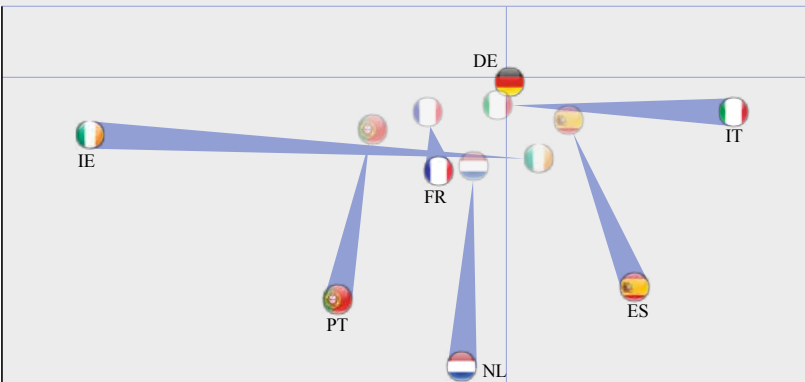
b) Pre-crisis

(distance between country orbs = change in bilateral domestic bank claims)



c) Post-crisis

(distance between country orbs = change in bilateral domestic bank claims)



Source: BIS.

5 POLICY PROGRESS, BUT NOT COMPLETE

That being said, collective actions by European authorities have filled many of the gaps laid bare by the crisis, demonstrating a commitment to improving EMU architecture. Fiscal governance has been strengthened and rationalized with the Fiscal Compact, six-pack, and two-pack. Significantly, there have been encouraging moves towards a banking union. The unprecedented monetary policy response (e.g., LTROs, OMTs) has provided time to enhance EMU architecture.

But despite these achievements, which have significantly reduced sovereign and corporate borrowing costs, key changes to make EMU architecture more robust remain incomplete, financial market fragmentation persists, and the recovery is weak and fragile.

Looking beyond the crisis, has enough been achieved to reduce materially the risks of future private imbalances? We must acknowledge that no matter what architecture in place, identifying private imbalances *ex ante* will always remain a significant challenge, as will foreseeing the channels through which they are transmitted in times of crisis.

And since fully insulating EMU against private imbalances is impracticable, improvements in the EMU architecture must aim to minimize not just their occurrence but also their scope for disruption to the economy. Moreover, for market discipline to work and play a complementary role, robust bail-in and burden sharing frameworks are necessary.

6 MINIMIZING RISKS AND DEALING WITH THE CONSEQUENCES IF RISKS MATERIALIZE

Inevitably, crises will emerge, but by strengthening the common institutional frameworks and increasing the flexibility of economies, EMU will become more resilient. How can this be done?

First, policies to improve market discipline should be put in place. This needs to be supported by clear rules for bail-ins, harmonization of insolvency regimes at the national level, and a Single Resolution Mechanism (SRM), with centralized powers to trigger resolution and make decisions on resolution and burden sharing in the financial sector. In this respect, the current lack of a common backstop – such as direct recapitalization of banks by the ESM – limits the credibility of the SRM and SSM. Without this, bank-sovereign links cannot be fully severed. A truly common backstop would reduce the fallout through the financial sector of any crisis and minimize the fiscal impact for any one country.

Second, with the policies and structures just mentioned in place, especially an effective SRM, the Single Supervisory Mechanism (SSM) would be more credible. This would help ensure transparency and bolster confidence in the financial system. Together with strengthened macroprudential toolkits and

structural reforms in the financial sector, these would reduce the build-up of private imbalances and the attendant risks to financial stability.

Third, while the Macroeconomic Imbalances Procedure is a welcome process, it suffers from two shortcomings which need to be addressed: (i) it requires greater emphasis on emerging competitiveness gaps and corrective action before they translate into imbalances; and (ii) it currently lacks sufficiently strong corrective mechanisms.

Fourth, deeper and broader capital markets are needed to diversify funding sources for firms. This would reduce their vulnerability by reducing reliance on the banking sector. To promote the development of such markets, concerted policy actions at both the euro area and national levels are needed to address regulatory, legal and structural hurdles.

Fifth, provided that stronger fiscal governance is enforced, a shared approach with some elements of centralized fiscal policy would expand the scope of available countercyclical tools when national policies are constrained by limited market access or fiscal rules. This would avoid excessively restrictive fiscal stances during severe recessions and excessively loose ones during expansions.

Sixth, to enhance growth prospects, there is a need to have a process that monitors and enforces structural reforms already agreed (Services Directive), and proactively advocates growth-enhancing reforms. Product market reforms that open up professional services, telecom, and electricity could provide an important boost. There is also a need to harmonize labor market regulation and facilitate much greater mobility of labor than is currently the case. Protecting workers with unemployment benefits and re-training rather than trying to protect positions through prohibitive hiring and firing costs would help get more people working. These would place the European economy on a higher growth path, helping to bring down elevated levels of debt. It would also make the economy more resilient to shocks, helping ease adjustment.

7 EUROPE AT THE CROSSROADS

In the words of Robert Schuman's 1950 proposal for a European Coal and Steel Community: "Europe will not be made all at once, or according to a single plan. It will be built through concrete achievements which first create a *de facto* solidarity." As bad as the crisis has been – and it has been extremely damaging with the crisis response far from ideal – one should not lose sight of the fact that Europe has responded with more solidarity and greater integration. If political will can be maintained, further integration coupled with steps to boost growth can create a more durable foundation for continued prosperity in the region.

THE EMS CRISIS OF THE 1990S: PARALLELS WITH THE PRESENT CRISIS?

DANIEL GROS¹

INTRODUCTION

The crisis in the European Monetary System (EMS) of the mid-1990s was considered at the time as posing an existential threat to the process of monetary integration. For a while it seemed that the markets (and the sceptics) had won, in the sense that in 1993 the EMS had de facto been abandoned with the widening of the bands of fluctuations to +/- 15%. But the crisis also provided a stark illustration of the problems that can arise when capital is mobile and exchange rates are set by market pressures. In the end the crisis thus reinforced the determination of policy-makers to implement the Maastricht Treaty, which had been signed just before the crisis broke.

At the time, it was argued that countries, such as Italy (or Spain), with a weak reputation for price stability had a strong interest in entering Economic and Monetary Union (EMU) because this would deliver lower interest rates. The argument was that by joining the single currency, Italy could convince financial markets that it would not use the printing press to inflate away the value of its debt and hence benefit from lower risk premia.

Oddly enough, the opposite argument is often used today: some argue that Italy and Spain have to pay a high risk premium because they have lost the option to use the printing press.

The common thread in these two arguments is that a self-fulfilling crisis can arise under both scenarios.

Moreover, it has been argued that the higher interest burden could exceed the willingness of the public to pay taxes, thus pushing the country into default if interest rates stay too high.

This paper starts by providing a brief review of the EMS crisis, emphasising that the most interesting period might be the “post-EMS” crisis of 1993-95. It then reviews the crisis factors in section 2, comparing the EMS crisis to today’s euro crisis. Section 3 outlines the main analytical issue, namely the potential instability of high public debt within and outside a monetary union. Section 4 then compares the pressure on public finance coming from the crises in the case of Italy. Section 5 uses data on “foreign currency” debt to disentangle expectations of devaluation/inflation from expectations of default. Section 6 concludes.

1 The author gratefully acknowledges financial support for his research from the Belgian Federal Science Office, in connection with the “Beldebt” project.

The EMS was set up in 1979 to create a “zone of monetary stability” in Europe. It was essentially a “fixed but adjustable” system of exchange rates with a grid of bilateral “central” rates at its heart, with fluctuation margins of +/- 2.25% – the Exchange Rate Mechanism (ERM). These exchange rates were supposed to be defended by both sides with interventions of potentially unlimited amounts. The institutional and operational set-up underpinning the EMS (see Gros and Thygesen, 1998, for a more detailed explanation) did not change substantially over its lifetime (essentially 1979-93), but the way the system was managed had to evolve in the late 1980s and early 1990s, as capital movements were progressively liberalised as part of the internal market or “1992 programme”. With free capital movements, the system became vulnerable to speculative attacks whenever the market expected discrete changes in exchange rates and national central banks could no longer control their domestic (short-term) interest rates. See De Grauwe and Ji (2013) for an in-depth analysis of short-term and long-term interest rates during the EMS.

By 1992 there had not been any change in parity “realignment” since 1987, although prices and wage competitiveness indicators had diverged considerably between Germany and its main partners. At the same time, Germany experienced considerable inflationary pressures in the aftermath of the boom created by unification.

The need for a realignment appeared obvious to some (especially the Bundesbank), but it was resisted by others and badly managed. It proved impossible to agree on “maxi realignment” to re-establish competitiveness in an orderly way and the Bundesbank refused to engage in unlimited intervention as price stability in Germany seemed at stake. The result was that two major currencies – the lira and the pound sterling – left the system (formally only the Exchange Rate Mechanism or ERM) in September 1992, in the midst of public recriminations among major policy-makers. (Annex 1 provides a brief discussion of why the events of 1992 meant the end of the crisis for the UK, but only the beginning of a more acute phase for Spain.)

However, even after the partial break-up in 1992, the strain on the remaining participants persisted. The most visible sign of these difficulties was the continuing large interventions at the margin, which were necessary to keep the exchange rates of the remaining participants within the normal margins of fluctuation. Public disagreement among major policy-makers contributed to unsettling markets. Bundesbank officials insisted on their duty to preserve price stability in Germany, which, in their view, limited their ability to intervene or to lower interest rates. Important policy-makers from France and other countries argued that Germany had undertaken a precise commitment to defend the EMS and that its policy-makers should take the overall European economic context into account in setting policy for the country.

From today’s point of view, it is important to note that doubts about the sustainability of public finances were not among the many factors that were

held responsible for the problems at the time: apparent overvaluation of some participating currencies, German unification and the associated distortions in the German policy mix, doubts about the feasibility of EMU in the light of the difficulties of ratifying the Maastricht Treaty in several Member States and the weakness of the US dollar. Even with the benefit of hindsight, it is difficult to disentangle the relative importance of these factors, but until 1993 the sustainability of public finances did not figure importantly in official discussions or market commentary.

As the tensions continued into 1993, and the Bundesbank remained reluctant to continue its interventions, the system could no longer be defended; the margins of fluctuations were increased to +/- 15% at the end of a dramatic ECOFIN meeting held on 31 July and 1 August. This led to a temporary calm in markets as the risk for speculators had become more two-sided. But after a more stable 1994, turbulence resumed in 1995. The peseta and the lira were then the main targets. At one point in 1995 the lira had depreciated by more than 60% relative to its 1992 Deutsche Mark parity within the EMS and the differential on longer-term interest rates increased to over 6%. It is during this “post-ERM” crisis period that public finance issues came to the forefront of market concerns and policy discussions. It is this period that might contain lessons for today’s crisis.

2 CRISIS FACTORS

The focus of this contribution will thus be on this “post-ERM” period, with particular attention on Italy and Spain (and to some extent Portugal) because these were the key countries for the EMS.

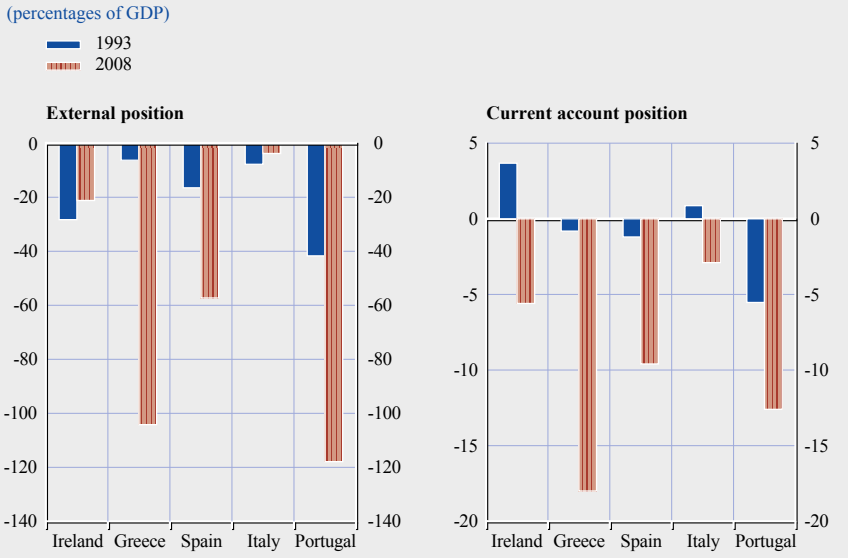
As mentioned above, the higher inflation rates in the EMS “periphery” had led to a gradual erosion of their competitiveness. Different indicators (unit labour costs, relative CPIs, etc.) gave somewhat different numerical results, but whatever loss of competitiveness had accumulated during the tranquil period from 1987 to 1992, it had been compensated for by the realignments and devaluations by 1993.

At any rate, the external disequilibria were minor by comparison with today, both in terms of flows and stocks. By 1993 Italy had a small current account surplus and Spain had a current account deficit of only 1% of GDP. Moreover, neither country had a history of large current account deficits, as can be seen by the fact that their net external position (the cumulated current account balance up to 1993 serving as a proxy) was very small.

By contrast, Spain was running a current account deficit of close to 10% of GDP in 2008 and that of Portugal was even larger.

Public finance became the key issue after 1993, but even here the situation looked less alarming in comparison with today. The debt ratios were actually much lower than today, except in the case of Italy, which already had a higher debt at that time.

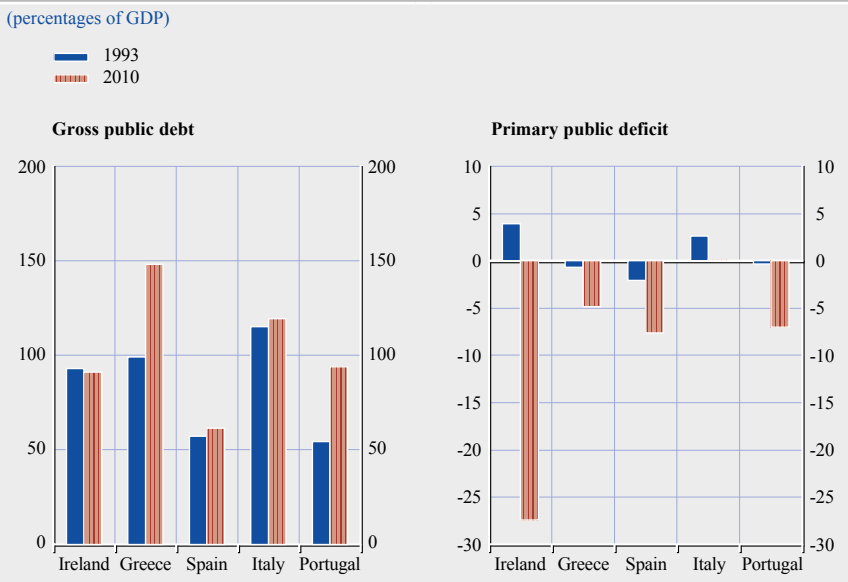
Chart 1 External position and current account position in Ireland, Greece, Spain, Italy and Portugal, 1993 and 2008



Source: AMECO, 2014.

Fiscal deficits, however, were even higher than today. However, part of this was due to higher inflation (which meant that part of the interest expenditure was in reality a reconstitution of the real value of the debt). Italy had no primary deficit

Chart 2 Gross public debt and primary public deficits in Ireland, Greece, Spain, Italy and Portugal, 1993 and 2010



Source: AMECO, 2014.

Note: Data for Spain are from 1995 and 2000.

at the start of the crisis (1991) and its primary balance kept on improving until it reached close to 4% of GDP at the height of the crisis in 1995. The present crisis shows a very similar pattern with Italy starting in 2010 with an approximate primary balance and now a surplus of about 3% of GDP.

The primary balance of Portugal was somewhat more variable, but it was also in surplus for most of the turbulent period (whereas at the outset of the present crisis, Portugal started with a primary deficit of 7% of GDP).

3 ANALYTICAL ISSUES: THE INSTABILITY OF HIGH PUBLIC DEBT WITHIN AND OUTSIDE A MONETARY UNION

The present crisis has led to the observation that a high level of public debt can lead to self-reinforcing feedback loops and even multiple equilibria in a monetary union. The argument is quite simple; even a rather high level of public debt can be sustainable if the government only has to pay a low interest rate, for instance close to the compensation required on a riskless investment. However, the same level of debt might become unsustainable, forcing a country into default, if the borrowing cost is much higher. Hence many authors (most persuasively De Grauwe, 2011) have argued that there might be multiple equilibria; if the market thinks the government can pay, it will be able to pay because its borrowing cost will be low. However, if the market thinks the government cannot pay, in practice it will not be able to pay because the high-risk premium requested will make the debt service so expensive that it will not be able to find the necessary resources. Doubts about the ability of a government to service its debt could thus become self-fulfilling. This line of reasoning has been used to justify central banks' interventions in the market, for example, the Outright Monetary Transactions (OMTs), which have been widely credited as having stopped the crisis.

However, the EMS crisis of the 1990s prompted a similar resurgence of the view that self-fulfilling speculative attacks could be destabilising. The first leg of the EMS crisis seemed to justify the models of self-fulfilling speculative attacks on fixed exchange rates. But the "post-EMS" (1993-95) experience of Italy led to an application of these models to public finances. These models were actually used to justify the creation of EMU with an independent central bank. The reasoning was very similar: if the market suspects the country will abandon the commitment to price stability, it will ask for a high-risk premium (a high nominal rate of interest). However, if the rate of interest is very high, the government will find it very difficult to keep the commitment to price stability because this would imply very high ex post real interest rates and a correspondingly high burden to

service the public debt.² The strength of this mechanism depends of course on the size of the public debt (relative to GDP).

Countries with a high level of debt thus seem to have only bad choices: if they enter a monetary union a speculative attack can force them to default; but if they keep monetary autonomy a speculative attack can force them into high inflation.

Calvo (1988) confirms this; he considers both the case of a country when it has monetary autonomy and when it does not. He finds that multiple equilibria can arise in both cases. He also finds that in both cases the high interest rate equilibrium is Pareto inferior.

This result is not surprising. From the point of view of investors it should not really matter whether the government defaults on its obligations and imposes a haircut on investors or whether it is forced into high inflation, which then reduces the real value of the debt securities they hold, even without a formal default.

Assume for instance that within a monetary union, the probability of a default of a member country is 1/5 and that the haircut in case of default is 20%. This would justify an interest rate premium (over the riskless rate) of 4 percentage points. If the country had kept its own currency, the risk of abandoning the hard currency policy might also be 1/5 and the inflation rate, in case the hard currency option is abandoned, might be also 20%. For a risk-neutral investor this would also require additional compensation (a risk premium) of 4 percentage points. The risk (and thus its price) should be the same under both circumstances: being part of a monetary area or having one's own currency.

One could of course argue that, at least for a euro area country, both the cost of defaulting on government debt and that of exiting the euro area would be much higher than the cost of merely exiting a fixed exchange-rate regime (and permitting inflation to increase to higher levels). However, the usual models of speculative attacks would then also imply that, given the much higher cost of defaulting, the credibility of the government not defaulting should be much higher and consequently the likelihood of multiple equilibria much lower. This was indeed one argument widely used to illustrate the advantages of giving up one's currency.

2 This mechanism in turn is similar to the one for a fixed exchange rate system. According to Adrian and Gros (1999), a "fixed exchange rate regime can experience a self-fulfilling crisis if a high risk premium leads to high domestic interest rates that depress domestic activity, and thus make it more likely that the government will actually abandon the system. Depending on the parameter configuration, two equilibria might exist. One is characterised by low interest rates and a low (possibly zero) probability that the exchange rate commitment will be abandoned; the other is characterised by high interest rates and a high probability that the exchange rate commitment will be abandoned". This quote refers to the analysis of a country under a fixed exchange regime, but it also applies to the case of a free-floating exchange rate. The debt burden in both cases would be reduced through inflation; the difference is that under the fixed regime there is first a currency crisis and the exit from the hard peg regime. A number of other authors arrived at similar conclusions (see Obstfeld (1995) and the further references provided by Gros (2011)).

The practical argument that speculative attacks can in reality only be of limited importance remains the same today. It is simply the fact that only a relatively small portion of public debt has to be refinanced at any point in time. For example, with an average maturity of seven years even a country with a debt-to-GDP ratio of 130% of GDP needs to refinance “only” less than 20% of its GDP every year. This implies that a speculative “attack” would have to persist for some time before it would result in higher debt-service costs. This was also observed in Italy during the 2011-12 crisis; although the interest rate reached 7% at times (for longer maturities), the actual average debt service costs moved very little.

A key aspect of the models of multiple equilibria is that even if investors demand higher interest rates to hold the public debt because they expect either inflation or a default, the government is not forced to validate these expectations. It can increase taxes or reduce expenditure to pay for these higher interest rates. This is indeed what happened during the “post-ERM” crisis period. However, not validating the expectations of either default or high inflation comes at a cost: ex post, the cost of servicing public debt is very high.

Ex ante, it is impossible to say under which regime the ex post cost of not validating the doubt of investors concerning the sustainability of public finances is lower. This depends on the nominal risk premium demanded by investors and the debt-to-GDP ratio. Differences between these key variables might decisively affect any comparison between regimes. Nevertheless, a comparison between the 1990s and today is instructive.

4 THE CASE OF ITALY

Let us first consider the case of Italy. Italy’s debt-to-GDP ratio is today about 130%, only slightly higher than the 120% of GDP already reached during the post-EMS crisis of the 1990s. In this respect, therefore, there is little difference between today and the EMS crisis period.

Annex 2 shows that Belgium had an even higher debt ratio than Italy during the 1990s, but paid much lower interest rates. In this sense it is surprising that Italy was affected by the post-EMS crisis, but Belgium was almost not at all. It is easier to understand why Belgium was not affected by the euro crisis because at that point Belgium had a much lower debt-to-GDP ratio owing to the fact that it had continued to maintain substantial primary surpluses during the first, calm decade of the euro.

Given the debt-to-GDP ratio, the key indicator for the sustainability of government debt is then the difference between the borrowing cost and the growth rate of GDP, which is often also called the “snowball factor”. If the interest rate is higher than the growth rate, the debt-to-GDP ratio will continue to grow and eventually explode unless the country continuously runs a primary surplus.

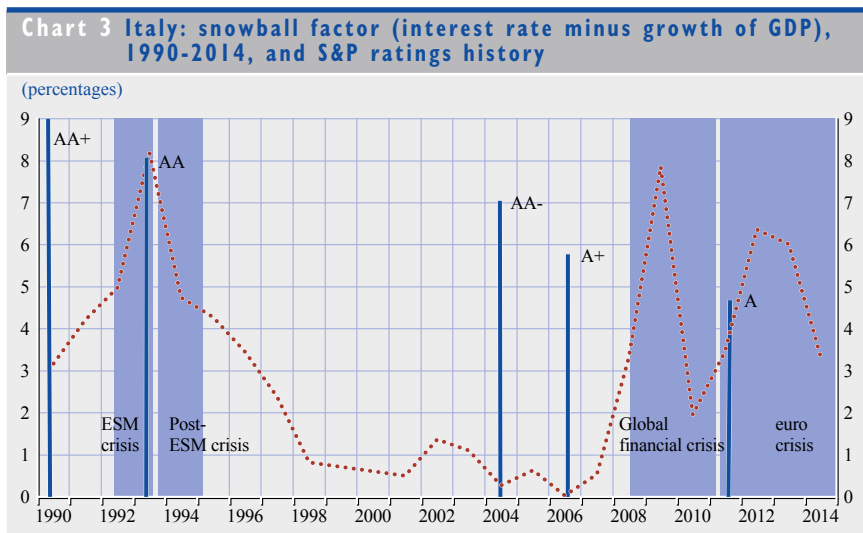
In the multiple equilibrium view of the world, a speculative attack starts when the “risk premium”, i.e. the difference between the risk-free rate and the borrowing

cost of the country in question, increases. The level of threat that an attack then poses can be measured by the size of this snowball factor (multiplied by the debt-to-GDP ratio), but this parameter was about the same in both the EMS crisis and the present crisis).

Chart 3 shows the evolution of the “snowball effect” measured by the difference between the long-term interest rate on Italian government debt and the growth rate of nominal GDP (realised over the preceding twelve months). It is apparent that the country was under extreme stress during the wave of speculative attacks of the early 1990s. In 1993, when the authorities were still defending the peg within the ERM, the difference between the (nominal) interest rate and the growth rate of (nominal) GDP was over 10 percentage points. The snowball effect then declined after the country left the ERM, but it disappeared gradually, only as it became more and more likely that Italy would join EMU.

Figure 3 also suggests that the sharp fall in nominal GDP right after the Lehman collapse induced a short-lived spike in the snowball effect, which was apparently discounted by the financial markets because of its temporary nature.

A comparison of this period of flexible exchange rates with the euro crisis suggests that the speculative pressures are less acute today; the snowball factor remains, at around 2 to 3 percentage points, much below the level of the early 1990s, and the peak reached in 2012 remains much below the peak of the 1990s. The spread on German government securities (the benchmark risk-free rate) would have to double for the snowball factor to reach the same level of tension as 15 years ago. Moreover, interest on public debt now accounts for about 5% of GDP, which again is less than one half of what it was during the 1990s, and it would take several years for high interest rates to translate into materially higher interest expenditure for the government.



Sources: Own calculations using ECB and European Commission Services (AMECO) and Standard & Poor's. Notes: The snowball factor is defined as the difference between the interest rate on 10-year government bonds and the actual nominal growth rate.

The nature of the speculative pressures during the post-EMS crisis period can be illustrated by looking at the pricing of the foreign currency debt of Italy, compared to its “national” currency debt.

5 DEFAULT VERSUS INFLATION

It is generally assumed that during the 1990s the difference between the lira and Deutsche Mark interest rates reflected expectations regarding the future evolution of exchange rates (which in turn, at least in the long run, are usually supposed to be equivalent to differences in inflation rates). However, the government of Italy could also have defaulted formally on its debt even if it was denominated in lira. Reinhard and Rogoff (2009) show that defaults on domestic currency debt are rare, but they do occur.

There is a way to disentangle the devaluation/inflation risk from the risk of a formal default. The government of Italy also had debt outstanding in other currencies, notably in US dollars. The risk premium the Italian government paid on its US dollar debt (i.e. the rate paid by the Italian government minus the rate paid by the US government, which presumably reflects the riskless rate in US dollars) should thus provide evidence on the likelihood.

Since the start of EMU, all Italian government debt has been denominated in euro. The difference between the interest rate of debt issued by the German government and that issued by the Italian government during the euro crisis presumably reflected only expectations of default, as both governments now issue debt in the same currency. In this context it does not matter whether this default takes the form of a haircut or an exit from the euro area.

The pricing of the Italian dollar-denominated debt during the 1990s compared with today can thus be used to infer the probability of a formal default. The two charts below show the co-movements of the US dollar spread to the national currency spread during the 1990s and the euro crisis. (The national currency spread refers to lira-denominated versus Deutsche Mark-denominated debt for the 1990s and to euro versus dollar debt during the euro crisis.)

A simple comparison of the two charts below shows the key difference between the 1990s (national currencies: Deutsche Mark and lira) and the euro crisis (national currency: euro).

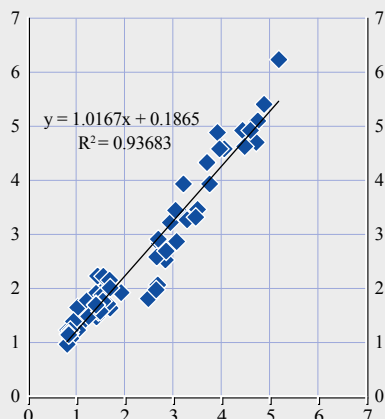
During both turbulent periods,³ there was a strong correlation between the risk premia on debt denominated in dollars and the national currency, but there was one key difference; during the 1990s an increase in the difference between lira and Deutsche Mark interest rates of 1 point led to an increase in the risk premium on Italian dollar-denominated debt of only 0.15 points. By contrast, during the euro crisis an increase in the spread on Italian euro-denominated

3 During the credit boom period with low risk aversion, both spreads were an order of magnitude lower and the correlation fell to about 20% (with negative values at times).

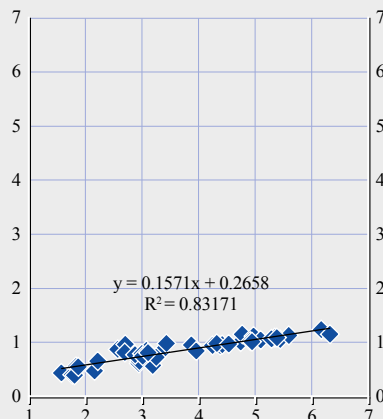
Chart 4 Foreign currency and domestic currency risk premia compared

(percentages)

x-axis: euro-denominated risk premium
y-axis: dollar-denominated debt risk premium



x-axis: lira minus Deutsche Mark interest rate on public debt
y-axis: dollar-denominated debt (Italy minus US) government, same maturity



Source : Bloomberg

debt was also accompanied by an increase in the spread on dollar-denominated debt of 1 full point. The spread on dollar debt follows one to one the spread on euro-denominated debt. In other words, the market is pricing euro-denominated debt as foreign currency debt.

The data from the 1990s thus suggest that for financial markets the probability of a formal default on public debt is much lower than the probability of the government allowing the exchange rate and inflation to increase. This in turn suggests that the political and economic costs of a formal default are perceived to be much higher than the cost of breaking an exchange rate commitment or allowing higher inflation.

6 CONCLUDING REMARKS

The overall conclusion one should draw from the experience of the EMS and post-EMS crisis of the 1990s is that a highly indebted country has nowhere to hide. If it keeps a national exchange rate, it is subject to potentially self-fulfilling speculative attacks on its exchange rate and government bond market. If it enters a monetary union, it is still subject to potentially self-fulfilling attacks on its government bond market and has to rely on liquidity support from elsewhere.

The break-up of the EMS in 1993 is a red herring. The fact that it proved impossible to defend a fixed exchange rate system with open capital markets does not imply that floating exchange rates insulate against speculative attacks on government bond markets. Subsequent experience (especially that of Italy

in 1995) has shown that even when the exchange rate is floating, a highly indebted country can still be forced to pay very high risk premia.

A review of the EMS (Gros and Thygesen, 1998) stated: “There are two types of mistake that an exchange rate system must attempt to avoid. The first is to defend rates that are perceived by markets to be misaligned; the second is to give in to speculative pressures when rates are in good correspondence with fundamentals.”

The euro crisis suggests that a similar conclusion might be appropriate for the European Stability Mechanism (ESM):

There are two types of mistake that a Stability Mechanism must avoid. The first is to provide financing to countries with public debt that are perceived by markets as unsustainable; the second is to give in to speculative pressures when public finances are fundamentally sound.

The key question that remains at the analytical level is thus: What mechanisms make a formal default with a haircut different from debt monetisation followed by inflation?

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ANNEX I “TEFLON” UK?

Comparisons of the experience of the UK with that of Spain have been used recently to illustrate the advantage of having a national currency (Kopf (2011) and De Grauwe (2011)). Interestingly enough, a comparison of the same couple of countries during the 1990s shows a similar pattern. The pound left the ERM in 1992 (along with the lira), whereas the peseta remained, although its central rate against the Deutsche Mark was repeatedly realigned, leading in the end to an even larger devaluation than that of the pound. It is thus difficult to argue that Spain’s formal membership of the ERM constituted a serious constraint. However, despite the fact that exchange rates were de facto flexible for both countries, there was a big difference in interest rates, which remained low and rather stable in the UK, whereas they were high and variable for Spain.

The UK was also able to pursue an aggressive fiscal policy, letting the deficit increase to about 7% of GDP in 1994, without incurring any perceptible risk premia. In 1995, at the peak of the crisis, Spain and the UK had almost exactly the same primary deficit (slightly above 2% of GDP in both countries). There was also little difference in the public debt ratios – in 1991 it was only 43% of GDP in Spain, just 10 percentage points higher than in the UK.

Given this similarity in the fiscal fundamentals, it is difficult to understand why the markets perceived Spain in such a different vein. (Ratings remained different; yet even here the difference was not that large, with the UK remaining at triple A compared to a double A for Spain.) The UK appears to be more favourably perceived in the markets, which is independent of the exchange rate regime.

ANNEX 2 THE DOG THAT DID NOT BARK: BELGIUM VERSUS ITALY

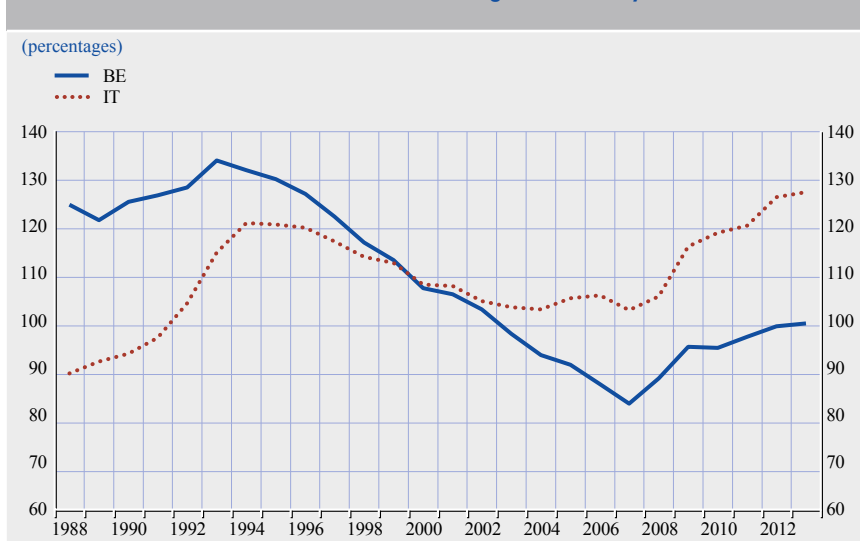
Belgium is the one country conspicuous for its absence from the EMS crisis (except for a few months in 1995), even though its public debt ratio at the start of the crisis was almost 30% higher than that of Italy (in 1991 Italy had a debt ratio of less than 100% of GDP, whereas that of Belgium was close to 130% of GDP). In both countries the debt ratio increased during the turbulent period of 1991-1995. But it increased much more in Italy, partially because Belgium was running somewhat larger primary surpluses, but also because Belgium had to pay much lower risk premia. The result of these two factors was that by the end of the 1990s the initial difference of 30% of GDP had been eliminated and the two countries then entered into EMU with about the same debt-to-GDP ratios.

Over most of the following decade there was little difference in the cost of servicing the debt between the two countries, but Belgium maintained a much larger primary surplus, especially during the good times in the early years of EMU. This proved to be an important investment since the debt-to-GDP ratio fell to 84%, which was one key reason why the cost of servicing Belgium's debt remained low even after the start of the euro crisis, whereas that of Italy rose. After two decades, the positions of the two countries are thus completely reversed: Italy is now where Belgium was in 1991 and Belgium is today where Italy was more than 20 years ago (see Chart A1).

The return to fiscal prudence or the price of profligacy

During the period of low risk premia in the early 2000s, the return from lowering the debt ratio appeared minor. With an interest rate of around 2% in real terms, Belgium could expect to save interest payments worth only about 0.4% of

Chart A1 Public debt-to-GDP ratio: Belgium vs Italy, 1998-2013



Source: European Commission.

GDP per annum. The failure of Italy to reduce its debt ratio seemed thus to be of secondary importance. However, when the crisis broke, Italy had to pay a substantial risk premium on its entire debt, worth 100 % of GDP. If one assumes that this risk premium amounts to 2.5%, one could argue that Italy had to pay 2.5% of GDP more than Belgium simply because of its failure to reduce its debt ratio during the good times. For Belgium the return for its prudent policy was thus the riskless rate plus $2.5/20$, or an additional return of 12.5%. Ex post, Belgium thus made a higher profitable investment by reducing its debt ratio during the good times. Another way to look at these numbers is to conclude that Italy should have taken into account the potential consequences of a return of risk aversion and calculated that the cost of public debt would be 15%. This figure might actually have been even higher since this calculation is based only on the public finance aspect and does not take into account the loss of output caused by the public finance crisis in Italy.

FROM THE MAASTRICHT TREATY TO THE EURO: AN ECONOMIC AND FISCAL POLICY PERSPECTIVE

THOMAS WIESER AND WIM HAINE

I INTRODUCTION

The Maastricht Treaty of 1992 laid down the foundations of Economic and Monetary Union (EMU), explicitly recognising the single currency as one of the Union's objectives. The creation of EMU, culminating in the launch of the euro in 1999, is a landmark in European integration. EMU reflected both economic and political aspirations. Price and currency stability would provide the environment for sustainable growth and would foster political integration in the Union.

EMU was established in a gradual manner with a view to ensuring that by 1999 the appropriate economic conditions and policy framework would be in place for the stable functioning of monetary union. The 20th anniversary of the establishment of the EMI, the organisation which was entrusted with the technical and organisational preparations for the ESCB and the ECB, provides a good opportunity to look back and ask if the Maastricht Treaty and the ensuing initiatives indeed delivered the above-mentioned aim.

Looking at the road that was taken from the Maastricht Treaty to the euro will mean revisiting some of the building blocks of EMU, as well as taking a closer look at the subsequent efforts to mould EU economic and fiscal governance, including the latest reforms that were prompted by the financial and sovereign debt crisis in recent years.

2 TREATY INSTRUMENTS FOR ECONOMIC AND FISCAL POLICY COORDINATION

EMU involves a unique set-up for a monetary union that combines centralised monetary policy with largely decentralised fiscal and economic policies by participating Member States. The adoption of a single currency would eliminate the disciplining factor of exchange rate risk premia and was also expected to reduce the disciplining factor of interest rate risk premia. Against this background, the risk of countries attempting to free-ride by running budget deficits without taking into account long-term fiscal sustainability considerations and possible negative spillovers across the euro area, was recognised. In addition, it was acknowledged that in the absence of the possibility for exchange rate adjustments and a cross-border fiscal transfer mechanism, and given the likely limitations of alternative adjustment tools (stemming from low labour mobility and price and wage rigidities, among other things) divergences in business cycles could create tensions among Member States and hamper the effectiveness of a single monetary policy.

Therefore, the founders of EMU specified strict convergence criteria which Member States had to fulfil in a sustainable manner to ensure that they would enter the euro area on a sound fiscal and economic footing. The Stability and Growth Pact (SGP) of 1997 (see below) was designed to ensure fiscal discipline once euro introduction had occurred by operationalising the Treaty's Excessive Deficit Procedure (EDP). In addition, the Treaty recognised that Member States should treat their economic policies as a matter of common concern and foresaw a soft form of coordination through the Broad Economic Policy Guidelines (BEPGs). This set of rules should be seen in conjunction with the monetary financing prohibition and the "no-bailout" clause. The former contributes to a clear separation between monetary policy and fiscal policy, thus ensuring that a stability-oriented monetary policy is not compromised by the monetisation of deficits. The latter makes clear that in EMU, Member States are not liable for other Member States' debt, which was intended to encourage financial markets to distinguish between different euro area governments' debt instruments, thereby strengthening financial market discipline on fiscal policies.

2.1 CONVERGENCE CRITERIA

Among the four convergence criteria – price and exchange rate stability and sustainable public finances, as well as long-term interest rate convergence – the fiscal criterion proved the most challenging for many Member States to reach in the 1990s.

The convergence criteria were already criticised at the time of inception; opponents accused the criteria of being arbitrary, too stringent and some have found them to be inadequate in ensuring the needed discipline. In addition to problems with the criteria themselves, compliance raised further difficulties.

Despite setting strict fiscal targets for the Member States, the Treaty left large discretionary powers to the national governments regarding how to pursue and achieve these targets. In the period from the establishment of the criteria until the actual introduction of the euro, Member States were deemed to have, *prima facie*, successfully carried out fiscal consolidation under pressure consistent with the convergence criteria. However, to qualify for euro area membership many countries opted for quick fixes to ensure compliance with the nominal targets, rather than addressing underlying structural problems by enacting long-lasting reforms. It has been pointed out that, to some extent, the fiscal consolidation countries underwent was illusory – nominal benchmarks were achieved through privatisation of state-owned companies and banks, the selling of gold reserves, or even levying a one-time tax to meet the targets. As a result, compliance with the fiscal Maastricht criteria in itself did not provide adequate safeguards for sound and sustainable fiscal policies.

In the second half of the 1990s Member States managed to secure exchange rate stability and witnessed a rapid reduction in inflation, as well as nominal and real interest rates. The focus on nominal convergence in the initial stages had, however, diverted attention from factors that matter for real convergence, notably productivity and competitiveness developments, product and labour market

reforms, the composition of growth supporting the catching-up process in some Member States and private sector balance sheets.

2.2 BROAD ECONOMIC POLICY GUIDELINES

As the proper functioning of EMU also required a close coordination of a broad range of economic policies, over and above those in the fiscal area, the founders introduced the concept of Broad Economic Policy Guidelines (BEPGs) in the Maastricht Treaty. This soft method of economic policy coordination was not entirely new as the Monetary Committee of the European Economic Community had been issuing annual reports with policy guidance to Member States since the late 1950s. These reports can be seen as a precursor to the BEPGs. Later, both the Werner Report and the Delors Report also noted the need to coordinate economic policies in their plans for EMU.

The Guidelines were, in some aspects, visionary as they called for an average inflation rate of no more than two to three percent, broadly anticipating the ECB's view of price stability. The BEPGs also set the goal of achieving close to balanced budgets by 2000, foreshadowing the medium-term objective set out in the 1997 Stability and Growth Pact.

Initially the emphasis was on budgetary issues. Over the years, however, the country-specific guidelines came to address and promote structural reforms in labour markets. Nevertheless, the BEPGs proved to be of limited practical use. First, in the early days of the exercise, the guidelines were vague as they addressed all Member States and therefore proved difficult to translate into practice. The first time country-specific guidelines were issued was in 1998; these in turn were criticised for lacking concreteness. Second, the lack of peer pressure, the non-binding nature of the BEPGs and the lack of political ownership undermined the credibility of the exercise. It is telling that the “quasi-sanctioning mechanism” foreseen in the Treaty, which entitled the ECOFIN Council to issue, in the event of non-compliance and on a recommendation of the Commission, a non-binding recommendation for corrective action, has been used just once. In 2001, Ireland adopted tax cuts despite calls to show fiscal restraint in the face of rapid economic growth. Although the Council issued a warning to Ireland, the failure to correct pro-cyclical budgetary plans is testimony to the failure of peer pressure to impact Member States decisions. The Irish Independent newspaper quoted a government official as saying “everybody is quite relaxed” about the Commission's comments.

With the relaunch of the Lisbon Strategy in 2005, the concept of Integrated Guidelines was introduced, combining the BEPGs and the Employment Guidelines, which were later replaced by the “Europe 2020 Integrated Guidelines”. Although the aims were to limit the number of guidelines issued, ensure internal consistency and focus on the right priorities, this integrated strategy did not generate much more traction due to a continued lack of ownership.

3 SECONDARY LEGISLATION – STABILITY AND GROWTH PACT

Realising that the adoption of the euro marked a “point of no return” and that incentives for sound policies and, in particular, fiscal discipline were to remain crucial even beyond the run-up phase to the euro introduction, the Treaty included an Excessive Deficit Procedure (EDP), requiring Member States to avoid excessive government deficits and debt. The Stability and Growth Pact (SGP), which was introduced in 1997, sought to operationalise and strengthen the fiscal framework of the Treaty by laying down more detailed rules on budgetary surveillance to prevent and, where necessary, correct fiscal policies that did not comply with the above-mentioned obligation.

The reality of fiscal discipline following the launch of the euro fell short of the original aim of the SGP, which took effect a year before the euro was launched. The fiscal consolidation that took place between the mid-1990s and late 1990s stalled or even reversed in several Member States. The SGP did not prevent pro-cyclical policies when the economy was peaking between 1999 and 2000, which, compounded by the subsequent economic downturn, resulted in deteriorating fiscal positions. The SGP suffered from weak national ownership and left significant discretionary powers with Member States, which were reluctant to rigorously and consistently apply its rules and procedures, thereby debilitating the Pact. A case in point was the ECOFIN Council’s decision not to step up the EDP for Germany and France in 2003, thereby ignoring Commission recommendations and undermining the SGP’s effectiveness and credibility.

Taking into account this initial experience with the Pact, the 2005 SGP reform sought to improve the fiscal surveillance framework notably by introducing more flexibility to take into account economic conditions, as well as the specific circumstances of each Member State, for instance when defining the medium-term objective (MTO) and the adjustment path towards it. However, enforcement provisions, considered by many to be the main shortcoming of the Pact, were not improved. The reforms also failed to increase national ownership.

4 2010 REFORMS AND BEYOND

The financial and sovereign debt crisis exposed serious shortcomings in the economic governance of the EU, and in particular of the euro area. The instruments embedded in EU primary and secondary law, and their implementation not only proved to be insufficient to ensure a stable environment for the smooth functioning of monetary union, but they also failed to deliver their stated aims. In response to rapidly eroding confidence, and as part of a comprehensive strategy to combat the financial crisis, EU institutions and Member States embarked on a major overhaul of the EU’s economic governance framework and created financial assistance facilities linked to policy conditionality.

4.1 IMPROVED ECONOMIC GOVERNANCE

The “six-pack” legislation that entered into force in 2011 marked a first milestone in this exercise. The preventive and corrective arms of the SGP were strengthened notably by introducing an expenditure rule to ensure that government expenditure remained consistent with the aim of the SGP, a gradual system of quasi-automatic financial sanctions kicking in at an earlier stage and a rule to operationalise the debt criterion. Member States were also required to put in place national fiscal frameworks with minimum requirements. Through the fiscal compact included in the intergovernmental Treaty on Stability, Coordination and Governance, the SGP was further strengthened and a balanced budget rule, as well as an automatic correction mechanism, are set to be enshrined in national law. These new measures should help to ensure consistency between national and European fiscal rules and foster national ownership.

Over the preceding years economic policy coordination took a backseat to fiscal governance and received considerably less attention. However, internal and external macroeconomic imbalances had been building up in a number of Member States. These included deteriorating unit labour costs and competitiveness developments, unsustainable residential property price increases, excessive credit and rising private debt levels. The six-pack legislation consequently introduced a significant enhancement of macroeconomic surveillance through the Macroeconomic Imbalances Procedure, which aims to identify potential risks early on, prevent the emergence of harmful imbalances and correct the imbalances that are already in place.

Another important and novel improvement in governance was brought about by the adoption of the “two-pack” legislation, which strengthens coordination and budgetary surveillance in the euro area. It requires Member States to submit draft budgetary plans on which the Commission provides an ex ante assessment of compliance with the SGP’s existing fiscal surveillance framework and can request a redraft in case of serious non-compliance. This form of ex ante coordination is expected to increase national ownership of the multilateral surveillance framework. The experience with the first round of assessments in late 2013 is promising. The Eurogroup has engaged in an in-depth and frank debate on the draft budgetary plans and Member States have committed to addressing the risks identified by the Commission.

In terms of process, the European Semester brought the surveillance of both fiscal and economic developments together under one umbrella, to ensure consistency of the policy advice given. Participating Member States’ National Reform Programmes and Stability Programmes serve as the basis for the Commission and the Council to assess whether Member States have complied with their MTOs and if they are responding to the EU policy advice. Country-Specific Recommendations (CSRs) provide the euro area and Member States with concrete suggestions on fiscal and economic policies. Although the CSRs constitute an important step forward, the experience of 2012 has shown that a close monitoring of their implementation is also required.

4.2 FINANCIAL ASSISTANCE FACILITIES AND ADJUSTMENT PROGRAMMES

Interestingly, and reflecting undue confidence in the effectiveness of market discipline and the original policy coordination framework, the founders of EMU assumed that euro area sovereigns would not face financing problems. Hence, the Treaty did not foresee the possibility for euro area countries to have recourse to a financial assistance facility linked to policy conditionality, whereas for non-euro area Member States, the Treaty foresaw a balance of payments facility. The crisis has exposed this as a major shortcoming in the institutional set-up of EMU. The creation and activation of financial assistance instruments – Greek Loan Facility (GLF), European Financial Stabilisation Mechanism (EFSM), European Financial Stability Facility (EFSF) and, ultimately, the permanent European Stability Mechanism (ESM) – proved to be a painful exercise in which diverging views had to be reconciled. The same holds true for the design of the accompanying adjustment programmes and their integration in the regular EU coordination framework. Adjustment programmes constitute the most intrusive form of policy coordination and are negotiated between by the beneficiary Member State and the Commission in liaison with the ECB, and, as a rule, the IMF, while taking into account the views of the other Member States on key policy elements and their own financial constraints.

5 CONCLUSION – LESSONS LEARNED

The recent crisis has taught us some hard lessons. The instruments provided for by the Maastricht Treaty and secondary legislation, as well as their implementation, proved to be both inadequate and insufficient for creating a stable environment necessary for the smooth functioning of monetary union. The euro area has, however, demonstrated its ability to adapt and evolve in the most challenging of times. Since 2011, major steps have been taken to strengthen the economic governance of the EU and the euro area in particular.

The revamped rules-based framework will help in addressing current imbalances and preventing new imbalances emerging in the future, provided that a rigorous implementation of the policy prescriptions is ensured. As the new framework has already introduced a gradual system of fines in case of transgression, coupled with more automaticity in the related decisions, a further strengthening of these components is probably not realistic. One area where further progress should be made in the near to medium term concerns a significant increase in national ownership. At present, and notwithstanding steps in the right direction with the ex ante coordination of draft budgetary plans, decisions pertaining to the domain of economic governance remain largely in the remit of finance ministers. It could be envisaged that national ownership is enhanced by giving a stronger role to national parliaments, as well as putting in place an increased and more visible form of accountability (in the event of non-compliance by a Member State, its finance minister could, for example, be asked to provide explanations in a hearing at the European Parliament).

It should be borne in mind that improved economic governance is only one element in the euro area's crisis response, as pointed out notably in the report "Towards a Genuine Economic and Monetary Union" by the Presidents of the European Council, European Commission, Eurogroup and European Central Bank. The establishment first of temporary financial assistance facilities and later of a permanent firewall, as well as decisions to activate these for a number of vulnerable Member States, underscored the resolve to safeguard the stability of the euro area. The creation of a banking union is a crucial step towards breaking the sovereign-banking nexus and, hence, the completion of EMU. Decisive steps have been taken towards this end. Finally, it needs to be acknowledged that despite the improved economic governance framework, decentralised fiscal policies remain a potential weakness of the euro area in comparison with other successful monetary unions. Therefore, completion of EMU would in principle entail a move towards some degree of fiscal federalism, involving joint decisions on certain elements of national fiscal policies in order to overcome the risks posed by decentralised fiscal policies and the inherent market segmentation. As it requires changes to the EU Treaty and national constitutions, such a move can only be envisaged in the long run.

In the interim, work on integrated financial, fiscal and economic frameworks, as well as enhanced political accountability, is set to continue in a gradual manner under the aegis of the Euro Summit and Eurogroup. This should ensure that the remaining lessons learnt in this financial and sovereign debt crisis are not forgotten, making the euro area better equipped to tackle the next crisis.

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FINANCIAL CRISES UNDER TWO EUROPEAN MONETARY REGIMES: EMU VS EMS

ANDRÉ SAPIR

I INTRODUCTION

Just as it was celebrating its tenth anniversary, the euro was hit by a financial crisis that started in the United States but then rapidly spread to Europe. As Economic and Monetary Union (EMU) was ill prepared to deal with the situation in the banking sector, the financial crisis turned first, in 2010, into a Greek sovereign crisis and then, in 2011-12, into a full-blown bank sovereign debt crisis that at one point threatened the very existence of the monetary union.

For those old enough to remember it, the euro crisis was reminiscent of the crisis of an earlier European monetary regime, the European Monetary System (EMS), whose existence had been equally called into question two decades earlier in 1992-93.

Between September 1992 and August 1993, the exchange rate mechanism (ERM) of the EMS was the subject of repeated speculative attacks. This activity led to the temporary (for the Italian lira) or permanent (for the British pound) exit of currencies from the ERM, to devaluations within the ERM of several others (the Spanish peseta, the Portuguese escudo and the Irish pound) and eventually to the widening of the size of the ERM bands from 4.5% to 30% (15% on either side of the central parities). Chart 1 shows the evolution of some exchange rate parities against the ecu/euro during the period 1990-1999, with the contrasting situation between the Deutsche Mark and the French franc on the one hand and the lira and the peseta on the other.¹

Two factors were responsible for the EMS crisis: full liberalisation of capital movements for European countries in July 1990 and German reunification in October 1990, which led to an important change of policy mix in the EMS anchor country, which was not appropriate for other EMS countries.² These two factors proved incompatible with membership of the ERM, or at least of its relatively narrow-band version, unless countries were willing to live with German monetary policy (as Belgium, Denmark, France, Luxembourg and the Netherlands proved to be)

- 1 The EMS started in March 1979 with two fluctuation bands: a narrow band (+/- 2.25%) for Belgium, Denmark, France, Germany, Ireland, Luxembourg and the Netherlands; and a wide band (+/- 6%) for Italy. Three countries joined later, but before the beginning of the crisis in September 1992: Spain in June 1989 and Portugal in April 1992, both with a wide band, and the United Kingdom in October 1990, with a narrow band. Also, in January 1990 Italy moved to a narrow band.
- 2 Greece, Ireland, Portugal and Spain had derogations giving them until December 1992 to fully liberalise capital movements.

and the Bundesbank was willing to provide sufficient liquidity support to these countries to fight off speculative attacks.³

The purpose of this paper is to examine the 2012-13 EMU crisis in the light of the 1992-93 EMS crisis and to draw lessons for the stability of the European monetary union.

2 NATURE OF AND RESPONSES TO CRISES: EMS AND EMU

Under both monetary regimes, EMS and EMU, two types of crises can occur: crises of fundamentals arising from real exchange rate misalignment or problems of government solvency; and self-fulfilling liquidity crises that can be triggered simply by a change of expectation.

In the view of Gros and Thygesen (1998), the EMS had to avoid two types of mistakes: one was to defend parities against speculative attacks when fundamentally misaligned; the other was not to defend parities against speculative attacks when fundamentally sound. Similarly, according to Gros (2014), EMU has to avoid two types of mistakes: one is to provide financing to countries whose governments are insolvent; the other is not to provide financing to countries whose governments are solvent. In other words, EMU still basically faces the same problem as the EMS did in its time.

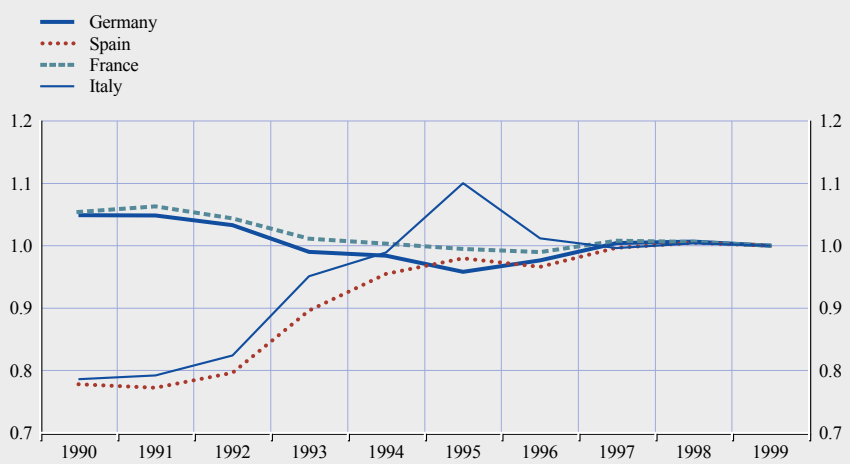
When fundamentals go wrong, crises seem inevitable: just as much in 2011-12 under EMU as they were in 1992-93 under EMS. On the other hand, self-fulfilling liquidity crises could have been avoided under both regimes, provided there existed an appropriate lender of last resort (LOLR), as argued by De Grauwe and Li (2013). Table 1 examines the LOLR situation under EMS and EMU for self-fulfilling crises in two different markets: the government bond market and the money market (which includes the foreign exchange market).

Two EMS regimes are distinguished in Table 1: the situation before 1990, when some restrictions on capital movements still existed in the European Union (EU); and the situation after 1990, when free capital movements prevailed.⁴ Under the EMS, both before and after 1990, national central banks could, in principle, act as LOLR to their national governments and therefore prevent self-fulfilling crises in the government bond market. The situation was different in the foreign exchange market. Here the Bundesbank, the central bank of the EMS anchor country, was the de facto LOLR to other national central banks of countries belonging to the ERM prior to 1990. However, with the full liberalisation of capital movements, the Bundesbank basically refused to continue acting as unlimited LOLR to the other central banks of the system. It only accepted this role for some countries – those whose exchange rate parities it deemed were not (too) misaligned.

3 There has been much controversy about the Bundesbank's unwillingness to provide liquidity support to the Bank of England to fight off speculators in September 1992, which this paper will briefly discuss.

4 However, see footnote 2.

Chart 1 Exchange rate parities against the ecu/euro (1999=1), 1990-1999



Source: Own calculations based on AMECO database.

As Chart 1 shows these countries included France, which was the subject of repeated speculative attacks during the 1992-93 crisis yet the franc’s ERM parity was successfully defended by joint interventions of the Banque de France and the Bundesbank.

Table 1 also distinguishes three EMU regimes: the situation that prevailed from the creation of the euro in 1999 to the 2011-12 crisis; the situation that has existed since the creation in 2013 of the European Stability Mechanism (ESM), which like its predecessor – the temporary European Financial Stability Facility (EFSF) set up in 2010 at the time of the Greek crisis – provides financial assistance to euro area countries experiencing or threatened by financing difficulties; and the “Genuine Economic and Monetary Union” (GEMU), the long-term “vision for a stable and prosperous EMU” proposed by President Van Rompuy and prepared in close cooperation with the Presidents of the European Commission, the Eurogroup and the European Central Bank.^{5, 6}

Table 1 Lender of last resort under EMS and EMU regimes

Market	EMS Before 1990	EMS After 1990	EMU Before crisis	EMU Since crisis	GEMU
Government bond market	National Central Banks	National Central Banks	None	ECB ESM (But DE)	ECB Euro Treasury
Money market (including foreign exchange market)	DE (Bundesbank)	None	Eurosystem (Target 2)	Eurosystem (Target 2)	Eurosystem (Target 2)

5 Van Rompuy (2012).

6 The three regimes are examined in the contributions by Moghadam (2014) and Wieser (2014).

Since the start of EMU, the function of LOLR in the money market has been provided by the TARGET system (replaced in 2007 by the TARGET2 system), the unlimited interbank settlement system owned and operated by the Eurosystem, consisting of the European Central Bank (ECB) and the euro area national central banks. On the other hand, so far, EMU has no proper LOLR for government bonds. National central banks have lost this function with the creation of the euro and depending on one's perspective, it is now partially or not fully exercised by the ECB and by the ESM, though the legality as far as the ECB is concerned is contested, mainly in Germany, by the Bundesbank among others. The creation of a GEMU could make it possible for the ECB to fully exercise the role of LOLR in the government bond market in the future.

3 LESSONS OF THE 1990S EMS CRISIS FOR THE 2010S EURO CRISIS

The previous discussion suggests two lessons of the 1990s EMS crisis for the 2010s EMU crisis.

Lesson 1: The nature of the crisis needs to be clearly identified in order to solve it

Like the 1992-93 EMS crisis, the 2011-12 EMU crisis lasted longer than it should have because its nature was not well identified.

The EMS crisis was a crisis of fundamentals originally interpreted as a liquidity crisis. The introduction of free capital movements in 1990 revealed the incompatibility between diverging monetary policies and membership of the ERM. Severe misalignment of the British pound, the Italian lira and the Spanish peseta with the Deutsche Mark (DM) meant that these currencies could not be defended by pouring liquidity against speculative attacks, as the Bank of England painfully discovered on Black Wednesday (16 September 1992), when it lost GBP 1 billion to George Soros. The Bundesbank was right to refuse to act as lender of last resort to the Bank of England and central banks from peripheral countries whose currencies were severely misaligned as the crisis required a change in fundamentals (i.e. exchange rate realignment) rather than liquidity.

The opposite occurred in 2011-12 when, apart from Greece, euro area sovereigns suffered a crisis of liquidity rather than solvency, as De Grauwe (2011) was first to correctly diagnose. The best proof that it was indeed a liquidity crisis is that the mere announcement of the ECB's Outright Monetary Transactions (OMTs) in September 2012 virtually terminated the euro sovereign debt crisis. And while there are several possible interpretations of the OMTs, one of them is that they involve the ECB taking on the role of LOLR to governments, subject to certain conditions.⁷

7 See, for instance, Sapir (2012b) and Winkler (2014).

Lesson 2: crises of fundamentals could have been avoided under EMS and EMU

Like the 1992-93 EMS crisis, the 2011-12 EMU crisis was the result of incoherence mistakes.

The EMS mistake was insufficient recognition that the introduction of free capital movements in 1991 made it impossible for member countries to conduct diverging monetary policies while trying to preserve fixed parities.

Similarly the 2011-12 EMU crisis could have been avoided if three failures of coherence had not occurred: an intellectual failure; a coordination failure; and a surveillance failure.

EMU's intellectual failure

We all knew (or at least should have known) 20 years ago that the EU countries which were about to join the euro did not constitute an optimum currency area (OCA). Two specific issues were raised at the time.

First, there was a recognition that EU countries were heterogeneous in terms of their capacity to abandon the exchange rate instrument: some countries were deemed to be less exposed to idiosyncratic shocks and to be better equipped to deal with such shocks should they occur nonetheless, while others were viewed as potentially more exposed to shocks and less able to cope with them outside the exchange rate instrument because of relatively rigid products and/or labour markets. The former, already at that time called “core countries”, were essentially those that belonged to the ERM throughout the 1990s, including during the 1992-93 crisis, namely Germany, France and the Benelux countries; Austria, which only joined the EU in 1995, but had mimicked the other core countries in terms of exchange rate behaviour, was later added to the list of core countries. These six countries were also often referred to as the DM zone;⁸ the other EU countries were already labelled as “peripheral countries”.⁹

The second issue was the absence of EMU mechanisms capable of substituting for or complementing national adjustment mechanisms (i.e. exchange rate changes before EMU and market flexibility after the creation of the euro) in the event of idiosyncratic shocks. Two potential mechanisms could have been labour mobility (as originally envisaged by Mundell, 1961) or fiscal transfers (as suggested first by Kenen, 1967) between EMU countries, but neither was put in place.

The heterogeneity of EMU countries, in particular structural differences between the former DM-zone countries and the peripheral countries, combined with the absence of EMU mechanisms to handle idiosyncratic shocks should have alerted us to the potential fragility of the system in the case of such shocks. There were some warnings (even in official or semi-official publications like

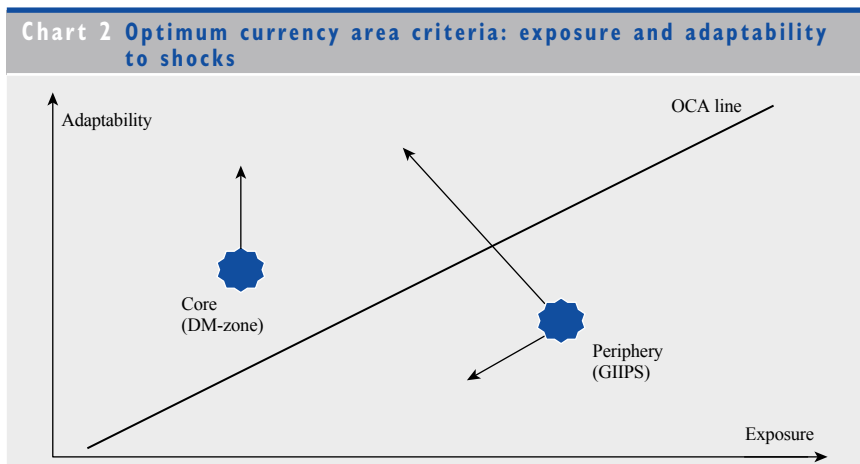
8 Denmark also belonged to the DM zone, but politically it was not regarded as a core country since it had obtained a permanent derogation from joining the single currency during the Maastricht negotiation.

9 See, for instance, Eichengreen and Frieden (1993).

Buti and Sapir, 1998) on the eve of the creation of the euro that “many aspects of product and labour markets in EU Member States are currently insufficiently flexible”, but the hope was that “adjustment in market structure and response [was] likely to emerge as an endogenous consequence of the Single Market and the new monetary regime” (as Frankel and Rose (1997) had suggested), though it was acknowledged that “these changes will emerge only gradually in the new regime”.¹⁰

In their assessment of EMU a few years later, Buti and Sapir (2002) found that “heterogeneity and limited availability of adjustment instruments may have contributed to the heightening of economic divergence in the initial years of EMU” and wondered whether “more symmetry in economic behaviour between current euro area members [was] going to occur during the next few years”.¹¹ Their view was that “a more homogenous economic behaviour can be expected provided [EU] policy surveillance is effective in fostering further adaptability and reducing exposure to asymmetric disturbances” but that such outcome “is not yet in sight”.¹²

Chart 2, indicates the two scenarios envisaged by Buti and Sapir (2002) for the peripheral countries (Greece, Ireland, Italy, Portugal and Spain (GIIPS)), which, contrary to the DM-zone countries, were below De Grauwe (2012)’s OCA line at the start of the euro:¹³ less exposure to idiosyncratic shocks, with more or less adaptability to shocks. Unfortunately, the GIIPS remained below the OCA line; heterogeneity and with it the likelihood of a shock continued to increase, while the availability of adjustment mechanisms and therefore the ability to respond to



Sources: Adapted from Buti and Sapir (2002).

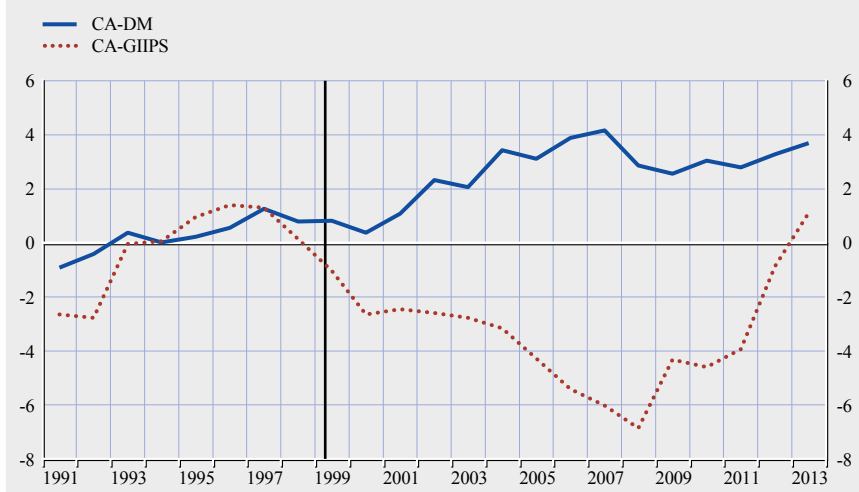
10 All the quotes in this paragraph are from Buti and Sapir (1998), p. xiv.

11 Buti and Sapir (2002), pp. 32-3.

12 Buti and Sapir (2002), p. 36.

13 Points on the OCA line define combinations for which the benefits of monetary union are equal to its costs. Countries above (below) the OCA line have benefits that are greater (lower) than the costs.

Chart 3 Current accounts as percentage of GDP, 1991-2013, DM-zone countries vs. GIIPS



Source: Own calculations based on AMECO database.

shocks remained insufficient at the national level. And it remained totally absent at euro area level.

Chart 3 shows why differences between the DM-zone countries and GIIPS increased after the creation of the euro. The chart plots the behaviour of the (aggregate) current account balances for the two groups of countries for the period before and after the creation of the euro. In 1991-92 the current account deficit of the GIIPS countries is at more than 2% of GDP, but the exchange rate adjustments in 1992-93 rapidly bring the situation back to equilibrium. By contrast, after the creation of the euro in 1999, the current account deficit of the GIIPS countries gradually deteriorates, reaching an unprecedented (aggregate) level of nearly 7% of GDP in 2008, thanks to the absence of exchange rate crises. The sudden stop in the accumulation of negative external imbalances by the GIIPS countries only occurred after the start of the financial crisis, when financial markets suddenly realised that the situation had become unsustainable.

In addition we totally ignored the possibility of financial crises, the main concern at the time of the creation of the euro being price stability, whereas financial stability received little attention from academic economists or policy-makers.¹⁴ For instance the Maastricht treaty mentions the word ‘stability’ 13 times: 12 times in the context of price stability, but only once in the context of financial stability. As a result, the creation of the monetary union was not accompanied by a banking union.

The absence of a euro area banking resolution authority has been a major hindrance in coming to terms with what started as a global financial crisis in 2008 and evolved in 2011-12 into a European financial-cum-sovereign-debt crisis of

14 One notable early exception is Prati and Schinasi (1999).

considerable magnitude. In June 2011, the crisis was viewed by the European Systemic Risk Board (ESRB) as posing the “most serious threat to financial stability in the EU”.¹⁵ Three months later, the same body considered that “risks to the stability of the EU financial system ha[d] increased considerably. The key risks stem from potential further adverse feedback effects between sovereign risks, funding vulnerabilities within the EU banking sector, and a weakening of growth outlooks both at global and EU levels”.¹⁶

The recognition that Europe’s banking regulatory and supervisory architecture was deficient led to the creation of the ESRB and to the transformation of the Committee of European Banking Supervisors (CEBS) into the European Banking Authority (EBA) in January 2011. But these are EU rather than euro area bodies, and are only meant to safeguard the financial integration logic of the single market by making sure that national supervision operates according to common EU rules. These new bodies were not designed to address the more ambitious common financial supervision and resolution logic that the common currency requires.¹⁷

The creation of the banking union, as decided in June 2012, is meant to prevent situations like the one experienced in 2011-12 in the future. Having a banking union may not have prevented the crisis, which was caused by the over-accumulation of private and public debts partly fostered by economic differences within EMU and intermediated by banks, but it would have greatly helped its prompt resolution and prevented protracted difficulties that were not yet fully resolved at the time of completing this paper in April 2014.

EMU’s coordination failure

The Delors (1989) Report considered that the creation of a monetary union among sovereign states necessitated “*effective coordination* of policies remaining within the competence of national authorities” (emphasis added).

The Maastricht treaty stated that “Member States shall regard their economic policies as a matter of common concern and shall coordinate them within the Council”. Coordination would take place through the adoption by the Council, on a recommendation by the Commission, of “broad guidelines of the economic policies of the Member States and of the Community”. Furthermore, so as “to ensure closer coordination of economic policies and sustained convergence of the economic performances of the Member States, the Council shall, on the basis of reports submitted by the Commission, monitor economic developments in each of the Member States and in the Community as well as the consistency of economic policies with the broad guidelines”.

Unfortunately no mechanism was put in place to ensure macroeconomic policy coordination, except in the area of budgetary policy, where the Maastricht treaty demanded that “Member States (...) avoid excessive government deficits”

15 See ESRB (2011a).

16 See ESRB (2011b).

17 See Sapir (2012a).

defined as excesses over a reference value equal to 3% of GDP. This requirement was later reinforced by the Stability and Growth Pact (SGP), which committed EMU countries “to respect the medium-term budgetary objective of positions close to balance or in surplus”. This would allow EMU countries to deal with normal cyclical fluctuations while keeping their government deficit below the reference value of 3% of GDP. In essence, therefore, the SGP was meant to transform the 3% reference value specified in the Treaty, which remained untouched, into a hard ceiling.

After the creation of the euro, the Maastricht Excessive Deficit Procedure (EDP) and the subsequent Stability and Growth Pact were regarded as the main instruments of policy coordination of EMU, whereas the Broad Economic Policy Guidelines (BEPGs) were essentially ignored. The reason (and the consequence) was that coordination in EMU was interpreted as negative coordination, which simply aims at avoiding conflict between parties, rather than as positive coordination, which seeks the more ambitious goal of building coherence between the parties and their policies. The EDP and the SGP were therefore emphasised since they were meant to prevent countries from harming other EMU countries (negative coordination). On the other hand, the BEPGs were largely ignored because they were (at least potentially) meant to prevent harmful behaviour (negative coordination) and to seek common action in the collective interest (positive coordination).

The same logic that prevailed after the creation of the euro was applied after the start of the crisis when the main emphasis was that debtor countries “put their house in order”. As Wieser (2014) discusses, there were important efforts to build a “common house” with the institution of the European Stability Mechanism (ESM) and the creation of the Single Supervisory Mechanism (SSM) and Single Resolution Mechanism (SRM) as part of the banking union, though both the ESM and SRM are clearly intergovernmental rather than community institutions. More generally, the common house definitely tilts in the direction of reinforcing negative coordination with the adoption of new fiscal rules, such as the “six-pack”, the “two-pack” and the “fiscal compact”. Negative coordination was also strengthened with the creation of the European Semester procedure that builds on the BEPGs idea, but leaves aside its use as a positive coordination device, in particular to ensure that national fiscal policies add up to a coherent fiscal stance for the euro area as a whole.

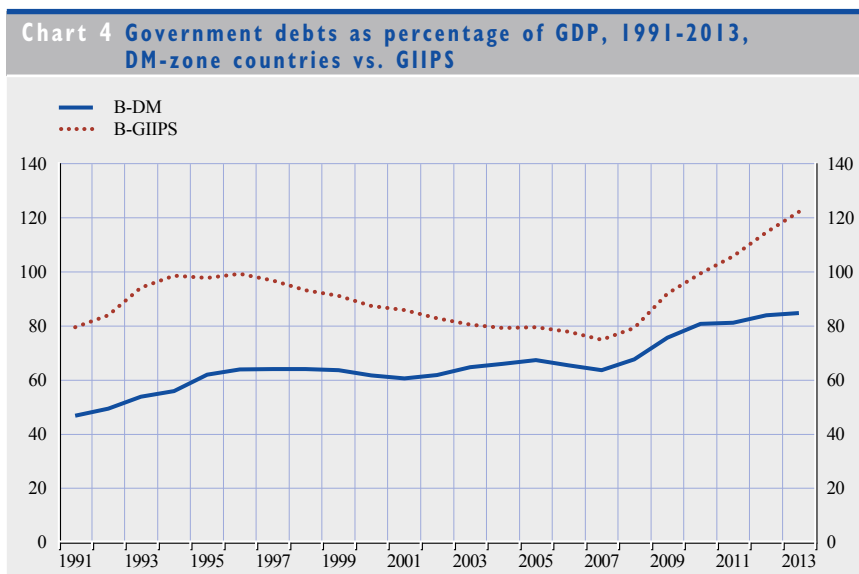
One of the tragedies of the euro area crisis has been the lack of an authority capable of providing the necessary coordination between the various actors, mainly the national governments and the independent central bank resulting in a game of chicken among governments and between governments and the central bank. The latter was partly resolved when Mario Draghi insisted, during the announcement of the ECB’s OMT programme on 6 September 2012, that solving the crisis required a two-legged approach involving both the ECB and governments. The OMTs’ conditionality mechanism was precisely meant to ensure that each leg moves in the right direction.

EMU's surveillance failure

Economic surveillance, like coordination, focused almost exclusively on government deficit, with the EDP and the SGP. Public debt received relatively little attention and private debt received no attention at all.¹⁸ Similarly, external debt (and current account imbalances) was all but ignored.

Chart 3 (already discussed in the previous section) indicates that close surveillance of current account imbalances between the DM zone and the GIIPS countries would have probably triggered concern on the part of policy-makers of the dangers that had accumulated in the euro area.

By contrast, as Chart 4 indicates, monitoring of public debts in the two groups of countries would have painted a much more benign situation. At the start of the euro in 1999, the DM zone had a public debt level of 64% of GDP, while it amounted to 91% for the GIIPS countries. By 2007, the public debt level had remained unchanged in the DM zone, but decreased to 75% in the GIIPS countries. Thus, in 2007 not only was the debt level in GIIPS at a record low level, but so was the difference between the debt levels in the GIIPS countries and the DM zone. As the crisis has progressed debt levels have sharply risen in the two zones, though much more in the GIIPS countries, which had accumulated large current account deficits before the crisis, than in the DM-zone countries, which had accumulated current account surpluses. By 2013, the gap in public debt levels between the GIIPS and the DM-zone countries stood at nearly 40 points, not only much more than the 11 points of 2007, but also more than at any other point during 1991-2013.



Source: Own calculations based on AMECO database.

18 Moghadam (2014) focuses on the role of private sector debt in the euro crisis.

One of the important outcomes of the crisis has been the decision to extend the scope of EU surveillance with the Macroeconomic Imbalance Procedure (MIP), which now monitors 11 economic indicators for each EU member state: the current account balance; the net international investment position; the export market share; nominal unit labour costs; the real effective exchange rate; private sector debt; private sector credit flow; house prices; government debt; the unemployment rate; and financial sector liabilities.

Although the MIP represents an important step forward for EU surveillance, it still suffers from three drawbacks.

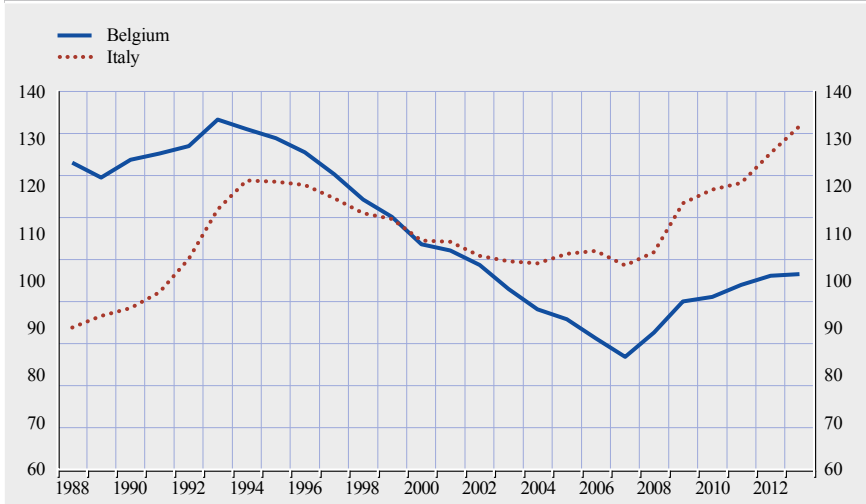
First, the MIP covers too many indicators. A focus on indicators most pertinent for countries that have given up their currency (or plan to do so in the near future) would have been preferable to ensure that surveillance translates into appropriate policy changes. A reduced set would include just five indicators: the nominal and real effective exchange rates;¹⁹ the current account balance and the net international investment position; and government public debt. In particular, there is no need for the MIP to monitor financial stability (with indicators about private sector debt, private sector credit flow, house prices and financial sector liabilities) since other EU institutions have recently been set up for this purpose (such as the European Systemic Risk Board).

Second, the governance of the EDP and the MIP should be modified. At the moment, EU surveillance is essentially the responsibility of an EU institution, the European Commission. It would be preferable if EU surveillance were instead conducted by a network of institutions comprising both national and EU institutions, with the European Commission at the centre of the network just like the European Central Bank is at the centre of the European System of Central Banks. The advantage would be greater national ownership of the process of surveillance than is actually the case and therefore more cooperation between Brussels and the national capitals in working toward the common good. In this respect, the requirement of the fiscal compact that member states put in place national fiscal councils is an important step forward.

Chart 5 shows what difference national fiscal councils can make by examining the evolution of public debts in Belgium and Italy. By combining the Maastricht rules and its national fiscal framework, Belgium succeeded in lowering its public debt from a post-war level of 135% of GDP in 1993 to 115% at the start of the euro in 1999 and about 85% before the start of the crisis in 2007. By contrast, without a national fiscal council, Italy only managed to reduce its debt level from a record 120% in 1994 to 115% in 1999 and to about 105% in 2007. The same difference occurred with the advent of the crisis, the public debt reaching only 100% in Belgium in 2013, compared with nearly 130% in Italy.

19 Moghadam (2014) also notes that the MIP requires greater emphasis on emerging competitiveness gaps.

Chart 5 Government debts as percentage of GDP, 1988-2013, Belgium vs. Italy



Source: own calculations based on AMECO database.

Third, the scope of EU surveillance should be extended beyond macroeconomic indicators. Differences in the functioning of product and labour markets among EU countries, especially those in the euro area, remain extremely worrisome. For instance, Table 2 shows the scores of (some) euro area countries with respect to the World Bank’s Ease of Doing Business indicator. The table indicates that some EMU countries rank quite well globally, while others perform rather poorly.

Table 2 Ease of Doing Business, selected eurozone countries, 2013

Eurozone economies	Ease of Doing Business Rank 2013
Finland	12
Ireland	15
Germany	21
Estonia	22
Netherlands	28
Austria	30
Portugal	31
Slovenia	33
Belgium	36
France	38
Slovak Republic	49
Spain	52
Italy	65
Greece	72

Source: World Bank (2014).

4 CONCLUSION

The EMS crisis in 1992-93 was the result of a number of failures that unfortunately were imported into EMU and led to the crisis in 2011-12. Faced with what President Van Rompuy described in November 2011 as an “existential crisis [that] we mean to overcome”, the euro area was able to take significant steps to correct EMU’s failures, including the establishment of important elements of a banking union.

Yet we are still far from a Genuine Economic and Monetary Union, or even a genuine banking union. At the same time, the euro area remains deeply divided between its core and its periphery not only in terms of unemployment rates (which currently range from about 5% in Austria and Germany to more than 25% in Greece and Spain) and in terms of public and private debt levels, but also in terms of structural conditions, in particular the functioning of product and labour markets.

Without greater efforts to bridge both macroeconomic and structural divides in the euro area, it will be difficult for its member countries to reach a common vision of the long-term future of EMU. Equally, without a shared vision of what constitutes a “genuine EMU” in the long term, it will be difficult to take the short and medium-term measures required to mend the scars brought by the crisis and to make the structural reforms that are necessary, not only to ensure the better functioning of EMU, but above all to ensure that EMU delivers higher growth and more jobs. Resolving this conundrum requires replacing the old “single currency” logic of EMU with a new one – that of a “common currency”.

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II THE CONTRIBUTIONS OF THE EMI IN THE LIGHT OF THE PRESENT CRISIS

FROM THE MAASTRICHT TREATY TO THE EURO: THE ROLE OF THE EMI

ROBERT RAYMOND

It is a very nice idea to recall today what the architects of the euro had in mind and to remember the existence of this temporary and transitory institution called the European Monetary Institute, something that most people have never heard about or have forgotten. It may also be useful, when the ECB is at the forefront of people's consciousness, to be aware of why and how it was built up this way. In recent years, the ECB has indeed made an essential contribution not only to price stability, but also to financial stability. This has led some observers to reconsider the appropriateness of its status, or to wonder how it was possible for this institution, with a reputation for being conventional, to take up decisively the challenges raised by an unpredictable situation.

I FOUNDATIONS

The ECB and the euro did not just come out of the blue. At la Ferme de Dorigny, on the campus of the University of Lausanne, where the Jean Monnet archives are stored, you can read a manuscript page drafted by Jean Monnet in 1958 about the steps to be contemplated after the ratification of the Rome Treaty. He quoted not only the single market but also the single currency. In 1962, Robert Marjolin wrote in a memorandum that the common market, would it be successful, would at some stage require its own currency. You all know how it happened through a series of milestones, such as the Werner Report, the Single Act and the Delors Committee, leading to the Maastricht Treaty.

In the meantime central banks had to adapt themselves to many changes, which those among us who started early enough in the central banking business had in mind at the beginnings of the EMI. First, the oil shocks made productivity gains more difficult to achieve and inflationary threats more severe in most European countries. Second, the collapse of the Bretton Woods System led to floating exchange rates. Therefore it became difficult to maintain stable rates within the European Monetary System. Third, the constraints placed by the foreign exchange control on the real economy, and its progressive loss of efficiency, led to the deregulation of international financial operations. Capital movements entailed an unprecedented volatility of exchange rates in general, with specific tensions within the European Community. Arbitrages between the dollar and the Deutsche Mark, added to national imbalances, triggered huge and unstable distortions, in countries other than Germany, between the effective exchange rate, the equilibrium exchange rate, to the extent it is possible to identify such a rate, and the purchasing power parity. Given the size of the intra-zone exchanges, these countries had no better choice than becoming good followers of the Deutsche Mark instead of pursuing independent monetary policies.

The crisis of 1992 and 1993 undoubtedly created a fatigue in a number of countries, some of which were obliged to devalue and others which fought to prevent the same happening to them.

What better solution to avoid exchange rate crisis than to have a single currency? What else was there to do in order to fight home-made or imported inflation than to adopt the German culture of stability?

Other benefits could be expected. The size of the European Union would make it a large economy, less open than any national one, with very considerable intra-zone trade, and therefore an economy better sheltered from the impact of the volatility of the dollar. The intra-zone trade would not require any costly hedging. The single market with a single currency would promote fair competition.

That was the intellectual environment when the EMI started. At the same time, on institutional grounds, the Treaty provided for a Stage One on the road to the single currency. It consisted of the reinforcement of the Secretariat of the Committee of Governors, which was in fact to become more than a secretariat: a true team, including a group of economists, as well as other experts in various fields, managed by Gunter Baer.

Then the Committee, which had previously established two working parties, on monetary policy and foreign exchange, set up several sub-committees, which included members of the Secretariat and representatives of national central banks. The Governors mandated the sub-committee in charge of monetary policy matters with a review of all the strategic and implementation issues related to the monetary union. When the EMI started, there was already a strong base on which to build a new institution and design a relevant strategy.

2 THE BIRTH OF THE EMI

From the beginning, the Treaty provided a framework setting both the duties and the limits of our action. That was included in the mandate of the institution, headed by a Council, composed of the Governors of the central banks of the member countries, and a President, appointed by the Heads of State or Government.

The Treaty also provided a deadline for the introduction of the single currency: 1st January 1999. The European Council decided in December 1995 that this day would indeed be D-day, with no earlier date being practicable given the diversity of the problems to solve. Legally, the EMI disappeared as a legal entity at the end of May 1998, and was replaced by the ECB.

The EMI was financed by the return on its capital, was hosted first by the BIS in Basel and then rented the top of the Eurotower in Frankfurt. It started with the staff of the Secretariat of the Committee of Governors and recruited slowly but continuously, with up to 550 people on 1 June 1998, and with 200 more having already been recruited to join the ECB after the summer break.

3 THE CHALLENGES AHEAD

It was clear from the beginning that the EMI would be faced with many challenges.

Quite understandably, the first question put on the table was: is Europe, or part of it, an optimal currency area? A positive answer to this question was officially obvious and enshrined in the Maastricht Treaty, provided that the convergence criteria were met. Yet, some scepticism was expressed by a significant part of the academic community, which added to nationalistic political reactions created by what could be called an opposition party. In my country, for instance, the Maastricht Treaty was ratified with a tiny majority. It was noted that the convergence criteria were restricted to nominal monetary and financial variables, but did not address the structural differences among countries seeming to converge with respect to the formal criteria. It was underlined that some elements of an optimal currency area were missing, in particular the mobility of manpower between participating countries, due to differences of language and culture and to the stickiness of social benefits. It was also clear that the transmission mechanism of monetary policy would differ from country to country, so that the single monetary policy would have a slightly different impact on the national economies and that external shocks would have asymmetrical effects. The counterargument put forward by those who supported the monetary union was that, at a time of globalisation, the differences among a core, at least, of European countries were less important than the similarities and would vanish over time. In the same vein, the assessment on the degree of convergence required, when the Heads of State or Government had to make the final decision, would be based on the trend of some of the variables towards the objective rather than on the achievements, in particular relating to the debt ratio.

As the monetary union was a political project, this semi-philosophical issue could be left aside, and the Member States were cooperative in considering the main progress to be made. Nevertheless the project was the first true federal move, including a transfer of sovereignty and the creation of the first new European institution since the Treaty of Rome. Constitutional adjustments were needed, for instance to make the national central banks independent in their own countries, as well as the ECB, in accordance with the Treaty. It was a sensitive issue. It should not have been a surprise, therefore, to notice the reluctance of the member countries and their central bank to reduce their autonomy and a desire to limit as far as possible the scope of the “communitisation” of related functions or systems. The fashionable word at that time was “subsidiarity”, which was used to explain that what can be done properly at the local level should not shift to the centre. It is not often mentioned any more, as far as I know as a simple citizen. However, it would frequently be raised in our debates about how to organise the burden sharing, the practical tasks and the operational competences between the ECB and the national central banks.

Indeed the single central bank could not be anything else than a hub and spoke system. One central bank meant one decision centre, the Governing Council of the ECB in Frankfurt, while independent states applied different legislative

rules and used different institutional frameworks to implement the instruments of the single monetary policy. So, the national central banks had to be in charge of the interface between the ECB and their banking and financial community. Together with the ECB, they would constitute the Eurosystem, one single entity, all the more so as they were the European Central Bank's shareholders and their Governor was part of the Governing Council. During the preparatory work, the EMI staff, keeping in mind the model of a central bank in accordance with the textbooks, had a natural tendency to centralise, on the grounds that it was more rational, safer and less costly to master a chain of operations than to disperse it, whereas national central banks preferred to keep as much at home as possible while just reporting back to the centre. This kind of negotiation was kept technical, did not prevent friendly relations from being established and the project being completed smoothly. It was sometimes made tricky by the high cost of several undertakings, such as banknotes and payment systems.

Another challenge had to do with public opinion across the European Union. In some countries, for instance in the Benelux countries, the majority was clearly in favour of the single currency. In others, it was negative, such as in the United Kingdom. In many, opinion was divided, sometimes even within a political party, with pros and cons and a lot of "don't knows". There was often an understandable attachment, due to history, to the old domestic currency as a national symbol.

Right from the start, the diversity and to some extent the volatility of public opinion in Europe drew attention to the issue of public accountability. Not only would the ECB be independent, but it would also be so vis-à-vis not one government, but many. This applied to the EMI as well. How to ensure public accountability within each country became a popular topic, although in principle the Treaty had actually provided for it. The President would have to go to the European Parliament for occasional hearings. His communication policy, both for speaking in his own name and on behalf of the Council, was of paramount importance from the beginning. Alexandre Lamfalussy had to convince all leaders, citizens and institutions that the monetary union was the best thing to do and that it was the right time to do it, and Wim Duisenberg was keen to secure the independence of the future ECB and right from the start. The question of hearings at the level of national Parliaments was raised, too, but discarded, at least at the time, so as to avoid interfering with negotiations among governments on the one hand, and central banks on the other hand, on how to build up the ECB.

Real apprehension was felt about whether households would accept the banknote changeover. You all know that the launch of the new euro banknotes and the withdrawal of those denominated in national currencies were postponed and finally went ahead three years after the introduction of the euro as the single legal currency for contracts, accounting and markets. In the meantime, national notes and coins would just be subdivisions of the euro. In the end, it was completed without major difficulties, although in many countries the idea that shopkeepers put up their prices on this occasion persisted in the memory of many.

Last, but not least, the banking industry, although it had globally a positive reaction, was faced with a serious challenge. Banks were willing to be ready in

time but had to bear heavy costs for doing so without knowing if their country would be selected or not. Business circles were rather welcoming, but afraid of the costs involved in the launch of the euro.

In fact, there was a need to create a strong expectation that the euro would indeed see the light of day, and this need was met. Major efforts were made in most of the member countries to improve convergence and price stability, markets were convinced and this led to the spontaneous stabilisation of exchange rates.

4 HOW WE WERE ABLE TO MOVE FORWARD

The main concern, at the level of the Governing Council and for the various teams in charge of the main projects, was to make sure that everything that was needed would be completed in time. Internally, the EMI Council adopted a master plan as early as autumn 1994, including a timetable for all the main decisions to be made by the Governing Council in order to meet the deadline. This document implied that these decisions would come out in the right order and would be coordinated, so as to ensure the correct sequence of tasks. It proved to be a remarkable piece of logistics, which was able to guide the various departments in providing their output exactly when necessary, and helped national central banks to adapt their own systems.

The structure put in place for finding solutions and for the decision-making process was very efficient. Under the chairmanship of the EMI President, the Council had the responsibility of steering of the whole exercise. The EMI staff would provide the background papers, including the analysis of each task and proposing a solution. This input was discussed in specialised committees, for instance on monetary policy, foreign exchange, legal issues, banknotes and each of the support functions. These committees were made up of representatives of the national central banks, which would bring their own input and requests, and of EMI experts. The synthesis between the reports from these various bodies lay in the hands of the Committee of Alternates, comprised of the alternates of all the Governors and chaired by the EMI Director General. Most conflicts could in fact be solved at this level during a session dedicated to the preparation of the Governing Council's meetings. Only the most fundamental choices would be left to the Governors themselves, who could have an informal mediation session before the meeting itself. This smooth process worked rather well.

Finally, “il n'est de richesse que d'hommes”, the true wealth lies in the quality of mankind. We were able to select top-quality staff from among a large number of applicants. We benefited from close cooperation among central banks. Technical relations between the EMI staff and the European Commission were excellent and fruitful. There was visible momentum at the political level. This momentum, which did not persist afterwards, created a virtuous circle leading to an effective anti-inflationary policy in member countries, to falling and converging interest rates, and to appropriate efforts to comply with the fiscal criteria, being understood that, for the debt ratio, a clear trend towards the threshold of 60% was sufficient. A strict compliance with the debt ratio would have eliminated several

countries that were in fact selected to participate. Everywhere, national pride was at stake. The wording of the Treaty allowed this flexibility.

When the button was pushed on Monday 4 January 1999, the Eurosystem made a good start.

5 WHAT WAS NOT DIRECTLY ON THE EMI'S AGENDA?

Some issues which are familiar to central bankers and do matter for price and exchange rate stability were not directly on the agenda of the EMI, or rather I should say: could not be included in its competence.

The future policy mix, important as it may be, could not be defined in advance. In a given country, the policy mix is the outcome of fiscal and monetary policy which are each run by one institution: one State, encompassing its executive and legislative powers, and the central bank. The first acts by discretionary decisions, and the second has to react, within the limits of its independence. The central bank has a reaction function. The European monetary union was to create a reverse distribution of responsibility: the single independent central bank applies the monetary policy stance appropriate for the global situation in the euro area, seen as one country. But this does not necessarily induce the optimal policy mix in each of the participating countries. It is therefore all the more important for each participating State to adjust its fiscal policy to the single monetary policy. So it is the State which should have a reaction function, describing how it adjusts fiscal policy to the global situation of the euro area, as assessed by the central bank. Obviously, any such conversion is not self-evident at national level. We know from experience that it did not really work. True, the Stability and Growth Pact provided some discipline by curbing the excessive annual budget deficit and the sovereign debt, but it was not effectively applied. The Broad Economic Policy Guidelines issued by the Commission were supposed to be an important tool for economic policy coordination, to help participating countries deal with the differences between the cyclical patterns in the various countries.

Financial stability was another side subject. The ECB was not directly responsible for bank regulation and supervision, having only a consultative role. A specific committee was set up to advise the Governing Council. There is no need today to comment. Everybody is aware of the recent developments in this field. No mention was made of a potential role for the ECB as a lender of last resort, a question that had often been raised by academics at the time.

Finally, the ECB was not supposed to adopt an exchange rate target. The exchange rate (mainly with the dollar) would just be one piece of information among others bearing on the price level, and therefore would be included in all the various data used by the ECB to design its policy. Interventions and fine-tuning would of course be technically possible, but should in principle be avoided. Exchange rate analysis would obviously matter, but would be part of the global economic analysis.

6 WAS THERE AN EMI LEGACY?

The outcome of the transition from national currencies to the framework under the Maastricht Treaty was an engine supposed to work perfectly in the absence of a systemic crisis.

It was assumed that the monetary union would be successful. The single currency was seen as a major step towards more convergence and closer integration, and the appropriate efforts would simply continue. The virtuous circle would go on. This would prevent any systemic crisis. Unfortunately, that is not quite what happened. In fact, it was mainly the banking and sovereign debt crisis which revived the integration process.

On more practical grounds, the EMI had several projects in mind to prolong its action. On the subject of post-trading operations on financial markets, the Committee on Payment Systems, chaired by Mr Hartmann, Member of the Board of the Deutsche Bundesbank, arranged two meetings, in 1997 and 1998, for representatives from the various national and international central depositories and clearing agencies, to invite them to harmonise their interfaces and to coordinate their operations within some kind of European network. A flavour of this orientation, which was not really taken on board later on, can be found today in TARGET2-Securities and in the concept of a single counterparty. On a different subject, setting up a single bank supervision system remained at the back of many people's minds. I remember a letter sent to Mr Giscard d'Estaing, in his capacity as Chairman of the Convention for the Constitutional Treaty, in connection with the newly created Eurofi and under the umbrella of a club of bankers in Paris, to suggest the insertion of an enabling clause in the Treaty about such a scheme, but this could not be sold politically. In the end, the Eurofi President, Mr de Larosière, managed to push the idea forward.

In every domain we see that efforts to better converge, harmonise and integrate are indeed in progress today, but the difference now is that this is being done under the pressure of the crisis, having failed to be done before.

THE QUEST FOR SUSTAINABLE CONVERGENCE IN EMU: THE EMI'S CONVERGENCE ASSESSMENTS

FRANK MOSS¹

I INTRODUCTION: THE ROLE OF THE EMI IN THE CONVERGENCE PROCESS IN STAGE TWO OF EMU

On 11 December 1993 the governments of the EU Member States at the level of their Heads of State or Government decided to appoint Baron Alexandre Lamfalussy as President of the European Monetary Institute (EMI) for an initial period of three years.² On 1 January 1994, soon after the conclusion of the ratification process in October 1993 by all EU Member States of the Treaty on European Union, which had been signed at Maastricht on 7 February 1992, the EMI was formally established.

In essence, its key tasks can be described as being geared towards achieving two objectives: first, to organise a series of central bank cooperation activities, and notably to strengthen monetary policy coordination, during Stage Two of Economic and Monetary Union (EMU) (see Article 109f (2) TEC)³; and second, to prepare for a single monetary policy, to be conducted by the European Central Bank (ECB) as from the start of Stage Three of EMU (Article 109f (3) TEC). Somehow bridging these two objectives was the requirement for the EMI to annually report on the state of preparations for Stage Three of EMU, which was expected to comprise both an assessment of the progress towards monetary and economic convergence in the Member States of the EU and a presentation of the progress towards the adaptation of legislation, instruments and procedures necessary for the conduct of a single monetary policy in Stage Three.

The Maastricht Treaty additionally conferred upon the EMI – alongside the European Commission – the task of reporting on the progress being made in

- 1 The author would like to thank E. Dorrucchi, S. Huemer, I. Maes, W. Schill and F. Smets for their comments and suggestions.
- 2 On 13 December 1996 the Heads of State or Government reappointed Mr A. Lamfalussy for a further six months and appointed as his successor Mr W.F. Duisenberg.
- 3 Treaty article numbers refer to the original numbering in the Treaty establishing the European Community (TEC) as amended by the Treaty on European Union (TEU), better known as the Maastricht Treaty. Following the entry into force of the Treaty of Amsterdam, a new sequential numbering of Treaty articles was introduced so that Articles 109f (2) and 109f (3) became Articles 117(2) and 117(3) respectively. Following the entry into force of the Treaty of Lisbon, the TEC was partially folded into the Treaty on the Functioning of the European Union (TFEU) and the former Article 117(2) TEC became part of Article 141 TFEU. All references to the EMI were dropped from the TFEU as the EMI was superseded by the ECB in accordance with Article 109I (2)/Article 123 (2).

respect of the fulfilment by the Member States of their obligations regarding the achievement of EMU (Article 109j (1) TEU).⁴

The purpose of this paper is very specific: it attempts to examine how the EMI has exploited the analytical margin of manoeuvre between legal requirements and economic rationale to assess notably the concept of “a high degree of sustainable convergence”. It does not purport to cover the overall assessment by the EMI of the state of convergence, including legal convergence, in the EU, nor is it envisaged to dwell on the broader role assigned to the EMI of preparing for Stage Three of EMU, inter alia by fostering monetary policy coordination and convergence.⁵ Hence, it will only address the economic part of the various convergence assessments, which the EMI has undertaken during Stage Two of EMU.

Section 2 hereafter offers a reminder of the legal requirements. Section 3 looks at the various elements of the EMI’s assessment of sustainable convergence and how they have evolved through its three key publications on convergence, also in comparison with the Commission’s assessments. Section 4 evaluates the legacy of the EMI’s assessment, against the background of subsequent developments. Section 5 presents some conclusions.

2 THE TREATY’S DEFINITION OF THE REQUIRED DEGREE OF ECONOMIC CONVERGENCE

Article 109j (1) was very prescriptive on what the Council was expecting to find in the EMI and European Commission convergence reports. It stipulated that these “reports shall include an examination of the compatibility between each Member State’s national legislation including the statutes of its national central banks, and Articles 108 and 109 of this Treaty and the Statute of the ESCB. The reports shall also examine the achievement of a high degree of sustainable convergence by reference to the fulfilment by each Member State of the following criteria:

- the achievement of a high degree of price stability: this will be apparent from a rate of inflation which is close to that of, at most, the three best performing Member States in terms of price stability;
- the sustainability of the government financial position; this will be apparent from having achieved a government budgetary position without a deficit that is excessive as determined in accordance with Article 104(6);
- the observance of the normal fluctuation margins provided for by the exchange rate mechanism of the European Monetary System, for at least two years, without devaluing against the currency of any other Member State;

4 Subsequently Article 121 (1) TEC and Article 140 (1) TFEU.

5 On this latter aspect, see Scheller (2014).

- the durability of convergence achieved by the Member State and of its participation in the exchange-rate mechanism of the European Monetary System being reflected in the long-term interest rate levels.”

The four criteria mentioned and the relevant periods over which they were to be respected were developed further in a dedicated Protocol (No 6) on the convergence criteria, annexed to the Treaty. A separate Protocol (No 5) contained additional details on the excessive deficit procedure.⁶ Given that these Protocols have the same legal value as the Treaty itself, the degree of prescription imposed on the EMI, and on the European Commission for that matter, was very high. Moreover, Article 109j (1) went on to stipulate that the reports of the European Commission and the EMI should also “take account of the development of the ECU, the results of the integration of markets, the situation and development of the balance of payments on current account and an examination of the development of unit labour costs and other price indices.”

The reason for this prescriptive approach as to how convergence should be assessed and why it was preferred to include precise language in the Treaty and related Protocol is described in Bini Smaghi, Padoa-Schioppa and Papadia (1994).⁷ Given that the Treaty was a contract between Member States, it needed to be legally specific to be enforceable. Lack of precision in defining the criteria for assessing convergence would have entailed the risk of future disputes on the meaning of the term “convergence”, possibly jeopardising the enforceability of the contract embodied in the Treaty. At the same time, the contractual nature of the engagement, as laid down in the Treaty, implied that any departure from the agreed framework for the assessment of convergence would require unanimity among all Treaty signatories.

The authors also explain why ultimately a political consensus was reached on four key criteria with other criteria being relegated to the background. Still, in order to achieve this political compromise, it was eventually also necessary to depart from a fully mechanical application of the criteria. This was done in both a general and a specific manner. In general terms, the wording that the EU Council, “on the basis of” the EMI and European Commission reports, would assess for each Member State to determine whether it fulfilled the necessary conditions to adopt the single currency implied a certain amount of room for political judgement. Indeed, the ultimate decision on whether a country fulfilled the convergence assessment and hence was deemed ready to join the euro area, remained a political one, involving a discussion in the European Council as well as a decision by the EU Council, based on a proposal from the European Commission.⁸ In more specific terms, some space for economic interpretation

6 Both Protocols are also annexed to the consolidated version of the Lisbon Treaty (TFEU), respectively as Protocol No 14 and No 13.

7 Bini Smaghi, Padoa-Schioppa and Papadia (1994), pp. 21-31.

8 The decision on the initial group of countries entering the euro area was taken at the level of the Council, meeting in the composition of the Heads of State or Government.

remained in each of the convergence criteria⁹: the reference to the “at most three” best performing Member States in terms of price stability and long-term interest rate levels remained to be clarified; the excessive deficit procedure for the determination of a sustainable government financial position provided for judgemental elements to be exercised by the European Commission in its assessment (the EMI/ECB had no formal role in the excessive deficit procedure); and the required observance of the “normal” fluctuation margins in the exchange rate mechanism left undefined what the “new normal” was after the (initially temporary) widening of the fluctuation bands in the European Monetary System to +/-15%.¹⁰ The largest scope for economic interpretation undoubtedly existed in trying to assess the “achievement of a high degree of sustainable convergence by reference to” fulfilment of the four specified convergence criteria.

In contrast with the European Commission, the EMI was not obliged to deliver a recommendation as to whether a particular Member State was ready to adopt the single currency. Therefore, at least in principle, it had more intellectual leeway for assessing in depth the state of convergence in the EU, allowing it to draw more explicit attention to the risks attached to the sustainability of the observed indicators of convergence and thus delivering a tone that was not too lenient or too soft. As Alexandre Lamfalussy himself had indicated, the main instruments at the disposal of the EMI were, in practice, analysis and persuasion.¹¹ At the same time, however, the EMI was bound by the same legal provisions laid down in the Treaty and the Protocol as was the European Commission in its evaluation of the state of convergence.¹² Beyond the legal argument, it also made good economic sense not to over-interpret the convergence criteria. For one, there had been a lot of criticism in academic circles regarding the usefulness of, in particular, the fiscal criteria in assessing the readiness of an EU country to join a monetary union.¹³ In addition, responding to some of these criticisms by conducting the convergence assessment in a particular way could run the risk either of being perceived as straying too far from the legal assignment given or of failing to ensure equal treatment across countries in a time-consistent manner.¹⁴

- 9 Thygesen (1998) considers that two of the criteria, namely the ones on inflation and long-term interest rates, are free of ambiguity as they do not allow for any discretion at the political level.
- 10 On 7 October 1994 the EMI Council delivered an opinion in which it considered it advisable in the light of the experience made and the then prevailing circumstances to maintain the widened ERM fluctuation bands, which had been jointly decided on 2 August 1993 by the Ministers of Finance and Central Bank Governors of the EU. For a good overview of the exchange rate turbulences in the EMS leading to the widening of the fluctuation bands, see James (2012) pp. 324-381.
- 11 See Lamfalussy (1995).
- 12 Pursuant to Article 19 of the Statute of the EMI (see Protocol No 19 of TEU), it would have been possible for EU citizens to question the legality of the interpretation of the Treaty and Protocol provisions on the convergence indicators by calling upon the European Court of Justice to provide its interpretation.
- 13 See for instance Bean (1992) doubting the usefulness of fiscal rules in the monetary union, Buitter (2006) revisiting his 1993 paper on the sense and nonsense of Maastricht, or De Grauwe (1992) pp. 170-177 on the debate on rules versus discretion in handling budget deficits in a monetary union.
- 14 On the latter point, see also section 4.2 concerning the discussion on the relevance of, and interpretation to be given to, the convergence criteria following the EU enlargement with the transition economies of central and eastern Europe.

Table 1 Overview of the EMI's convergence assessments			
Type of report	Legal basis	Time of publication	Number of pages
1994 Annual Report	Art. 7 + 11 EMI Statute	April 1995	45
Ad Hoc Report on Progress towards Convergence	Art. 7 EMI Statute	November 1995	136
1995 Annual Report	Art. 11 EMI Statute	April 1996	33
Progress towards Convergence	Art. 109 j (1) TEU	November 1996	142
1996 Annual Report	Art. 11 EMI Statute	April 1997	33
1997 Update on Legal Convergence	Art. 7 EMI Statute	October 1997	61
Convergence Report	Art. 109 j (1) TEU	March 1998	360
1997 Annual Report	Art. 11 EMI Statute	May 1998	28

During its life span of slightly less than four-and-a-half years, the EMI produced a number of reports in which the state of convergence was assessed. Table 1 above presents an overview and points to the different legal bases that were at the origin of the various reports.

3 THE EMI'S ASSESSMENT OF SUSTAINABLE CONVERGENCE

3.1 GENERAL OBSERVATIONS

“In the economic field a wide range of decisions would remain the preserve of national and regional authorities. However, given the potential impact on the overall domestic and external economic situation of the Community and their implications for the conduct of a common monetary policy, such decisions would have to be placed within an agreed macroeconomic framework and be subject to binding procedures and rules. This would ... avoid unsustainable differences between national member countries in public sector borrowing requirements and place binding constraints on the size and financing of budget deficits (...). The Committee is fully aware that the process of achieving monetary union is only conceivable if a high degree of economic convergence is attained.”¹⁵

The above excerpt from the Delors Committee report makes it clear that the community of EU central bank governors, who were all members of this Committee, together with a few external experts including Alexandre Lamfalussy, was acutely aware of the need for achieving sustainable convergence in order for the EMU process to be durable. It was by no means a coincidence therefore that in Art. 109j (1) TEU the words “sustainable”, “sustainability” and “durability” were all used in qualifying the required degree of convergence which the EMI and the European Commission were expected to assess.

Neither should it therefore come as a surprise that the first dedicated EMI assessment on the state of convergence, which because of statutory reasons

15 See Report on Economic and Monetary Union in the European Community (1989), paragraph 19, p. 18.

preceded the one by the European Commission,¹⁶ made it very explicit that sustainability implies that the achievements made in terms of convergence should not only hold at a specific point in time, but should also be durable in order to serve a sustainable EMU.¹⁷ Likewise, in the EMI's first convergence assessment produced in accordance with Art. 109j (1) TEU, the issue of sustainability was raised at the outset, in contrast to how it was presented in the European Commission report.¹⁸ As a matter of fact, on 7 November 1995 Alexandre Lamfalussy reportedly summed up the "tour de table" discussion in the EMI Council on the subject of the EMI's first Convergence Report by stating that almost everyone in the room had made the point that the sustainability of positions regarding inflation and public finances needed to be emphasised. He would see to it that this would be naturally introduced in the main body of the report as well as in its executive summary so that it would really hit the reader right at the beginning and provide a very good basis for the remainder of the text.

One year later Alexandre Lamfalussy referred to the definition typically given in dictionaries of sustainability as being "the ability to maintain or keep an effort going continuously".¹⁹ The question to be asked therefore was, in his words, whether there were reasons to believe that a satisfactory performance is maintained only due to special circumstances, with the "headline" performance obscuring the underlying situation. In particular as regards the fiscal situation, he had doubts and argued that a sustained strategy of fiscal consolidation across most Member States would be warranted, not only in the immediate future but also well beyond the start of Stage Three. He therefore underscored the need for a strong and credible Stability Pact,²⁰ but also highlighted the need to have a careful selection of the initial batch of countries that would be deemed ready to adopt the euro. This would in his view impose on the Heads of State or Government the need to stick to both the spirit and the letter of the Treaty, granting deviations from the deficit and debt reference values sparingly, carefully assessing whether the fiscal numbers for 1997, which were to form the basis of the decision in the spring of 1998, were sustainable and, in case of doubt, to lean towards caution.

Similar echoes can be found in the convergence assessments which De Nederlandsche Bank and the Deutsche Bundesbank produced in the spring of 1998 for their respective national parliaments in view of the May 1998 European Council decision on the selection of the countries joining the euro area from the start. The Dutch central bank very much stressed the importance of the Stability and Growth Pact (SGP) with its stability programmes aimed at reaching the

16 As a matter of fact, the European Commission wanted to have some parallels with the EMI's assessment, not just for the reports to be produced in accordance with Art. 109j (1) TEU. It therefore decided to produce an annual report on the convergence in the European Union as from the first year after the start of Stage Two of EMU. The reports produced for the years 1994 and 1995 were published in January of the subsequent year. Prior to the start of Stage Two, the Commission had been obliged, pursuant to Article 109e (2)b TEU, to produce a one-off report on progress with regard to economic and monetary convergence and with the implementation of Community law concerning the internal market.

17 See EMI (1995) p. 3, as well as the first pages of the executive summary (p. VIII).

18 See EMI (1996b) p. 7 as opposed to European Commission (1996).

19 See Lamfalussy (1996).

20 It was only afterwards that the term Stability and Growth Pact came to be used.

medium-term budgetary objective of close to balance or in surplus as a key guarantee for sustainable convergence and a durable monetary union, next to fulfilling the convergence criteria.²¹ The German central bank, along the same lines, underlined that durability required looking not only at point-in-time results, but also into past and future perspectives. In the fiscal domain, a lot hinged on a credible implementation of the SGP, given that the fiscal convergence criteria had only been met rather recently. Moreover, the public debt criterion needed to be given due attention.²² The following quote (p. 22) is revealing: “The greater the shortcoming in meeting the criteria and the less they can be regarded as safeguarded on an enduring basis, the greater are the risks for economic growth and employment in the monetary union and the less the expectations that are placed on monetary union can be fulfilled. The economic fundamentals must be right upon entry into monetary union and be sustainable on a permanent basis.”

In what follows, it will be shown how the concept of sustainability was assessed for each of the four main convergence criteria in the various EMI assessment reports. Also, the role of the “other factors” in the assessment of sustainable convergence will be highlighted. Reference will be made to the treatment applied to the concept of sustainability in the successive European Commission convergence reports. As a non-negligible footnote, it can be added that in all of its Annual Reports, the EMI stressed that policies aimed at achieving compliance with the convergence criteria were not just beneficial for joining monetary union, but were cornerstones of sound economic management per se, irrespective of the EMU process.

The EMI made it clear from the outset that it would assess the state of convergence and its sustainability in full independence, but it would do so in a fully accountable manner by stressing in advance that it would apply the following four guiding principles: (1) the individual convergence criteria would be interpreted and applied in a strict and rigorous manner; (2) they would be regarded as a coherent and integrated package that would all have to be satisfied on an equal footing; (3) they would have to be met on the basis of current data which would therefore also need to be as harmonised as possible; and (4) compliance with the criteria would be assessed in a consistent, transparent and simple manner.²³ Full independence, of course, should not be equated with strict autonomy in the assessment methodology applied. On many technical aspects, the EMI staff collaborated closely with European Commission staff, in particular so as to avoid confusion arising from the use of different indicators at the level of the political addressees of the EMI and European Commission convergence reports.²⁴ This also entailed close cooperation in the construction of cross-country comparable or harmonised statistics. Yet, in the language chosen to summarise its assessments, the EMI clearly stood out with wordings, including for individual countries, that did not paper over potential problems of sustainability.

21 See De Nederlandsche Bank (1998), p. 32.

22 See Deutsche Bundesbank (1998), p. 17.

23 These four guiding principles have been taken over by the ECB and have continued to apply ever since, see for example the 2013 ECB Convergence Report on Latvia, p. 7.

24 See also Raymond (2014), p. 5.

Needless to say, the drafting sessions of each EMI convergence report, in which all EU central banks participated, were at times lengthy. The eventual outcome, however, was therefore always a product that genuinely reflected the collective wisdom of the EU central banking community at the time.

3.2 ASSESSMENT OF THE SUSTAINABILITY OF PRICE DEVELOPMENTS

Already in its very first preliminary assessment of convergence, contained in its 1994 Annual Report, the EMI had pointed out that price stability needed to be maintained over the long term. Moreover, it had observed that inflation rates of 2% or less are levels that are generally regarded as price stability.²⁵ As mentioned previously, however, the EMI intended to rigorously stick to the legal provisions of the Treaty. Still, this left some marginal room for interpretation as the legal text was not unequivocally clear on a few elements.

One such element was the statistical way of determining “the average rate of inflation observed over a period of one year”, where the European Commission and the EMI agreed to use a definition that would minimise the volatility impact of exceptional factors.²⁶ A “high degree” of price stability as mentioned in the Treaty also needed to take due account of special circumstances that might influence a particular annual inflation outcome. Three considerations were already being highlighted by the EMI in its 1995 convergence assessment. First, the role played by temporary factors that could lead to one-off changes. Indirect tax changes were explicitly referred to in this context. Second, the possibility of falling prices on account of a debt deflation environment, which it characterised by a high rate of bankruptcies, a banking crisis, a sharp contraction of money and credit and rapidly declining property prices. Third, the macroeconomic environment whereby the inflation performance achieved during a recession should be deemed unlikely to be sustainable over the course of the economic cycle. These various considerations could lead to a situation in which a very low inflation performance of a particular country had to be considered as an “outlier” result in the group of the “at most three best performing” countries in terms of price stability. As a corollary, it could reasonably be assumed that such an outlier result would not be sustainable. Yet the EMI was careful not to circumscribe the concept of an “outlier” too precisely *ex ante*, in order not to get pinned down on overly tight definitions ahead of

25 See EMI (1995), p. 50.

26 Hence, it was deemed preferable not to use the more easily understandable approach of using the year-on-year change of the monthly inflation rate, because this carried a risk of base effects distorting the underlying picture. Moreover, looking at the average change in the last twelve months over the preceding twelve months was felt to be more compliant with the legal provision of looking at the price performance observed over a period of one year before the examination.

time, thereby allowing for full consistency in its assessment over time.²⁷ This prudent stance applied more generally to its assessment of the sustainability of price developments: “Given that sustainability of price developments cannot be captured in simple models, a consistent and transparent assessment of compliance with the criterion of sustainable price convergence cannot be done *ex ante*, but has to be done at the time when the assessment is to be made.” The successive EMI convergence assessments therefore paid increasing attention to (1) past trends of inflation, (2) underlying factors affecting inflation, and (3) long-term policy drivers of inflation.

To better gauge inflation developments across the business cycle, the EMI reports generally produced longer backward-looking time series of inflation outcomes than the European Commission did. While the European Commission stressed that longer backward time series were not available on a harmonised basis²⁸ and could hence not be used for a cross-country comparison, the EMI preferred to look at longer back-dated inflation series to better assess the relative importance of temporary versus underlying drivers at the individual country level. More specifically, the EMI convergence assessments looked at past inflation records for each country covering 6 years in its 1995 and 1996 assessments (starting in 1990 and 1991 respectively) and covering 8 years (1990-1997) in its 1998 assessment.

In addition the EMI reports highlighted – also in statistical terms – a number of underlying factors affecting inflation outcomes. Notably, the role of commodity prices and exchange rate changes affecting import prices and consequently consumer prices more generally was underscored, the impact of international and domestic demand trends affecting production and capacity utilisation, as well as autonomous cost pressures particularly influencing unit labour costs and profit margins, and the statistical impact on the CPI of indirect tax increases.

27 Eventually, the concept of “outlier” became relevant only in the convergence assessments after the start of Stage Three. The ECB took on the same prudent, non-mechanical approach as the EMI. In practice, for a country to be identified as “outlier” two conditions need to be fulfilled. First, a statistical condition: the country’s 12-month average inflation rate has to be significantly below the comparable rate in other EU Member States. Second, an economic condition: price developments must be affected by exceptional factors. In the assessment of these conditions, no numerical threshold applies, rather sound analysis is performed on a case-by-case basis. Hence, it considered the 12-month average inflation rate of Lithuania in its 2004 Convergence Report to be an “outlier”, not because it had registered a negative inflation rate, but because of “an accumulation of specific factors”. Similarly in 2010 and 2013, the Irish and Greek inflation rates, respectively, were considered “outlier” results since these countries’ rates had been significantly lower than those of other EU countries “on account of exceptional, country-specific factors”, relating essentially to the impact of the adjustment process in the wake of the 2009-2010 crisis.

28 It is worth remembering that the 1996 convergence assessments by the EMI and the EC made use of Interim Indices of Consumer Prices (IICPs) and only the 1998 convergence assessment had recourse to Harmonised Indices of Consumer Prices (HICPs). For more details on the IICPs see EMI (1996a) Box 5; for details on the HICPs see European Commission (1998), pp. 74-76.

The same factors were also analysed in the successive European Commission reports on convergence. However, up until 1998, the European Commission seemed to prefer keeping their treatment confined to the chapter analysing “other factors”, namely the development of unit labour costs and other price indices. The earlier EMI convergence assessments were much more inclined to use these “other factors” as complementary checks for the sustainability of the inflation performance, being for example more explicit about the risks of rigidities in labour markets reflecting negatively not only on potential upward wage pressures and hence unit labour costs, but also on the potential scope for sustaining a low inflation environment. The European Commission’s 1998 convergence assessment appears inspired by this EMI approach in that it contained a separate section on underlying factors and sustainability of inflation performance, which *inter alia* looked into the disinflation process being supported by adequate wage behaviour and into domestic reactions to changes in import prices.

Moreover, the EMI reports, in particular the 1996 report, highlighted the importance of long-term policy drivers of sustainable price convergence. It is interesting to note that both the EMI and the European Commission covered three types of long-term drivers in their 1996 reports: (1) the conduct of a price stability-oriented monetary policy in Stage Three by an independent ECB and NCBs that were moreover subject to the prohibition of monetary financing; (2) fiscal policies, whereby the European Commission put most of the emphasis on the budgetary consolidation under way and its favourable influence on inflation expectations, whereas the EMI drew most attention to the potential for budgetary slippage and the ensuing risk of an unsustainable macroeconomic policy mix;²⁹ and (3) structural factors contributing to a low inflation environment (such as the integration of goods markets centred on the completion of the single market) or putting such an environment at risk.

In contrast to the European Commission report of 1996, the EMI report at that time also pointed to the liberalisation of financial markets as a potential force exerting downward pressure on inflation. This element was no longer present in the 1998 EMI report, further diminishing the role played by financial factors in the assessment of sustainable convergence.³⁰ Another slight difference in approach between the European Commission and EMI assessments of sustainable price convergence concerned the treatment of the short-term sustainability of inflation

29 Alexandre Lamfalussy had already revealed his personal thinking about the sustainability of price stability being more than just the responsibility of the central bank’s monetary policy in his 1994 Per Jacobsson lecture. Here he argued that an independent central bank can in the end always achieve price stability, but with very different implications for growth, depending on the behaviour of the fiscal policy-maker. In other words, one cannot circumvent the need for an appropriate policy mix. As he put it, “Granting independence to central banks creates the conditions for a balanced dialogue between monetary and fiscal authorities, but an optimum policy mix requires two correct decisions, not simply one.” One of the examples he gave was that the efficient conduct of a non-inflationary monetary policy could be hampered by the level of government spending, given that a high level of transfer payments and the correspondingly high fiscal or wage cost burden weakens the kind of flexibility in price and wage formation that is essential to the smooth functioning of the transmission mechanism.

30 See also subsection 3.6 on “other factors”, as well as section 4.3.

outcomes. While both institutions included short-term forecasts (the European Commission only reflecting its own forecast, the EMI reproducing forecasts from the European Commission, the OECD and the IMF), the EMI also gave details on recent trends (based on three-month and six-month moving averages).

In conclusion, although by 1998 the European Commission report had taken on by and large the same type of assessment as the EMI, as regards the underlying factors and the sustainability of the inflation performance in EU Member States, the EMI reports of 1995 and 1996 had clearly taken the lead in this analytical presentation. Moreover, with the presentation of both backward and forward-looking indicators, the EMI reports were slightly more elaborate than the European Commission reports, underscoring the general objective of the EMI to put special emphasis on the concept of sustainability of the performance in terms of price stability.

3.3 ASSESSMENT OF THE SUSTAINABILITY OF THE GOVERNMENT BUDGETARY POSITION

Just as the methodological approach that was followed to assess the sustainability of the inflation performance had, the EMI 1995 report drew attention to the clear risk that data for individual years or shorter periods of time might mask underlying trends and make judgements regarding sustainability difficult.³¹ It made pointed observations on three underlying trends in the adjustment of governments' budgetary positions that placed question marks on their sustainability: (1) the sustained increase in the ratio of public expenditure to GDP outpacing that of the ratio of public revenue to GDP, without the difference between the two being wholly accounted for by an increase in public investment;³² (2) the clear tendency of structural budget deficit corrections to be smaller than those of nominal budget deficit corrections, irrespective of caveats to be made for the measurement of structural deficits; and (3) a persistent trend for rising gross public debt-to-GDP ratios on account of a significant rise in this ratio during times of deceleration in economic activity followed by only a stabilisation of the ratio during times of economic recovery.

The 1995 verdict of the EMI was therefore harsh and clear at the same time: "Over the medium term, the main characteristic of the development in government budgetary positions was one of divergence from the 60% [debt] and 3% [deficit] reference values while insufficient progress was being made to ensure a return to sustainable levels of deficits, let alone public debt levels". Given past developments and current levels of structural deficits and expenditure ratios, a successful rebalancing of public finances would require determined action over a sustained period. Without such determined measures, and also taking into account other longer-term fiscal problems related notably to the existence of large unfunded liabilities in public pension systems and the impact of ageing populations on the financing of social security and health systems, there was a

31 See EMI (1995b), p. 22.

32 This reference to a "golden rule type" of deficit financing stems from the fact that the Protocol on the convergence criteria explicitly called on the European Commission to look at this aspect.

major risk that debt positions would become financially unstable,³³ an issue that the EMI itself recognised as being often disregarded in the public debate.³⁴

To illustrate the potential for instability, the EMI's 1995 report provided a breakdown (for the years 1990-1995) of the three major components of the evolution of public debt: the evolution of the primary balance, the GDP growth/interest rate effect and stock-flow adjustments. Although the 1995 European Commission report presented the same analysis, it only did so in theoretical terms, preferring instead to focus on the (more favourable) picture of the declining positive values of the primary gap³⁵ between 1993 and 1995. More generally, the 1995 analysis by the European Commission of fiscal developments in the EU was rather more of the “glass-half-full” type, whereas the EMI analysis did not even reach the “glass-half-empty” mark.

Although the EMI pointed out in its 1995 Annual Report that there is no hierarchy in the convergence criteria, it stressed the key importance of a sound fiscal position to prevent financial instability, to avoid negative spillovers on the sustainability of the three other main convergence criteria (viz. the credibility of a price stability-oriented monetary policy, risk premia embedded in long-term interest rates and exchange rate stability), and also to deliver satisfactory economic performance. With regard to the latter, Box 4 of the same Annual Report reviewed the existing literature on the macroeconomic impact of fiscal consolidation, arguing that positive confidence effects may be reaped in the prevailing circumstances in Europe.³⁶

The 1996 EMI convergence report further deepened the analysis contained in the 1995 report. To gain additional insights into the nature of public financial imbalances, not only the influence of the business cycle and one-off factors were examined, but also changes in the structure of general government expenditures and receipts were considered. The 1996 report also contained Box 3.1 on the sustainability of fiscal positions with quite strong language on the great efforts that highly indebted countries would have to make. Reference was made to the potential crowding-out of non-interest expenditure by large interest payments, the potential problem of refinancing maturing debt, the vulnerability to sharp fluctuations in interest rates and exchange rates and the reduced flexibility to respond to adverse economic shocks. A related problem highlighted was the fact that high debt levels by themselves might trigger market volatility and seriously complicate the implementation of monetary policy, particularly in the case of a

33 It is to be noted that, since 2009, the European Commission has started publishing annual fiscal sustainability reports analysing the sustainability of public finances in EU countries against the background of the impact of the crisis and the demographic ageing projected in the Annual Ageing Report.

34 See EMI (1995b), p. 24.

35 The primary gap represents the difference between the debt-stabilising and the actual budget primary balance. If it is positive, it will lead to a decrease in the public debt-to-GDP ratio, assuming no countervailing effect from a positive stock-flow adjustment.

36 It is somewhat ironic to note that, as M. Buti observed during a conference in late 2012, a “war of the boxes” had erupted in that year, with the IMF, the OECD, the European Commission and the ECB all publishing boxes commenting on research regarding the size of fiscal multipliers.

high proportion of short-term debt or debt indexed to short-term interest rates. Although a sustainable fiscal position was often understood as a budgetary situation consistent with a stable debt-to-GDP ratio, stabilising an unduly high debt ratio could only be regarded as an interim objective.

To clearly illustrate the need for a reduction in public debt ratios, the EMI report evidently also referred to the Treaty requirement of convergence of the debt ratio towards a 60% reference value or below and calculated the debt convergence gap. Even though the Treaty was silent on the time horizon under which the debt convergence requirement would have to be met, common horizon calculations illustrated that the higher the initial debt burden, the more fiscal consolidation efforts would be required. Such debt convergence gap calculations were also called primary gap calculations, in as far as they assumed that the other drivers of debt ratio changes (the difference between the effective interest rate on outstanding public debt and nominal GDP growth, and stock-flow adjustments) would remain unchanged. With regard to the first element, the EMI was well aware of the forward-looking behaviour of financial markets having a favourable impact on fiscal consolidation efforts (lower interest rates would directly reduce the effective interest rate on outstanding public debt and could also indirectly lead, including via confidence effects, to lifting GDP growth). With regard to the stock-flow adjustments, the 1996 EMI report had already pointed to the occurrence of high adjustments of this type in several countries.

The thorough EMI analysis on the sustainability of budgetary convergence stood in stark contrast to the rather scant treatment it received in the 1996 European Commission convergence assessment. Perhaps this explains why Thygesen opined that, although the concept of sustainability of public finances is mentioned in the Treaty, it is unlikely to be discussed in any detail in the two official reports since it lacks quantitative precision, however relevant the concept may be.³⁷

It may be the case that in its 1996 convergence assessment the European Commission did not consider it necessary to provide an in-depth analysis of the sustainability of budgetary convergence, since it was already obvious prior to the writing of the report that there would not be a majority of EU Member States ready to embark upon monetary union in January 1997. It is noteworthy that the European Commission's 1998 convergence report does engage in a much more thorough assessment of budgetary sustainability issues, in a similar way to what was indicated earlier for the assessment of the sustainability of inflation convergence. Indeed, this report deals extensively with matters such as the influence of the economic cycle, the importance of one-off measures, the size and composition of budgetary adjustment, medium-term prospects as presented in EU countries' convergence programmes and sustainable debt trends (including calculations on the number of years needed by each country to bring its public debt-to-GDP ratio below 60%).

37 See Thygesen (1998), p. 7.

Meanwhile, in its 1998 report, the EMI made it clear that, in contrast to the European Commission, it had no formal role in the excessive deficit procedure. It also refrained from commenting further on EU Council decisions taken under the excessive deficit procedure. However, it continued to express its independent view on fiscal developments and hence was naturally inclined to focus on fiscal sustainability issues.³⁸ Its forward-looking analysis, which was entirely based on harmonised European Commission (Eurostat) fiscal data, was anchored in two new elements of the EU fiscal framework: (1) the medium-term fiscal strategies of EU countries which were described in the Convergence Programmes (which were still not compulsory); and (2) the prospective application from 1999 onwards of the provisions of the Stability and Growth Pact with its Medium-Term Objectives for fiscal balances of close to balance or in surplus, which made the calculation of the link between deficit developments and the prospective path in the debt ratio more constraining.

In conclusion, although by 1998 the European Commission's report can be deemed to be as rigorous as the assessment of the EMI as regards the underlying factors and the sustainability of the budgetary performance in EU Member States, the EMI's reports of 1995 and 1996 were also breaking new ground in their analytical presentation. Moreover, with the presentation of both backward (in respect of public deficits) and forward-looking indicators (in respect of public debt levels), the EMI's reports were slightly more elaborate than the European Commission's reports, underscoring the importance attributed by the EMI to the concept of the sustainability of fiscal performance, including for what concerns the conduct of monetary policy.

3.4 ASSESSMENT OF THE SUSTAINABILITY OF EXCHANGE RATE STABILITY

Although the argument was often made that the exchange rate stability criterion could only be evaluated from an ex post perspective, given that the domestic currency would be superseded by the single currency after a positive assessment of the country's convergence and hence readiness to enter the monetary union, the EMI in its 1995 assessment pointed out that the markets' changing assessment of the credibility and sustainability of a country's present and expected future policies were having a bearing on exchange rate developments. In general, a country's currency could be expected to be stable if markets considered the authorities' anti-inflationary commitment to be credible, if they were confident of the sustainability of its fiscal policy and if they deemed these two elements not to endanger the external competitiveness of the country.³⁹

The EMI in its various reports produced information on the evolution of the real effective exchange rates of EU countries while pointing out that the

38 In the case of Italy, the EMI statistical tables contained an alternative debt convergence calculation, based on a more favourable assumption regarding the real trend for GDP growth of the Italian economy than the European Commission was projecting. This had been added at the insistence of the Banca d'Italia.

39 See EMI (1996b) Box 4.1 on exchange rate developments and sustainability of convergence, p. 39.

sustainability of a country's nominal exchange rate could also be assessed against the background of the evolution of its real effective exchange rate over time. The European Commission's reports on convergence, at least during the lifetime of the EMI, stayed silent on this point even though a clear connection existed between the issue of nominal exchange rate stability (when measured in terms of deviations from the central rate in the exchange rate mechanism (ERM) of the EMS) and the irrevocable fixing of the conversion rate from the national currency into the euro.⁴⁰

In dealing with nominal exchange rate assessments the European Commission's reports had a peculiar way of measuring exchange rate stability, which was different from that of the EMI. The European Commission preferred to apply the median currency approach,⁴¹ which it claimed offered several important advantages compared with alternative approaches (notably its neutrality in terms of the denominator, its robustness against the outlier behaviour of currencies and its consistency with the spirit of the widened fluctuation margins in the ERM as had been decided in August 1993). Such an approach was also consistent with the role of the ECU/euro as the notional anchor of the ERM. The EMI on the contrary had no hesitancy producing data on the stability of exchange rates by measuring deviations from the central rates in the ERM against the strongest currencies or volatility measured against the Deutsche Mark.⁴² This type of approach better reflected the bilateral setting of central rates within the ERM and the de facto asymmetry between devaluation and revaluation of such rates.

As noted earlier, the EMI convergence reports also made more elaborate use of the "other factors" to provide auxiliary evidence on the sustainability of the four main convergence criteria. With regard to the exchange rate criterion, the sustainability of the exchange rate (and consequently also the prevailing central rate) was therefore also assessed in the light of external developments, most notably the evolution of the current account balances of EU countries, their net foreign asset/liability position and their degree of trade openness. The European Commission's reports, in dealing with current account balances under the "other factors", put more emphasis on the fact that the liberalisation of capital movements would allow for a better intertemporal optimisation of private sector spending and saving decisions with the result that it would be a better reflection of the saving/investment balance of the private sector than in the past. Seen from this perspective, it obviously remained an important indicator of national debt sustainability, when viewed in combination with indicators of public indebtedness.

40 In EMI (1995b) extensive evidence was produced on the short, medium and long-term evolution of the real effective exchange rates of EU countries, using four different deflators for the nominal effective exchange rates (consumer prices, unit labour costs, export prices and producer prices). The only reference to effective exchange rates found in the three European Commission convergence assessments between 1995 and 1998 was a table on p. 69 of European Commission (1996) showing the nominal effective exchange rate evolution in the context of the discussion on import prices under the "other factors".

41 See notably the box on p. 125 of European Commission (1998).

42 This slight divergence in approach disappeared after the start of Stage Three when the ERM became a "hub and spokes" mechanism with the euro as the anchor.

In conclusion, it is not an exaggeration to state that the EMI made an attempt to link the sustainability of the nominal exchange rates of EU countries to their real exchange rate evolution over time, by also drawing on the evidence from the current account data. This contrasted with the European Commission's approach, which did not address sustainability issues on the grounds that a currency's nominal exchange rate would no longer exist once its country had been selected for participation in the euro area.⁴³ The focus of the European Commission's assessment therefore remained on the best way of measuring the stability of the nominal exchange rates, for which it preferred a different method from the one applied by the EMI.

3.5 ASSESSMENT OF THE SUSTAINABILITY OF LONG-TERM INTEREST RATES

The treatment of long-term interest rates in the 1995 convergence assessment was relatively short and mainly driven by the need to address statistical data issues which at the time severely hampered a consistent cross-country comparison. In this regard, the EMI made a decisive contribution to the selection of suitable statistical data by advising the European Commission on a number of parameters that could usefully determine a harmonised set of benchmark long-term government bond yields.⁴⁴ In its 1996 assessment the EMI pointed to three determining factors for long-term interest rate differentials among EU countries: (1) differentials in expected inflation; (2) differentials in real interest rates (which should be tending to zero in an environment of full capital mobility); and (3) differentials in risk premia (singling out exchange rate risk, inflation risk, default risk and market volatility risk premia). It was explicitly mentioned that such risk premia might increase if domestic and/or external imbalances were regarded as unsustainable. It is noteworthy that the European Commission's assessment in 1996 is much more rudimentary on this matter, while its 1998 assessment very much echoes the 1996 EMI assessment approach.⁴⁵

Finally, it is worth highlighting that the EMI's 1998 assessment not only produced data on long-term interest rate differentials vis-à-vis the (at most) three best-performing countries in terms of price stability (as provided for in Protocol No 6 TEU), but also with reference to the "core" countries.⁴⁶ A reason for the

43 The importance of the real exchange rate evolution as an indicator of price competitiveness came to bear only after the start of the monetary union, when it became increasingly clear that the relatively overvalued conversion rate of the Deutsche Mark into euro was being corrected by more lax wage policies in other euro area countries, thus worsening their relative unit labour costs, as well as by sound adjustment policies in Germany from 2004 onwards. See also section 4.3 below.

44 In the Box on p. 18 of European Commission (1996), the EC explicitly acknowledged the role played by the EMI in developing a harmonised series of long-term sovereign bond yields to be used as the statistical data for the assessment of the interest rate convergence criterion. An updated box with a more explicit recognition of the work done by the EMI can be found on p. 147 of European Commission (1998).

45 See European Commission (1996), p. 57 and European Commission (1998), p. 143.

46 De facto comprising the countries which at the time had been closely pegging their exchange rate to the Deutsche Mark for a number of years, namely Belgium, Germany, France, the Netherlands and Austria (taking into account that Luxembourg did not have a central bank conducting an independent monetary policy).

inclusion of what could be regarded as a kind of complementary indicator was not explicitly given. Presumably it had to do with the fact that this core group could be regarded as having achieved sustainable convergence in long-term interest rates, whereas the observed convergence in long-term interest rates among other countries might reflect not only market expectations of converging inflation rates and fundamentals among the wider group more generally, but also the market assessment of the likely prospect of the monetary union starting on time⁴⁷ and hence embedding the fundamental economic outlook for the future euro area as a whole. Decreasing uncertainty about the prospective participants joining monetary union in 1999 had indeed led to a self-fulfilling prophecy of converging long-term interest rates, the so-called convergence play in financial markets to which both the European Commission and the EMI had previously drawn attention.⁴⁸

In conclusion, while long-term interest rates embedded information on market expectations of future inflation, fundamentals and risk premia, they ultimately provided little additional information on the sustainability of the economic convergence compared with the other main convergence criteria. Both the EMI and European Commission assessments were therefore relatively short in their analysis of this criterion. Only the EMI made a small attempt to dissociate the component on market expectations of participation in the monetary union for a given currency from the component on the country-specific risk premia, by including the core countries as a benchmark. However, this approach yielded limited additional information on the outlook for the sustainability of long-term interest rates, all the more so since, as the European Commission rightly observed, long-term interest rate developments in EU countries cannot be assessed without reference to developments outside of the EU.

3.6 ROLE OF THE “OTHER FACTORS” IN THE ASSESSMENT OF A HIGH DEGREE OF SUSTAINABLE CONVERGENCE

Notwithstanding the rigorous adherence by the EMI to the Treaty provisions on the assessment of a high degree of sustainable convergence, it is interesting to note that the 1995 and 1996 EMI reports treat the four categories of “other factors”, for which the Treaty stipulates an assessment, in exactly the opposite way to the way they are mentioned in the Treaty.⁴⁹ Such an inverse consideration makes sense from an economic perspective, especially if the intention is to focus on sustainability considerations on the one hand, and to use a corroborative type of approach in view of the close relationship between some of the “other

47 It should be recalled that a number of mostly non-European commentators still believed for some time that European leaders could decide to amend the “no later than” starting date foreseen in the Treaty in circumstances in which only a non-significant group of EU countries would qualify to start EMU in 1999.

48 See for instance Box 5.1 on long-term interest rates and sustainability of convergence in EMI (1996b), p. 47.

49 As mentioned above, the Treaty speaks of the need to take account of: (1) the development of the ECU; (2) the results of the integration of markets; (3) the situation and development of the balance of payments on the current account; and (4) an examination of the development of unit labour costs and other price indices.

factors” and the four main convergence criteria on the other hand. Indeed, the development of the ECU was never going to have a sustainable impact as it was to be submerged into the single euro financial market that would come into being at the start of Stage Three of EMU. It would probably have made sense to look more at the ECU market development as an indicator of financial market integration. However, since a literal interpretation of the Treaty provision was pursued, this avenue was not investigated.⁵⁰ It should be acknowledged though that the European Commission and the EMI convergence reports made some reference to the integration of financial markets, in that they paid attention to foreign direct investment flows, but this was done, in particular by the European Commission, as part of scanning broader evidence on the integration of markets in the EU. Such integration was expected to lead to greater competition, which over time would help improve the structural performance of goods and labour markets. In turn, this was deemed to increase the likelihood of convergence being sustainable, provided of course that obstacles to the integration of markets were removed. The EMI for instance explicitly referred to indirect taxation and capital income taxation differentials as hindrances to such integration. The third “other factor” concerned the situation and development of balances of payments on the current account. As noted above, and somewhat in contrast with the European Commission reports, the EMI convergence assessments used the current account information essentially for shedding light on potential problems with the sustainability of some of the main convergence criteria, notably exchange rate stability, but also the government’s budgetary position and inflation pressures. Similarly, the fourth “other factor” mentioned in the Treaty, the development of unit labour costs and other price indices, was seen primarily as a tool to provide additional information on the sustainability of the price stability achievement, as highlighted earlier. It must be added that such complementary checking needed to be done with due caution given the lack of harmonised price and cost data in many instances.

In conclusion, considering the secondary role played by the “other factors” in the convergence assessment as defined in the Treaty,⁵¹ and given also the lack of sufficiently harmonised data, the EMI early on, and subsequently also the European Commission, essentially utilised the information derived from these “other factors” to back up their assessment on the sustainability of the main convergence criteria. The EMI even pushed this logic in its 1998 report to the point of no longer considering in a separate section the “other factors” in its assessment of economic convergence, something the European Commission continued to do in order to be seen as fully complying with the Treaty requirements.

50 Accordingly, the consolidated version of the Lisbon Treaty in Art. 140 (1) TFEU only refers to three other factors, removing the reference to the development of the ECU, which could have been reinterpreted as the development of the euro financial markets. See also section 4.3 on the subsequent growing attention being paid in the ECB and European Commission convergence reports to financial market issues.

51 See also Bini Smaghi, Padoa-Schioppa and Papadia (1994), p. 25.

4 THE LEGACY OF THE EMI'S ASSESSMENT OF SUSTAINABLE CONVERGENCE

In accordance with Art. 109I TEU, the EMI went into liquidation upon the establishment of the ECB on 1 June 1998. Liquidation had to be completed by the start of Stage Three of EMU on 1 January 1999. It is a rare fact to see international institutions being liquidated, but in the case of the EMI, it could institutionally be described as a takeover by the ECB.⁵² Indeed, the President of the EMI, Mr W. F. Duisenberg, who, pursuant to Art. 23.7 of the EMI Statute, had to relinquish his office on 1 June 1998, became the first President of the ECB on that same day. One of the initial Executive Board members of the ECB later not only commended the excellent quality of the work delivered by the EMI, but also noted that the core of the ECB staff was composed of ex-EMI staff members.⁵³

Notwithstanding this institutional continuity and intellectual heritage, it is worth asking to what extent the EMI's approach to assessing the sustainability of the convergence process in the EU remained relevant after the end of Stage Two of EMU. After all, many things changed with the start of Stage Three in 1999. Moreover, only two countries initially remained subject to a biennial convergence assessment, as Table 2 illustrates.

One way of probing the robustness of the EMI's assessment of a high degree of sustainable convergence is to consider periods in which important macroeconomic developments or “shocks” occurred in the course of Stage Three and how they impacted on the convergence assessment methodology in general, and the assessment of “a high degree of sustainable convergence” in particular. In what follows, three such periods are successively assessed: (1) the period between 1999 and 2005, marked by a weak implementation of

Table 2 European Commission and ECB convergence assessment since 1 January 1999

Time of assessment	EU countries covered
May 2000	GR, SE
May 2002	SE
October 2004	CZ, EE, CY, LV, LT, HU, MT, PL, SI, SK, SE
May 2006 ¹⁾	LT, SI
December 2006	CZ, EE, CY, LV, LT, HU, MT, PL, SK, SE
May 2007 ¹⁾	CY, MT
May 2008	BG, CZ, EE, LV, LT, HU, PL, RO, SK, SE
May 2010	BG, CZ, EE, LV, LT, HU, PL, RO, SE
May 2012	BG, CZ, LV, LT, HU, PL, RO, SE
June 2013 ²⁾	LV
May 2014 ²⁾	BG, CZ, HR, LT, HU, PL, RO, SE

1) Specific request for an ad-hoc assessment pursuant to Art. 140 (1) TFEU

2) Tentative date

52 Further details on the origins of the temporary nature and limited responsibilities of the EMI can be found in James (2012), pp. 298-304 and Bini Smaghi et al. (1994), pp. 36-41.

53 See Issing (2008), p. 9.

the economic governance framework, exemplified by the introduction of a more flexible SGP; (2) the period between 2004 and 2007, during which the additional challenge of EU enlargement was presented; and (3) from 2007 onwards, featuring the global economic and financial crisis with the euro area sovereign debt crisis in its aftermath.⁵⁴

4.1 WEAK IMPLEMENTATION OF THE ECONOMIC GOVERNANCE FRAMEWORK

In contrast with the continued reliance on the Maastricht convergence assessment procedures, the record of continued compliance with, in particular, the Maastricht fiscal convergence criteria for the member countries of the euro area was much less satisfactory. The Delors Report had already drawn attention to the risk of insufficient market pressures and policy awareness of the need to correct national economic disequilibria after a country had joined EMU.⁵⁵ In its 1998 convergence assessment the EMI had clearly indicated that ensuring sustainability depends both on the achievement of a sound starting position and on the policies pursued after the start of Stage Three of EMU. Whereas the record on inflation convergence stayed very positive⁵⁶ and long-term interest rate convergence remained very strong, even up until the start of the global financial crisis at the end of 2008, the track record in terms of fiscal policy convergence in the first few years after the start of monetary union became increasingly unsatisfactory.

A number of the political economy factors that had been the basis of the successful fiscal convergence process laid out in the Maastricht Treaty were no longer effective, leading to an increasing disregard of the letter and the spirit of the original SGP. In 1999 Szász had already been rather prescient on the lack of political will to make the rules of the SGP bite: “It is far from certain that the draconian fines envisaged in the Pact will be imposed in practice, and this is less likely, the larger the number of participating countries having excessive deficits. The Pact can only be respected if countries reduce their public sector deficits sufficiently below 3% of GDP on average to have a safety margin allowing automatic stabilisers to function during cyclical downturns. In view of the difficulty of major countries, among them Germany and France, to reduce the deficit even to 3%, this seems far from certain.”⁵⁷

54 Apart from these three macroeconomic shocks, one could also refer to a fourth statistical shock which had to do with the realisation that the statistical data provided by the Member States to Eurostat were not in all cases sufficiently reliable. The case of Greece and its weak statistical governance is well known. With the EU entry of the “new” Member States in May 2004, the ECB started, from October 2004 onwards, including a special section on the statistical methodology of the convergence indicators in which the quality and integrity of the underlying statistics for the examination of the state of convergence was stressed.

55 See Report on Economic and Monetary Union in the European Community (1989), paragraph 26, p. 21.

56 While average annual HICP inflation in the euro area was broadly consistent with the ECB’s definition of price stability, the degree of inflation dispersion within the euro area was also low, even surprisingly so, as noted by Mongelli and Wyplosz (2009), p.28.

57 See Szász (1999), p. 163.

The story of the flexibilisation of the original SGP in 2005,⁵⁸ after the highly unusual court case between the European Commission and the EU Council following the latter's decision not to step up the excessive deficit procedure vis-à-vis France and Germany need not be retold here.⁵⁹ The ECB, in its special tenth anniversary edition of its Monthly Bulletin phrased it very diplomatically: "The implementation of the EMU fiscal surveillance framework has faced many challenges related to fiscal developments in euro area countries since 1999".⁶⁰ A quote from Alexandre Lamfalussy in 2006 sums it up more poignantly: "The cavalier way in which an increasing number of Member States have dealt with the constraints of the Stability and Growth Pact suggests that they have conveniently forgotten that this pact was explicitly designed (not in prehistoric times but in 1997) to preserve the constraining elements of the fiscal convergence criteria after accession to EMU, precisely because uncontrolled fiscal laxity could severely undermine the ECB's ability to fulfil its prime responsibility of maintaining price stability."⁶¹ The amendments to the SGP undertaken in 2005 did not sufficiently address the situation, but outcomes were papered over by the favourable effects of the "Great Moderation". Beneath the surface, however, they inexorably laid the ground for some of the problems encountered during the euro area sovereign debt crisis which erupted in 2010.

Featuring less prominently than the fiscal developments were the evolution of real effective exchange rates and the evolution of current account imbalances. Both of these developments had been looked into by the EMI as "other factors" that provided auxiliary information to assess the sustainability of the nominal convergence process of euro area participants. At the start of monetary union, Wim Duisenberg was able to claim, with a reasonable degree of satisfaction, that national differences in growth and inflation in the euro area were not unusual.⁶² Over time, however, persistent signs of divergence across euro area members became apparent. As the many drivers of these divergences belonged predominantly to the economic policy agenda which was largely within the remit of individual Member States, the only way forward for the European Commission was to engage in soft coordination, in full respect of the principle of subsidiarity. However, the main tools to this end, the Broad Economic Policy Guidelines, which allowed for Council recommendations and warnings under Art. 121 (4) TFEU, and the Lisbon Strategy, launched in 2000 with its "open method of coordination", remained ineffectual.⁶³

58 See Buiter (2006) who speaks of four key emasculating changes to the reformed SGP as adopted in March 2005, which effectively killed it. The Governing Council of the ECB in a statement of 21 March 2005 expressed its serious concerns about the changes to the corrective arm of the SGP.

59 A short summary of all the problems encountered with the implementation of the SGP in the first five years can be found in European Commission (2008), pp. 136-139.

60 See ECB (2008), p. 74.

61 See Lamfalussy (2006), p. 6.

62 See Duisenberg (1999).

63 See European Commission (2008), p. 140. A much stricter view of the weakness of economic policy coordination in the euro area prior to the outbreak of the crisis can be found in Pisani-Ferry (2006), pp. 836-841.

From the point of view of assessing the degree of sustainable convergence, the above merely confirmed the validity of the earlier EMI approach of looking very carefully at underlying fiscal developments in a medium-term perspective and of paying due attention to factors such as real exchange rate developments and current account balances as indicators of price competitiveness that needed to stay aligned in order for the monetary union to continue functioning smoothly.⁶⁴ The convergence assessment methodology applied by the ECB from 2000 onwards therefore only changed marginally compared to what the EMI had been doing. Some additional details on budgetary revenues and expenditures were added, as well as details on the general government deficit-debt adjustment data in the statistical tables on fiscal developments. Furthermore, more detailed information was provided on countries' balance of payment situations.

4.2 ENLARGEMENT OF THE EU

The political momentum towards reintegrating continental Europe led to a milestone enlargement of the EU in May 2004 when ten new Member States joined the EU. Even though, according to the Treaty provisions, their first biennial assessment of surveillance should have been conducted only in the spring of 2006, it was decided to delay the 2004 convergence assessment from May to October in order to be able to incorporate a first assessment of the state of convergence of the new Member States. This added to the debate about the relevance of the nominal convergence criteria as euro area entry criteria for countries at a very different level of real convergence, which was essentially the case for the economies in central and eastern Europe.⁶⁵

More specifically, the relevance of the Maastricht convergence criteria for determining the readiness of the new Member States to enter the euro area was contested on the following grounds. As regards the price convergence criterion, there were questions surrounding the appropriate reference value and whether it should be the average of the three best performers inside the euro area rather than the EU or the ECB's quantitative definition of price stability. With regard to the exchange rate criterion, there were questions on the entry into ERM II and on its appropriateness as a so-called training room to prepare for euro area entry, in view of the occurrence of Balassa-Samuelson effects leading to price level convergence. Concerning the long-term interest rate criterion, several of the new Member States had very limited sovereign debt markets and, more generally, small capital markets in domestic currency on account of a large degree of euroisation. As regards the fiscal convergence criteria, it was pointed out that a number of euro area Member States continued to violate them, while non-euro area Member States were obliged to meet them in order to qualify for euro area membership.

Notwithstanding lengthy debates, also in the General Council of the ECB, which had to approve the ECB Convergence Reports, the legal argument ultimately prevailed, namely that it was not possible to deviate from the Treaty

64 See ECB (2008), pp. 85-87.

65 The prolonged debate on nominal versus real convergence triggered many academic publications. By way of example, see Darvas (2010) and Paleta (2012) for a Hungarian and Czech perspective, respectively.

requirements which had been rigorously observed by the EMI/ECB and the European Commission in all of their successive convergence assessments for all EU countries. In response to those claiming that equal treatment was more than just applying an unchanged legal framework in the same way, but that it also involved fairness and economic rationality, the following counterarguments were put forward: first, it was fair not to make too many distinctions between “old” and “new” Member States nor between euro area and non-euro area countries; second, it was economically rational, also for the new Member States, to conduct economic policies that would lead them to meet the convergence criteria in a sustainable manner.⁶⁶

The convergence assessment methodology applied by the ECB from 2004 onwards therefore by and large followed the approach that the EMI had been following. Some additional “related indicators” were added in the country-specific statistical tables on price developments,⁶⁷ as well as some additional information on indicators of integration with the euro area. In the overview section, moreover, a table on governance indicators was added to provide some information on the quality of the institutional environment in all EU countries. As to the language used in assessing the degree of sustainable convergence, concerns were more strongly voiced by the ECB in the case of some of the former transition economies, taking into account their past experience.⁶⁸

4.3 THE GLOBAL FINANCIAL CRISIS AND THE EURO AREA SOVEREIGN DEBT CRISIS

The global financial crisis, the subsequent “Great Recession” and the eruption of the euro area sovereign debt crisis with its “doom loops” operating between the real and the financial economy, the real economy and the fiscal accounts, and the fiscal accounts and the financial economy, were epochal events that, in the view of a number of observers, brought the euro area close to the brink of unsustainability. As part of the measures taken that aimed at restoring an effectively functioning EMU, the fiscal framework of the SGP was considerably reinforced.⁶⁹ One of the reinforcements concerned the operationalisation of the public debt criterion allowing for more automaticity in the triggering of an excessive debt procedure. Other reinforcements concerned a more effective sanctioning regime, a strengthened national ownership of the EU fiscal governance framework, and the submission of draft national budgets for assessment by the European Commission and discussion in the Eurogroup.

66 See for example Papademos (2004) and Issing (2008), pp. 191-193.

67 Comparing price levels and GDP per capita levels with those in the euro area.

68 This was most notably the case for Latvia, with ECB (2013), p. 48 stating the following: “Joining a currency union entails foregoing monetary and exchange rate instruments and implies an increased importance of internal flexibility and resilience. Economic sustainability is thus conditional on a permanent willingness, on the part of both the authorities and the public at large, to adjust and to introduce the necessary reforms and policy measures to safeguard macroeconomic stability and the competitiveness of the economy.”

69 See ECB (2012), Box 2, pp. 10-12 and ECB (2013), Box 2, pp. 11-13 for an overview of the new legal provisions in the fiscal domain.

All of these elements⁷⁰ were supposed to contribute over time to more sustainable fiscal policies in the EU and euro area Member States, eventually showing up in declining debt-to-GDP ratios towards the Treaty reference value. One of the long-standing concerns, expressed in the first EMI convergence assessments, namely that fiscal sustainability cannot be guaranteed with a high, even though stable, debt-to-GDP ratio was thus addressed, at least in principle.

The macroeconomic surveillance framework was also distinctly reinforced with the introduction of the Macroeconomic Imbalance Procedure (MIP) that includes both a preventive and a corrective arm. The latter consists of the Excessive Imbalance Procedure, which provides for potential sanctions for euro area countries. The MIP also includes an alert mechanism for the early detection of possible imbalances, based on an annual scoreboard, containing 11 indicators. What is noteworthy is that a large majority of these indicators were already covered in the statistical tables included in the EMI's convergence reports.⁷¹ The missing ones were essentially financial in nature (private sector credit flow, private sector debt and total financial sector liabilities), all of which came onto the radar only after the outbreak of the global financial crisis. With hindsight, it seems odd that for a long time all the European institutions almost exclusively focused on public sector debt issues while neglecting private sector debt developments.

A further reinforcement concerned the formalisation of a European Semester approach in which the submission of National (structural) Reform Programmes by Member States gives rise to the formulation of Council Recommendations on Broad Economic Policy Guidelines, which members are subsequently expected to implement in the second semester of the annual cycle. In addition, there are specific Recommendations for the euro area as a whole which aim at strengthening the adjustment capacity of the euro area to shocks, focusing on such elements as flexibilising wage and price behaviour, facilitating the reallocation of resources between the tradable and the non-tradable sectors of the economy, and allowing for a better integration of euro area markets more generally.⁷² These elements will undoubtedly help to foster the market integration of the euro area, thereby adding to the sustainability as well as the optimum currency area features of the euro area. This is a domain in which the EMI in its convergence assessments can be seen as having underemphasised the importance of the structural reform agenda. However, as this agenda was not part of the Treaty convergence criteria, except for a brief mention under the “other factors”, it was not really taken up in the assessment of sustainable convergence by the EMI, with the exception of a summary table of integration indicators. This was not a matter of oversight, but one of deliberate policy choice to stick closely to the Treaty requirements, as was indicated early on in this paper. As a matter of fact, during the discussion on the EMI's first Convergence Report on 7 November 1995, one of the members of the EMI Council remarked that, while this report complied with a rigorous

70 The entire package tends to be referred to in the media as the “six-pack”, “two-pack” and “fiscal compact”.

71 This was the case, in EMI (1998a) for 7 of the 11 indicators: the current account balance, the net international investment position, the real effective exchange rate, nominal unit labour costs, house prices, general government debt and the unemployment rate.

72 On the first steps in this direction, see European Commission (2008), pp. 140-143.

interpretation of Article 7 of the EMI Statute (and hence with the Treaty), it deserved to be noted that there was a blind spot in the Treaty itself, namely the emphasis on structural reform. At some point in the future, this matter would need to be addressed. This member was Jean-Claude Trichet, who later became President of the ECB.

A similarly deliberate disregard concerned the financial sector side. Yet there was a clear awareness that the start of monetary union would have major implications for financial integration.⁷³ Moreover, Lamfalussy himself had throughout his professional life, notably at the BIS, undertaken work on financial stability issues in an environment of growing financial globalisation, and had triggered some internal EMI work on such issues. The ECB evidently also took a keen interest in financial integration in Europe.⁷⁴ However, the ECB also did so outside of the convergence assessment process, thereby maintaining the methodology applied by the EMI of staying close to the Treaty requirements. The only instances where the EMI convergence reports referred to financial developments concerned its treatment of ECU markets and the integration of markets. However, the ECU markets were deemed to have been phased out at the start of Stage Three, although one could claim that the international role of the ECU/euro continued after 1999.⁷⁵ Also, the treatment of the integration of markets included some reference to financial markets but only in terms of tax-related impediments to a full integration of financial markets. More generally, the EMI felt that these were “single market” issues to be assessed in the first instance by the European Commission.

Finally, experience has also clearly shown how important a strong national institutional environment is for the sustainability of economic integration, convergence and economic adjustment in Europe. Improvements in the institutional environment entail, among other things, better regulations, better governance, a better quality of statistics, a low degree of corruption and a more business-friendly environment.⁷⁶ In this context, it is worth making reference to the letter sent by the Latvian authorities to the President of the Eurogroup in connection with the country’s convergence assessment in June 2013, in which they acknowledge that “avoiding the return of pro-cyclical policies will be key and additional efforts shall be devoted to strengthening the quality of the institutions, business environment and governance underpinning the competitiveness and stability of Latvia’s economy”.⁷⁷

Notwithstanding all of these changes to the economic governance framework, which have left their imprint on the assessment of convergence by the ECB

73 A good overview of developments in the first ten years is provided by Lane (2009), in Maćkowiak et al. (eds.), pp. 82-115 and by Jappelli and Pagano (2010), in Buti et al. (eds.), pp. 315-353.

74 See ECB (2008), pp. 101-116 and Draghi (2014).

75 The ECB started publishing separate reports on the international role of the euro.

76 Since 2012 the ECB has included in its convergence reports a brief assessment of the quality of institutions in the countries assessed. See ECB (2012), pp. 46-48 and ECB (2013), pp. 55-56.

77 This “commitment letter” can be found on the website of the Latvian Ministry of Finance.

and European Commission,⁷⁸ the jury is still very much out on the best political economy method for securing what some have called a genuine EMU. One view is that “a key issue for sustainability is to resolve potential conflicts between national agendas for growth and employment creation. Here political will in either driving towards greater political integration or in the creation of cooperative fiscal arrangements will be vital for the underlying durability of EMU”.⁷⁹ A second view, espoused by Alexandre Lamfalussy,⁸⁰ is that “Since my suspicion is that the emerging differences between the growth performances within Euroland can to a large extent be attributed to policy decisions (or the lack of them) by individual countries, I come to the conclusion that we should not expect much help from any move toward macroeconomic fiscal federalism... I would therefore today put less exclusive stress on the need for macro-policy coordination than I did 16 years ago, but would rather emphasise the desperate need to accelerate – and collectively accelerate – the micro or supply-side reforms, of which we have so far seen only timid, and very uneven, beginnings. It is in this particular area that the E-leg [of EMU] should be strengthened.” Jean Claude Trichet a few years later publicly expressed the view that progress was needed both in the fiscal and the economic governance domain.⁸¹ An all-encompassing view, also incorporating the call for a much stronger financial sector governance framework, including a banking union, is reflected in the so-called Four Presidents’ Report of December 2012. In this report and its interim version some months before, the President of the European Council, in close collaboration with the Presidents of the European Commission, the Eurogroup and the ECB, outlined a series of actions required to ensure the stability and integrity of Economic and Monetary Union, covering financial, fiscal and economic policy issues, as well as elements of democratic legitimacy and accountability.⁸²

Whatever the future years may bring in terms of additional reinforcement of the sustainability of EMU, the convergence assessment reports by the ECB and European Commission are unlikely to change fundamentally what has been set up by EMI while the current Treaty provisions on the assessment of sustainable convergence remain unaltered. However, having learned the lessons from the global financial crisis and the euro area sovereign debt crisis, the assessment of the requirements for sustainable convergence has been broadened wherever possible. Mario Draghi summed it up as follows: “To be sustainable, nominal convergence should be underpinned by broader economic convergence, which in turn depends on the sustainability of the relevant monetary, fiscal, structural and financial policies before and after euro adoption”.⁸³

78 Both reports now include an explicit treatment of the Macroeconomic Imbalance Procedure. Given the absence of country cases subject to an Excessive Imbalance Procedure (EIP), it has not yet been formally determined whether this would disqualify a country from meeting the convergence requirements. ECB (2012), Box 5 p. 8, however, states that EU Member States with a derogation that are subject to an EIP can hardly be considered as having achieved a high degree of sustainable convergence as stipulated by Article 140 (1) TFEU.

79 See Bordo and James, (2010) in Buti et al. (eds.), “The Euro – The first decade”.

80 See Lamfalussy (2006), p. 8.

81 See Trichet (2011).

82 See Van Rompuy et al. (2012).

83 See Draghi (2012).

5 CONCLUDING OBSERVATIONS

Based on the evidence reviewed in the previous two sections, the conclusions of this paper on the role played by the EMI in the assessment of sustainable convergence of countries destined to enter the euro area from the start can be summarised in the following six messages.

First, in conducting its convergence assessment the EMI had to be a front-runner by necessity. Not only was it set up to prepare for the subsequent establishment of the ECB, it also had a statutory requirement to report on the state of convergence during each year of its existence. Hence, it was legally obliged to assess the state of sustainable convergence in the EU before the European Commission was mandated to do so.⁸⁴ While fully adhering to the Treaty requirements, the EMI opted to apply a wide-ranging approach in trying to assess a high degree of sustainable convergence in a rigorous, coherent and transparent manner (taking both a backward and forward-looking approach). This approach resulted in highly professional assessments from November 1995 onwards that contained many indicators of sustainability, which have only started to again receive the attention they deserve in the past several years, since the crisis commenced. The EMI's performance, which to a large extent reflected the collective wisdom of the EU central banking community at the time, not only boosted the credibility of the EMI in the eyes of the policy-makers at the time, it also left a strong imprint on the way in which the ECB – of which it was essentially the embryo – has conducted its own convergence assessments from 2000 onwards. Moreover, it decisively influenced the assessment methodology of the state of convergence as applied by the European Commission before the start of Stage Three of EMU.⁸⁵

Second, the independence of the EMI and its other statutory provisions, which did not foresee an active role in the decision-making process on recommending, let alone deciding on, which country should join the euro area as from the start of Stage Three, enabled it to engage in a deeper economic analysis of the concept of the sustainability of convergence referred to in the Treaty. This led the EMI to take a strong stance on in particular fiscal sustainability issues, even though it was bound by the formal process determining whether an excessive deficit exists in a particular country. It notably emphasised the importance of the Treaty language regarding the reference value of the public debt-to-GDP ratio and showed in a simple, mechanical way what the requirements were in terms of the primary public sector balance that would need to be fulfilled in order for the public debt level to approach or reach the Treaty reference value of 60%. Since the political decision was taken not to leave certain countries out of the starting group of euro area participants, the trade-off between a “no later than” starting point for Stage Three of EMU (“if (...) the third stage shall start on 1 January 1999”) and a rigorous assessment of the high degree of sustainable convergence attained

84 The European Commission was legally required to prepare a first assessment on the state of convergence in the EU in view of the political decision to be taken before the end of 1996 as to whether a majority of EU Member States was ready to adopt the euro as their common currency.

85 In addition to the formally required convergence report of 1998, the European Commission also published informal convergence assessments in early 1996 and 1997.

had to entail a promise of ambitious targets in terms of primary budget balances for a number of countries in order to achieve sustained public debt levels. Explicit commitments were made by some countries, but the commitments made, whether explicit or implicit, were not honoured in many instances.⁸⁶

Third, notwithstanding the clear messages conveyed by the EMI, in particular on the further fiscal consolidation requirements, but also on some of the “other factors” relating to competitiveness issues, the requirements for a high degree of sustainable convergence were insufficiently taken to heart by euro area governments after the start of Stage Three, irrespective of the warnings also delivered by the ECB.⁸⁷ This led to budgetary positions increasingly out of line with what the prevailing legal framework prescribed, persistently diverging real exchange rates and current account developments, and eventually a sharp divergence in long-term interest rates, in other words contradicting most of the convergence requirements laid down in the Treaty for durable participation in the monetary union. To solve this incipient deconstruction of a properly functioning euro area, a leap forward was needed, which – in large part also under the pressure of market forces that had settled into a risk-on mode after a very persistent risk-off mode during the “Great Moderation” – took the form of strong national adjustment efforts in a number of euro area countries, combined with a substantially reinforced euro area economic governance framework. In essence, the reinforced economic governance framework consisted of a more effective (and legally binding) framework for dealing with fiscal and macroeconomic imbalances, complemented by a number of institutional improvements at the national and the euro area or EU level.

Fourth, in staying very close to complying with the legal provisions for its mandatory task of assessing whether a high degree of sustainable convergence had been achieved (and thus focusing on developments in terms of the four main convergence criteria to which the “other factors” provided some complementary input), the EMI’s assessment proved robust when the challenge of how to deal with countries at very different levels of real convergence presented itself after EU enlargement. Given that the convergence requirements contained in the Treaty are expressed in nominal terms only, the convergence assessment methodology was by and large unaffected by the difficult subject of real convergence and its interrelation with nominal convergence. It also had the advantage that the later EU entrants from central and eastern Europe could not claim for a different treatment on grounds that otherwise the level playing field would not be respected. As a consequence, the EMI assessment methodology remained largely unchanged, even after 2004.⁸⁸ Sticking very closely to the legal requirements for assessing sustainable convergence as formulated in the Treaty, seen from today’s crisis vantage point, also had some drawbacks, as the following two conclusions indicate.

86 See Issing (2008), pp. 12-13 and 15-16 on the cases of Belgium and Italy.

87 Trichet (2011) recalls that the ECB had already been sending signals pointing to the risks associated with competitiveness losses in some euro area countries in 2005.

88 Even at the time of the discussion of a new European Constitution and subsequently the Lisbon Treaty, it had not been envisaged that there may be a need to reopen the EMU chapter in substance, given that it was felt that EMU was functioning properly.

Fifth, since the Treaty requirements were near silent on the role of the financial sector in securing sustainable convergence, and given the EMI's approach of adhering closely to a formal compliance with these provisions, the EMI convergence reports only very marginally touched on financial matters as being of relevance for the sustainable functioning of a monetary union. Only in dealing with two of the "other factors", the development of ECU markets and the integration of markets, were some financial sector issues addressed, albeit very sparingly. Even more limited were the references to the implications from unsustainable fiscal policies on financial stability. In contrast with the emphasis placed on public sector debt and its sustainability, no monitoring of private sector debt developments took place. With the benefit of hindsight, if the drafters of the Maastricht Treaty had been less limitative in the enumeration of "other factors" to be addressed in the convergence assessment, more analysis could have been incorporated into the convergence reports on the importance of, and requirements for, sustained financial stability as a prerequisite for a properly functioning monetary union. It took the global financial crisis and the subsequent euro area sovereign debt crisis to painfully bring home to policy-makers the message that credit booms and busts, the health of the financial sector and the way in which it is being supervised are key considerations for sustainable participation in, as well as functioning of, a monetary union.⁸⁹ The drafters of the Maastricht Treaty at least deserve praise for having retained the option of setting up a single banking supervision system in the single currency area.⁹⁰ This allowed the European Council to set in motion in June 2012 the speedy process of creating a Single Supervisory Mechanism. This is not to imply, however, that the EMI was ignorant about financial matters. In fact, a lot of internal work and debate went on regarding this subject. However, it did not find its way into the convergence assessments.

Sixth, since the Treaty convergence criteria essentially focused on macroeconomic policy requirements, the EMI convergence reports also underemphasised the role of structural policies in increasing flexibility and removing the remaining impediments to goods, services, labour and capital markets in the single market with the single currency, and their capacity to boost the growth and employment potential of the euro area, as was the expectation of many prior to the start of the euro. The EMI reports in effect only briefly touched on these matters, faintly echoing some of the economic literature on optimum currency areas. Again, with the benefit of hindsight, perhaps more attention could have been drawn to these aspects in the convergence assessments. It was partly as a result of the EU enlargement, which brought in prospective euro area countries with very different economic structures, and partly as a result of the need to deal with the fallout of the global financial and euro area sovereign debt crises, that the importance of structural policy tools compensating for the absence of monetary and exchange rate policy tools in order to effectively adjust to asymmetric economic shocks inside a monetary union was fully appreciated as a key consideration for the

89 As a consequence, both the ECB and the European Commission 2013 Convergence Reports on Latvia deal with financial sector issues (the ECB does so in the assessment part of price stability and long-term interest rates, the European Commission approaches it in the final section on "additional factors"). Both reports also reflect the outcomes of the Macroeconomic Imbalances Procedure.

90 See Art. 127 (6) TFEU.

sustainability of convergence. Once again, though, this conclusion should not be misread as suggesting that the EMI was oblivious to the importance of structural policy in countries embarking on the common destiny of a sustainable monetary union. It just did not wish to take such a route in its convergence reports.

All in all, the remarkable role played by a small and temporary institution – the EMI – in shaping the thinking on the conditions for sustainable convergence in EMU deserves to be underscored. A considerable part of the praise for this achievement must be attributed to the first EMI President, Baron Alexandre Lamfalussy, and the guidance he provided to the institution.

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THE DESIGN OF THE ECB'S TOOLBOX: FITTING THE EMI BLUEPRINT INTO A DEEPER EMU

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I INTRODUCTION

I am pleased to contribute to the proceedings of the conference that has been organised by the Nationale Bank van België/Banque Nationale de Belgique and the European Central Bank (ECB) for the 20th anniversary of the establishment of the European Monetary Institute (EMI) and in honour of its first President, Alexandre Lamfalussy and the EMI are two names that are inextricably linked together. If I am not mistaken, Alexandre Lamfalussy stated that the three-and-a-half years at the helm of the EMI was one of the most memorable periods in his professional life. The same period was certainly the most important in the development of the EMI, which was established on 1 January 1994 as a temporary Community body in the run-up to the final stage of Economic and Monetary Union (EMU), whose aim was to prepare for the establishment of the ECB and the conduct of the single monetary policy in the euro area from 1 January 1999.

2 THE EMI AS INTERMEDIARY BETWEEN EUROPEAN MONETARY COOPERATION AND MONETARY UNIFICATION

The EMI was a hybrid Community body. It was no longer a committee of central bankers like the Committee of Governors of the central banks of the Member States of the European Community, which had evolved over the 30 years of its existence as the institutional framework for monetary cooperation among the EU central banks and had eventually made an instrumental contribution to the move towards EMU.² Conversely, the EMI was not yet the European Central Bank (ECB). The Delors Report³ had suggested that the European System of Central Banks (ESCB) would be set up at the start of Stage Two of EMU and would ensure a gradual transfer of decision-making power from national monetary authorities to the new Community institution. This approach was in the end not carried out in the subsequent deliberations of the Intergovernmental Conference (IGC) on EMU. It was deemed incompatible with the principle of the indivisibility of monetary policy decisions, which was in particular defended by the German government and the Deutsche Bundesbank. Instead of setting up the ECB at

1 The views of the author are exclusively his personal ones and do not necessarily reflect those of the former EMI and those of the ECB.

2 For an objective assessment of the Committee's activities and achievements, see Baer (1994), James (2012), p. 382, and Scheller (2011).

3 Delors Committee (1989), p. 34.

the start of Stage Two of EMU, the Maastricht Treaty established the EMI as a transitional Community body that absorbed the previously existing institutional arrangements in the monetary field, on the one hand, and needed in particular to make all necessary preparations for the establishment and operational capacity of the Eurosystem at the start of Stage Three of EMU, on the other. However, the EMI had to carry out its duties without prejudice to the monetary policy responsibilities of the competent national authorities until EMU.⁴

What was the main difference between the EMI and its predecessor, the Committee of Governors? At first glance and except for a few differences with respect to institutional and legal features (including its own legal personality), the EMI looked rather similar to the former Committee of Governors with the central bank Governors becoming the members of the EMI Council. The former Committee's sub-committees became the committees of the EMI and played a prominent role in the functioning of the EMI until it went into liquidation following the establishment of the ECB on 1 June 1998. The main difference was the position of a full-time President, who was no longer elected from among the central bank Governors, but was instead appointed by the Heads of State or Government from outside "the existing central banking fraternity".⁵ The appointment of an external President who had to perform a triple function as Chairman of the EMI Council, Chief Officer and external representative of the EMI had been one of the most controversial issues both at the political level and among the central bank Governors and was only finally settled in the late phase of the IGC on EMU in 1991.

The EMI did not start from zero. It had inherited a wealth of knowledge and expertise in central banking from the Committee of Governors. It also inherited from this Committee a remarkable number of common beliefs and shared values, as well as a spirit of cooperation, which had evolved – during the preceding 30 years – among the Governors, as well as in the Committee's sub-committees. Furthermore, as stated by Alexandre Lamfalussy in his recollections, the numerous people involved in central bank cooperation under the aegis of the Committee of Governors, served as "a pool of resources" for the recruitment of staff for the EMI and the ECB.⁶

Yet it was a challenging task for the President to develop the EMI from a platform for cooperation between central banks into a Community body that was able to perform its tasks and functions. Shortly after the signing of the Maastricht Treaty, the Committee of Governors had started preparatory work for the operating features of the forthcoming European System of Central Banks (ESCB),

4 Article 3 of the EMI Statute.

5 James (2012), p. 300.

6 Lamfalussy et al. (2014), p. 141.

but little had been prepared for the EMI's logistical and staffing requirements.⁷ As a newcomer to the new post-Maastricht institutional structure of the EU, the EMI had to assert itself as the competent interlocutor and counterparty in the inter-institutional dialogue with the European institutions (European Council, EU Council and European Commission) and to gain a high public profile in the run-up to the final stage of EMU. The supreme governing body of the EMI, the EMI Council, comprised all EU central bank Governors, including those whose countries had an exemption from participation in EMU. Furthermore, the guidelines that the EMI Council could issue to the national central banks with respect to the conditions to be fulfilled for the performance of the ESCB tasks in Stage Three of EMU were not legally binding for the addressees.⁸ Thus, progress with respect to preparatory work for Stage Three of EMU very much relied on achieving consensus among all stakeholder central banks.

Nevertheless, when in mid-1997 Alexandre Lamfalussy passed his office to his successor, an important share of the EMI's mandate had been achieved. Preparatory work for Stage Three of EMU within the realm of the EMI had progressed well beyond the "conceptual phase" and key messages had been made to the financial industry and the general public, and, last but not least, the EMI had made recommendations with respect to the "changeover scenario". The adoption of this scenario by the European Council in December 1995 gave new impetus to the move to the final stage of EMU and brought about a distinctive change in sentiment vis-à-vis the forthcoming currency, at least in the European financial industry. In mid-1997, the EMI availed itself of highly competent, talented and motivated staff. It had grown from the initial 30 members of the Secretariat of the Committee of Governors, who had followed Alexandre Lamfalussy to the EMI, to more than 400 people. These people formed the initial staff of the future ECB. They were developing, in cooperation with the EMI's constituent central banks and under the auspices of the competent EMI committees, the infrastructure of the current Eurosystem, and were already waiting impatiently to "push the buttons", i.e. to put into practice the toolbox of the ECB.

7 Because of the late ratification of the EU Treaty, the decision on the seat of the EMI and the ECB was taken ten months after the deadline set by the Treaty. Given this late decision, the EMI had not yet availed itself of appropriate premises when it came into being two months later on 1 January 1994. To perform its statutory work from the start, the EMI had therefore to rely provisionally on the logistical infrastructure that had hitherto been provided by the Bank for International Settlements (BIS) in Basel to the Committee of Governors of the central banks of the EU Member States and the European Monetary Cooperation Fund (EMCF). In accordance with these arrangements, the BIS hosted the President and most EMI staff and provided administrative and logistical support such as meeting facilities for the EMI Council and the Committees and Working Groups. It was only in autumn 1994 that the EMI had found and refurbished suitable premises in Frankfurt, allowing it to perform its tasks at its headquarters.

8 Article 15 of the EMI Statute.

3 DESIGNING THE MONETARY POLICY FUNCTION OF THE EUROSISTEM

Pursuant to its mandate,⁹ the European Monetary Institute (EMI) had “to specify the regulatory, organisational and logistical framework necessary for the [European System of Central Banks (ESCB)] to perform its tasks in the Stage Three of EMU”. This framework had to be elaborated “at the latest by 31 December 1996” and was to “be submitted for decision to the ECB at the date of its establishment”.

Specifying “the regulatory, organisational and logistical framework necessary for the ESCB” was the core part of the EMI’s mission to prepare for the move to Stage Three of EMU. It included in particular the preparations for the monetary policy function of the new monetary system, which eventually performed its core tasks under the name of Eurosystem from the start of Stage Three of EMU. Pursuant to the Treaty, the Eurosystem, consisting of the national central banks (NCBs) of the forthcoming single currency area and the European Central Bank (ECB), had the task of defining and implementing the monetary policy of the Community, with the primary objective of maintaining price stability. At the helm of the Eurosystem, the ECB would be responsible and accountable for the proper performance of this task in conformity with the Treaty and its Statute.

The conduct of a single monetary policy in the euro area from the start of Stage Three of EMU was the *raison d’être* of the Eurosystem. With macroeconomic and macro-prudential policy remaining within the realm of Member States, the monetary policy of the ECB would be the sole genuine Community instrument in the economic governance framework designed by the Treaty, and the viability of EMU would crucially hinge on the conduct of an effective and credible monetary policy by the ECB. Furthermore, the task of the EMI was an unprecedented challenge insofar as it had to develop tools for conducting a single monetary policy in an environment that was characterised in particular by a lack of cross-national integration in key financial markets and by the diversity and complexity of local banking structures in the future euro area countries.

Against this background, preparations for the monetary policy function of the Eurosystem ranked high on the agenda of the EMI’s preparatory work. It only accounted for one out of 12 chapters of the extensive master plan of the EMI, which comprised almost 100 “fiches”.¹⁰ Most of the other preparatory work for Stage Three of EMU, in particular the supporting framework for the single monetary policy, which notably comprised the labour-intensive area of statistics and the design and implementation of an adequate market infrastructure for the

9 Article 109f (3) of the Treaty establishing the European Community and Article 4.2 of the Statutes of the European Monetary Institute.

10 Each fiche described the issue or the project, defined the interrelationship with other issues/projects, indicated the EMI business area or the Sub-Committee/Working Group, which was responsible for the performance of the work and the business areas/Sub-Committees/Working Groups which were expected to provide input or which had to be consulted, and set up a timetable for the completion of work and for deliberation in the EMI Council.

euro area (see Section 5 below) had to be synchronised with the preparations for the core function of the Eurosystem.

By the end of 1996, as required by the Treaty, the EMI had elaborated the basic elements of the monetary policy strategy of the ECB and had developed the operational framework under which the Eurosystem would conduct its monetary policy operations in the Stage Three of EMU. Meanwhile 1997 had become obsolete as the first possible date for the start of the Stage Three of EMU (because the required number of EU Member States that were fit for the adoption of the single currency was not met, not because the EMI had not “delivered”). Moreover, in accordance with the conclusions of the Madrid European Council of December 1995, the ECB was not to be established any earlier than June 1998. Nevertheless, the EMI went public with its findings in early 1997.¹¹ This move, which was hesitantly agreed upon by the EMI Council, was primarily intended to satisfy the interests of the counterparties of the future Eurosystem for knowing, at an early stage, the general direction of the EMI’s work on the monetary policy framework and to assist them when planning and preparing for the start of the Stage Three of EMU. However, the EMI’s report also accommodated the interests of the media and academic and parliamentary circles, by containing information on the gist of the monetary policy strategy that the EMI would propose to the ECB once it came into existence in June 1998.

Given the legal and institutional constraints, the EMI’s reports of January and February 1997 understated somewhat the degree of consensus that had already been achieved among its constituent central banks about the future monetary policy framework in the Stage Three of EMU. Despite this, the report gave evidence of all the necessary elements that enabled the ECB to finalise and announce its monetary policy strategy and the operational framework of the Eurosystem in autumn 1998.

4 IN SEARCH OF AN EFFECTIVE MONETARY POLICY STRATEGY FOR THE ECB

The EMI’s preparatory studies started from the basic consideration that the ECB would have to define a strategy. A strategy comprised a set of procedures according to which the ECB would decide how to act in order to achieve the primary objective of price stability in the euro area, to guide the use of its monetary policy instruments and to communicate its monetary policy actions to the public. The adoption and communication of a monetary policy had become standard practice since the beginning of the 1970s when the first central banks (e.g. the Deutsche Bundesbank) had started to fight the worldwide inflationary pressures following the breakdown of the Bretton Woods System by setting intermediate domestic objectives.

In the pursuit of the primary objective, however, the ECB, like all central banks, would face a complex transmission process from policy actions to price

11 EMI (1997a) and (1997b).

developments, which would be characterised by several interlinked transmission channels with long and variable lags. Thus, policy decisions directed at price stability would inevitably have to be both pre-emptive and forward-looking, taking into account all relevant information regarding the prospective evolution of prices and taking appropriate and timely action to ensure that the final objective was achieved.

Furthermore, it was evident that the ECB would be facing particular challenges at the start of Stage Three: first, the ECB would have no track record of its own and therefore had to attach the greatest priority to establishing a high degree of credibility. Second, the transition to Stage Three would constitute a major regime shift. This implied a high degree of uncertainty concerning economic and financial conditions and developments that would prevail in the euro area at the start of Stage Three; they were most difficult to assess in advance, in particular in the light of rapid financial change and innovation, as well as uncertainty as to the initial composition of the euro area.

It would be erroneous to summarise the deliberations within the EMI on the monetary policy of the future ECB as a fierce fight between the proponents of monetary targeting and those who advocated direct inflation targeting, as it was repeatedly reported in the media. The two alternative monetary policy strategies had emerged as the only two possible approaches that would be consistent with the mission of the ECB and the economic environment of the euro area.¹² After a thorough examination of both strategies with respect to effectiveness, central bank independence, medium-term orientation, transparency and accountability, no single strategy emerged as clearly superior to the other. Indeed, the monetary experts concluded that “while pure forms of monetary and direct inflation targeting could be clearly distinguished at a theoretical level, their application in different countries had shown that there existed several variants integrating elements of both strategies and that borderlines between the two strategies were sometimes less distinct than in theory”.

The main factor distinguishing the two strategies was the role played by monetary aggregates. A particular strength of the monetary targeting strategy was that it would clearly indicate the responsibility of the ECB for developments which were both easily observable and under its more direct control and, therefore, could be interpreted by the public in a transparent manner. However, uncertainty concerning the empirical properties of money demand in the euro area in Stage Three was the main argument against a monetary targeting strategy. The possibility of damage to the credibility of the ESCB under a monetary

12 The other three alternatives that were analysed by the EMI were not deemed suitable for the ECB. An exchange rate objective was not considered appropriate since, for an area potentially as large as the euro area, such an approach was deemed inconsistent with the internal goal of price stability. The use of an interest rate as an intermediate target was not considered appropriate given difficulties in identifying the equilibrium real interest rate that would be consistent with price stability. A nominal income target was in particular excluded because nominal income would be difficult to control by the Eurosystem and because it might lead to an indeterminate price/volume division in the short run, thus creating uncertainty about the inflation performance of the economy.

targeting strategy could not be excluded if monetary aggregates were highly volatile at the start of or during Stage Three.

With respect to an inflation targeting procedure, it was argued that it would directly stress the responsibility of the ECB for achieving and maintaining price stability and, if the strategy were credible, would affect public expectations in a favourable way. However, inflation could be less controllable than monetary aggregates in the short run and, to be successful, inflation targeting would require stable relationships between various economic and financial indicators, on the one hand, and future inflation, on the other.

Overall, however, the similarities in the behaviour of central banks that pursued these two strategies were deemed greater than the differences. In the light of these many similarities, in practice, the EMI recommended that elements of both inflation targeting and monetary targeting be combined in a flexible way and sketched out five key elements that were proposed to the ECB as a useful part of its strategy. They were actually largely integrated by the ECB in its monetary policy strategy that was announced in October 1998¹³ and confirmed after an overall evaluation in 2003.¹⁴

First, the announcement of a quantitative definition of price stability: in line with the practice of several central banks in the EU, the monetary experts proposed a range of zero to +2% to be achieved in the medium term. In the context of the overall evaluation of the monetary policy strategy in 2003, the ECB amended this definition to “below, but close to, 2%”.

Second, the ECB should monitor a broad set of economic and financial indicator variables: this was implemented by the ECB as the “two-pillar” framework “as the organising principle for the internal analysis underlying the ECB’s monetary policy deliberations and decisions, as well as for its communication to the financial markets and general public”, i.e. the “economic analysis” and the “monetary analysis”.

Third, among the financial indicators, the ECB should give monetary aggregates a privileged role in its strategy by publicly setting either “targets” or “monitoring ranges” for their growth, assuming that it is possible to characterise a stable long-term link to inflation. Until 2003, for the “monetary pillar” the ECB used to set an annual reference value for monetary growth but it emphasised that this was not an intermediate monetary target, which would imply “mechanistic” policy action in case of short-term deviations of the target variable from the reference value. The annual review of the reference value was given up in the context of the overall evaluation of the monetary policy strategy when the two-pillar approach was slightly amended with a view to providing a cross-check of the indications from the shorter-term economic analysis with those from the longer-term monetary analysis.

13 ECB (1998).

14 ECB (2003).

Fourth, the ECB should, irrespective of the strategy, have at its disposal its own forecasts for inflation and for other general economic developments to assist in its policy decisions. Together with other pieces of information and forms of analysis, the Eurosystem's staff projections play an important role in the economic analysis.

However, the ECB did not follow the fifth recommendation from the EMI. Instead, it made a further step by forgoing any formal targeting at all. Alexandre Lamfalussy, who had been an advocate of a rule-based monetary policy in the 1970s, commented in 2005 that, in the circumstances prevailing at the start of Stage Three of EMU, adopting an "eclectic" monetary policy strategy had been "an act of intellectual and professional honesty", for which the ECB deserved praise, rather than blame.¹⁵ Other commentators still saw it differently. The "eclecticism" of the ECB's monetary policy strategy met with heavy criticism mainly from national authorities, as well as from the IMF, the European Parliament and some academic circles. They more or less bluntly urged the ECB to move to setting annual inflation targets in order to provide a yardstick against which its performance could be measured.¹⁶ However, the ECB has stuck to its "two-pillar" approach. In order to offset a certain lack of "confort intellectuel",¹⁷ the ECB developed and refined its communication policy and deployed strong efforts to improve the statistical and econometrical foundations of its strategy.

Actually, the ECB's strategy proved to be very successful. The ECB gained credibility from the outset from financial markets and the public. It succeeded in firmly anchoring inflationary expectations (as reflected in measures derived from inflation-linked bonds and from surveys)¹⁸ around its quantitative definition of price stability. It thereby also achieved price stability over the medium term in the euro area, even against the backdrop of a sequence of substantial adverse upside price shocks, in particular the increase in oil and international food prices,¹⁹ as well as gaps between measured and publicly perceived inflation.

Adherence to a policy that focused on safely anchoring inflation expectations was also helpful when, in 2008, the ECB had to respond to extraordinary circumstances in a context of unusually high uncertainty and instability in financial markets. Inflation expectations even remained firmly anchored when the ECB had to take measures, which were unprecedented in nature, scope and magnitude and which met with criticism inside and outside the ECB. Conversely, the operational framework of the Eurosystem as designed by the EMI and brought into force by the ECB enabled the continued effective transmission of interest rate decisions to the wider economy, even in times of severe crisis and fragmented euro area financial markets.

15 Lamfalussy (2005), p. 13.

16 For instance, Svensson (2000); Woodford (2006).

17 Lamfalussy (2005), p. 14.

18 Consensus Economics Forecasts and ECB Survey of Professional Forecasters.

19 ECB (2008), p. 48.

5 DEVELOPING THE OPERATIONAL FRAMEWORK OF THE EUROSISTEM

Whereas the ECB's monetary policy strategy could only be finalised when the ECB was established in June 1998, the operational framework of the Eurosystem had in essence been defined when the EMI went public with its reports in early 1997. As a result of the long lead times, early decisions were necessary in order to establish, in good time, a logistical infrastructure that would guarantee consistent and effective implementation of the ECB's monetary policy decisions by the Eurosystem. The task of the EMI was an unprecedented challenge as the logistical infrastructure had to be set up in an environment which was characterised in particular by a lack of cross-national integration in key financial markets, the high share of bank loans in financial intermediation and the diversity and complexity of local banking structures in the future euro area countries.

5.1 GUIDING PRINCIPLES

Preparatory work by the EMI on the operational framework of the Eurosystem was guided by several principles and requirements, which were all interrelated and not necessarily easy to comply with at the same time. First, the operational framework had to comply with the relevant provisions of the Treaty and the ESCB Statutes. Compliance with the primary objective of price stability implied the principle of operational efficiency. In line with this principle, the monetary policy instruments and procedures had to enable the Eurosystem to perform its monetary policy function efficiently. An important element of an efficient operational framework was its capacity to enable monetary policy decisions to feed through as precisely and as quickly as possible to short-term money market rates and from there, via the transmission mechanism, to the real economy.

The Treaty also required the ECB to respect the principle of an open market economy with free competition. Compliance with this principle meant especially that the design of instruments had to be based on market mechanisms and had to provide a level playing field to credit institutions, which had to be given equal access to the Eurosystem facilities, irrespective of size and country of origin. Equal access meant the provision of identical conditions to all credit institutions in the euro area that would fulfil uniform and objective eligibility criteria to become counterparties of the Eurosystem and the harmonisation of NCBs' rules and procedures in dealing with the credit institutions within their jurisdiction.

According to the principle of decentralisation, which is specific to the Eurosystem, the ECB would have recourse to the NCBs to carry out operations "to the extent deemed possible and appropriate" (Article 12 of the ESCB Statute). Such involvement of the NCBs in the execution of the operations decided by the ECB was a way of using the NCBs' operational experience and existing infrastructures. In addition, decentralisation provided a level playing field for the different financial centres in the euro area. At the same time, however, the instruments to be employed had to be harmonised to the extent necessary across countries to ensure a single monetary policy stance across the euro area as well as the equal treatment of counterparties and the avoidance of regulatory arbitrage.

Finally, the system of monetary policy instruments had to ensure that the Governing Council of the ECB was in a position to control the overall stance of monetary policy at all times, in conformity with the decision-making framework of the ESCB. This required the monetary policy decisions of the Governing Council to be implemented to the greatest possible extent in a decentralised manner under the instructions of the Executive Board, but with little margin of discretion for the latter.

In line with these principles and requirements, the Council of the EMI defined a set of monetary policy instruments for application by the Eurosystem at the start of Stage Three. The set of instruments, which still forms the core of the current operational framework of the Eurosystem, was provided in particular for the use of open market operations to signal the stance of monetary policy, to manage the liquidity situation in the market and to steer interest rates in line with the official rates set by the ECB.

The most important open market operations were reverse transactions, which would – in principle – be executed in a decentralised manner, i.e. by the NCBs with a broad set of eligible counterparties. The main refinancing operations (MROs) would be regular liquidity-providing reverse transactions with a weekly frequency and a short maturity.²⁰ These operations would provide the bulk of refinancing to the financial sector and would be executed on the basis of standard tenders. In addition, longer-term refinancing operations (LTROs) with a maturity of three months were intended to provide a limited part of the global refinancing volume.²¹ The fine-tuning operations were aimed at smoothing unwanted interest rate effects of unexpected liquidity fluctuations. Only under exceptional circumstances could fine-tuning operations be executed in a centralised manner by the ECB itself. The standing facilities were aimed in particular at providing and absorbing overnight liquidity, thereby bounding overnight market interest rates within a corridor set by the interest rate on the marginal lending facility, and the interest rate on the deposit facility.

The opportunity to apply minimum reserves was a controversial issue throughout the life of the EMI. However, there was broad consensus that minimum reserves were an indispensable element of the operational framework based on the principle of decentralisation and a broad set of eligible counterparties of the Eurosystem in a bank-based financial system. By creating or enlarging a structural liquidity shortage of the banking system, it would bind the credit institutions closely to the Eurosystem. It would also help the ECB in stabilising money market interest rates and reducing the need for fine-tuning operations.

20 Initially, the maturity was two weeks but was reduced to one week in March 2004.

21 The three-month LTROs replaced the former rediscount facility, under which the Deutsche Bundesbank provided liquidity to German banks for limited amounts at a preferential rate (to compensate for banks' income losses from unremunerated minimum reserves). Most other central banks had already abolished rediscount facilities long before and were not prepared to reintroduce them in the context of the single monetary policy. In order to integrate the LTROs into the ECB's conceptual framework for implementing monetary policy, which focused on the very short-term end of the yield curve, it was eventually agreed that the ECB would act as a "rate taker" in such operations.

The breakthrough came about as it was agreed that minimum reserves would be remunerated at the main refinancing rate and that the system would not be used for the sake of controlling monetary expansion.

5.2 IMPLEMENTATION AND FURTHER DEVELOPMENT

The operational framework as designed by the EMI and eventually put in place by the ECB in 1998 has functioned very well, right from the outset of Stage Three of EMU. The combination of liquidity-providing main refinancing operations together with the averaging mechanism of the minimum reserves allowed the ECB to steer liquidity conditions and short-term interest rates in a smooth fashion. In the pre-crisis environment up to 2007, the volatility of money market interest rates was low and this was in general achieved with very little recourse to fine-tuning operations. Only minor adjustments to operating procedures were needed up to 2007, e.g. to prevent rate change speculation by underbidding and overbidding in the main refinancing operations.

The operational framework also proved to be adequate when in 2008 the ECB had to respond to the financial crisis. In addition to conventional interest rate cuts to historically low levels, the ECB adopted a series of temporary non-standard measures to support financing conditions and credit flows to the euro area economy. Many of the non-standard measures taken under the term “Enhanced Credit Support”, in particular the adoption of the fixed rate full allotment tender procedure for all refinancing operations and the extension of the maturity of liquidity provision with longer-term refinancing operations of up to three years, have exploited the flexibility of the existing operational framework. Actually, these operations meant a departure from the pre-crisis liquidity management of neutral liquidity allotment and increased the intermediation role of the Eurosystem. Despite a spectacular extension of the Eurosystem’s balance sheet and a high level of excess liquidity that peaked at more than EUR 800 billion in March 2012, they did not constitute a basic departure from the initial operational framework of the Eurosystem. They have, to a certain degree, built-in and self-correcting mechanisms, as they phase out automatically. The same applies to the Securities Markets Programme (SMP) and eventually the announcement of Outright Monetary Transactions (OMTs), which stalled speculation against the euro. Indeed, outright purchases were part of the large arsenal of monetary policy instruments that had been offered to the ECB by the EMI, albeit no one in the EMI had ever imagined in which conditions they would have had to be activated.

6 FINANCIAL MARKET INTEGRATION AND FINANCIAL STABILITY

The single monetary policy also acted as a catalyst for financial market integration, albeit with mixed success.

The keen interest of the ECB in financial market integration rests in particular in the consideration that a well-integrated financial system contributes to a smooth and effective transmission of monetary policy throughout the euro area. Furthermore, financial integration was expected to contribute to financial

stability, as it would enhance opportunities for sharing and diversifying risk and would increase the liquidity of financial markets, thereby more than offsetting spillover effects and contagion across borders.

When preparatory work for the conduct of a single monetary policy started in early 1992 just after the signing of the Maastricht Treaty, the prevailing financial market infrastructure was characterised in particular by an almost complete lack of cross-national integration. With the exception of the ecu clearing system, payment relations between EU countries relied exclusively on correspondent banking, which was not deemed sufficient to handle future large-value interbank payments in the euro area and those stemming from the monetary policy operations of the ESCB. An EMU-wide system therefore had to be established in order to enable the impact of monetary policy decisions to be transmitted quickly and efficiently to all participants in the unified money market, which would cover all Member States participating in EMU. In the field of securities settlement systems, there were hardly any safe and efficient mechanisms enabling cross border transfers. International linkages between central securities depositories did not yet cover the whole EU and were not expected to be in place at the start of Stage Three of EMU.

The time and resources required to design and implement any new system were such that preparatory work had to start several years in advance. The decision of the Council of the EMI of March 1995 to establish the TARGET system²² thus occurred just in time to create an indispensable prerequisite for the conduct of a market-based monetary policy from the start of Stage Three of EMU. Furthermore, the EMI had to develop the CCBM²³ that allowed for cross-border use of collateral in Eurosystem monetary policy operations.

The successful realisation of TARGET and of the CCBM by 1 January 1999 was the initial contribution of the ECB to the integration of financial markets in the euro area. Since then, the Eurosystem has acted as a catalyst for enhancing and optimising the financial market infrastructure as a stimulus for progress in financial market integration.²⁴ As a result of this policy, considerable progress in financial integration has been achieved in the euro area since the start of Stage Three of EMU. However, progress achieved in the euro area has varied considerably across market segments. In particular, integration has been more advanced in the areas closer to the single monetary policy. By contrast, progress in banking markets has remained more limited; this applies in particular to the retail banking segment, which has remained highly fragmented. This unsatisfactory outcome has been mainly the result of legal barriers and policy-related obstacles in the multinational set-up of EMU and is generally considered to have aggravated the impact of the financial crisis in the euro area (see below).

For obvious reasons, the EMI's legacy with respect to financial stability has been very limited. The role and function of the ECB in safeguarding financial

22 Trans-European Automated Real-time Gross settlement Express Transfer system.

23 Correspondent Central Banking Model.

24 For details of policy action taken and planned by the ECB, see in particular ECB (2008), p. 108.

stability was the most important controversial issue both at a political level and within the Committee of Governors at the time of the IGC on EMU. With the Maastricht Treaty introducing different institutional set-ups for monetary policy and financial stability,²⁵ it did not even achieve the modest conceptual approach recommended by the Delors Report for the involvement of the Eurosystem in banking supervision. The Delors Report had suggested that “the System would participate in the coordination of banking supervision policies of the supervisory authorities”.²⁶ The draft ESCB statute deliberated by the Committee of Governors initially provided that the ECB might “determine policies and take measures within its competence necessary for the purpose of maintaining the stability of the banking and financial systems”. However, upon the insistence of the Bundesbank, this provision was in the end removed from the draft ESCB statute that the Committee of Governors submitted to the IGC on EMU in 1990.²⁷ The Treaty eventually reduced the role of the Eurosystem in banking supervision to contributing “to the smooth conduct of policies pursued by the competent authorities relating to the prudential supervision of credit institutions and the stability of the financial system” and limited the ECB’s involvement in EU Member States’ macro-prudential policies to an advisory function.²⁸ The Treaty provision,²⁹ which enabled the ECB to perform “specific tasks concerning policies relating to the prudential supervision of credit institutions . . .,” was subject to the proviso that its implementation required a prior unanimous decision by the EU Council. It therefore remained dormant until recently when the financial crisis prompted substantial reforms of the macro-prudential governance framework.

Against this background, the EMI did not deal extensively with this sensitive issue. The task of specifying the scope and the nature of the contribution that the Eurosystem was expected to make to prudential control did not fall within the EMI’s preparatory work for Stage Three of EMU as defined in Article 4.2 of the EMI Statute. Thus, the Eurosystem has essentially contributed to financial stability by overseeing the financial market infrastructures and thereby enhancing the soundness, efficiency and security of payment and settlement systems. By contrast, the ECB’s contributions in the field of macro-prudential policies³⁰ were obviously not followed up sufficiently in the arrangements that were set up at the Union level for cooperation among the EU Member States in 2004.

The financial crisis of 2008 has shed light on the deficiencies of the institutional arrangements for prudential control at the EU level. It failed in crisis prevention and was not conducive to financial market integration in the banking markets. The result was the “famous bank sovereign nexus”³¹ that proved fatal in the emergence of the “euro crisis”. The substantial reforms implemented since 2009,

25 ECB (2008), p. 118.

26 Delors Committee (1989), p. 22.

27 For details of the proceedings of the Committee of Governors, see James (2012), pp. 291 and 313.

28 Article 105(5) of the Treaty establishing the European Community as well as Articles 3.3 and 25.1 of the ESCB Statute.

29 Article 105(6) of the Treaty establishing the European Community and Article 25.2 of the ESCB Statute.

30 ECB (2008), p. 120.

31 Draghi (2014).

in particular the Single Supervisory Mechanism, are expected to improve the conditions for ensuring financial market integration and financial stability in the euro area.

7 CONCLUDING REMARKS

Taking account of the experience gained in the last 15 years, one may conclude that the EMI blueprint of the ECB toolbox did fit with an evolving EMU. The ECB's monetary policy strategy did not initially meet with unanimous recognition everywhere but in practice proved very successful in stabilising inflation expectations in line with the ECB's mandate to ensure price stability in the euro area. The credibility and reputation of the ECB as a central bank that was able "to deliver" also enabled it to react efficiently to the financial crisis by introducing non-standard measures of monetary policy from 2008 onwards. These measures, which were unprecedented in size and nature, helped to restore confidence among market participants and to sustain financial intermediation in the euro area in an environment of unusually high uncertainty and instability in financial markets.

The financial crisis has demonstrated the limits of monetary policy's ability to preserve financial stability. Like other major central banks, the ECB witnessed the fact that monetary policy alone has been unable to break the pattern of cycles of financial boom and bust of increasing amplitude.³² That the financial crisis, which started in the United States, could spill over to such an extent to the euro area and could eventually evolve as a sovereign and finally a "euro crisis" was a specific EMU issue that originated from the asymmetry between its monetary and economic pillars. Intergovernmental cooperation in the field of macroeconomic and macro-prudential policies has proved to be inadequate and ineffective to sustain macroeconomic and financial stability in the single currency area. In the longer run, therefore, the viability of EMU cannot rely exclusively on a single monetary policy as the sole effective instrument in the economic governance framework of the euro area. In 2014, 20 years after the establishment of the EMI and 15 years after the start of the Stage Three of EMU, the history of EMU has reached a turning point. In the wake of the financial crisis, the EU Member States have achieved considerably more progress in strengthening macroeconomic and macro-prudential governance at the Union level although there remains some way to go before achieving a fully institutionalised Union approach in these policy fields.

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THE EVOLUTION OF THE EURO AREA POLICY FRAMEWORK: SOME CONSIDERATIONS

MARCO BUTI

I would like to comment on some points, touched upon by one or more of the papers presented in this session, which I consider to be particularly relevant. The intention is not to comment on ECB policies, but, since it has been 20 years since the establishment of the EMI, I would like to present some general reflections on the issues considered at the time.

The first point to stress is that the key principles and elements underpinning monetary policy strategy and framework for the euro area have stood the test of time. The EMI had to set up a monetary policy framework which was able to meet short-term challenges, such as the build-up of credibility or uncertainty about aggregate euro area behaviour, since (as noted by Hanspeter Scheller) the EMI and subsequently the ECB did not have, by definition, a track record. At the same time (as also indicated by Robert Raymond), monetary policy had to be designed for the longer term, thinking ahead to the steady state.

Overall, the ECB and its monetary policy framework – as set up and inspired by the EMI – have clearly delivered, both in terms of price stability and in terms of credibility. The adherence to its key principles of independence, the primary objective of price stability and the singleness of monetary policy were enshrined in the behaviour of the ECB. At the same time, the system was flexible enough to allow some fine-tuning. The definition of price stability (as also mentioned by Hanspeter Scheller) was adjusted following the 2003 strategy review to “inflation rates below, but close to, 2% over the medium term”. The build-up of credibility allowed the ECB, in the midst of the recent crisis, to adopt unprecedented measures. Its independence and stability orientation remain assets looking to the future.

In setting the monetary policy strategy (as mentioned in two papers by Robert Raymond and Hanspeter Scheller), a two-pillar approach was chosen, based on a monetary and an economic analysis. Hanspeter Scheller quotes Alexandre Lamfalussy, who stated that adopting an “eclectic” monetary policy strategy had been “an act of intellectual and professional honesty”. This is a very inspiring and valid definition. Starting with this hybrid strategy did not go down well in the academic community at the time. It was often criticised as old-fashioned for incorporating the “legacy” of the Deutsche Bundesbank, i.e. focusing on the evolution of monetary aggregates. Most of the academic profession at the time pointed to the economic pillar and strongly criticised the ECB for having a two-pillar approach, advising it to abandon the monetary aspect and to focus solely on the economic analysis by adopting a straightforward inflation targeting approach.

At the time, many economists, including myself, wrote models in which monetary policy behaviour was essentially captured by a simple Taylor rule, with monetary aggregates not playing any role in this modelling. The DSGE models at the time also used very few monetary and financial variables. If one looks at this in retrospect, the two-pillar strategy, in a certain sense, appears more modern and more adapted to challenges raised by the crisis than simple inflation targeting, in which financial and monetary variables do not play any role. Without trying to make an ex post rationalisation, which would not be historically founded, the monetary pillar in the ECB monetary policy framework allowed for considerations of monetary and financial variables which, in the light of the crisis, proved to be very useful.

With respect to the issue of euro area accession and the related framework, which is the topic of the paper by Frank Moss, the initial focus was clearly very much on the macroeconomic side. In a study by the European Commission, that André Sapir and I edited back in 1998 (which was probably the last comprehensive study on the functioning of EMU written on an ex ante basis), we were putting our faith in the euro not only as a single currency but also as a stable currency. Hence, the strong macro focus was linked to the stability of EMU and the stability of the currency. Some crucial dimensions were added later, such as more emphasis on structural policies and on the financial side. It is very clear (as elaborated by Frank Moss) that the criteria for euro area accession were strongly macro-based. There were some considerations on sustainable convergence but at the beginning these were relatively less developed. They were increasingly emphasised in the later years – an evolution reflecting the spirit of the time.

While keeping the convergence criteria intact, the turning point in putting more emphasis on the sustainability issue and on other relevant factors came with the 2004 enlargement of the EU. With the entry of countries that were “catching up”, the interaction of real and nominal convergence came to the fore in a very prominent way. As a result, more emphasis was put on sustainability considerations and on structural reforms, and to a certain extent, more elements from the broader “optimal currency area” approach were indirectly incorporated in the assessment framework, within the boundaries set by the Treaty. The hope at the time, and it was a completely frustrated expectation, was that Member States, once having joined, would spontaneously start internalising the policy requirements of EMU by orienting their domestic policy towards enhancing long-term performance. This is very much emphasised in the Raymond paper.

In 2008, when assessing the first ten years of the EMU, the European Commission report – EMU@10 – talked of an “anaesthetic” effect which took place in the first ten years of the EMU on the structural reform side. Thanks to nominal convergence there was an automatic benefit of lower interest rates which lessened the reform pressure as growth was (artificially) buoyant. The lower interest burden also, de facto, lessened budgetary constraints. Hence, the assumption of enlightened self-interest actually turned out to be naïve. It could be called the “ultima ratio” curse – until one’s back is against the wall one does not normally take the courageous decisions that are needed. That is what we saw at the time. As a result, the overall surveillance framework was recently strengthened with the Macroeconomic Imbalances Procedure and broader and more comprehensive governance.

It is clear from these reasons and considerations that the ECB and its monetary policy does not act in isolation. It therefore needs to be embedded in a consistent governance set-up supported by other policies. Nowadays there is clearly an interplay between monetary and macro-prudential policy. There also remains the more classic interplay between monetary and fiscal policy. The preoccupation in the original EMI construct and conceptual framework was to deal successfully with the risk of fiscal dominance. The intention was to build the euro area policy mix on the premise of monetary dominance in a Stackelberg framework, with no explicit ex ante coordination, but rather with the ECB as an independent actor taking into account the decision of fiscal authorities in setting the monetary stance. This implied that a sound and prudent fiscal stance would facilitate the job of monetary policy and enable the ECB to minimise its loss function while maintaining price stability.

Sargent and Wallace, in their famous 1981 paper entitled “Some unpleasant monetarist arithmetic”, show that if the fiscal authority decides to run deficits in a system where fiscal policy dominates over monetary policy, the central bank has to eventually give in and monetise the debt. In order to avoid this outcome, fiscal discipline has to apply. Two stylised approaches can be considered. Under the first approach, the fiscal authority only lets automatic stabilisers work, which should provide a sufficient degree of fiscal stabilisation. The second, more controversial approach is to allow for the possibility of discretionary fiscal policy. Recent experience suggests that in certain (crisis) circumstances a more active approach to fiscal policy may be required, which was the consideration underlying the 2009 EU recovery plan.

Beside the monetary-fiscal mix, there is the important issue of the interplay between the ECB and fiscal authorities more generally. At the time of the EMI and in the early days of the EMU, the debate focused on two stylised approaches. According to the first one, fiscal authorities had to be weak in order to ensure monetary dominance. Hence, the strength of the ECB was to be based on the dispersion of fiscal authorities. The second view suggested that a more cohesive and coordinated behaviour of fiscal authorities among themselves would actually mean the ECB was shielded from “populist” sentiment, especially in bad times, while also providing a more stable and more effective interlocutor. By and large, the first view was held by Otmar Issing and the second by Tomaso Padoa-Schioppa.

While the “newness” of the ECB and fear of political interference naturally urged the first view, having gone through the crisis, the experience arguably speaks in favour of the second view, notably in crisis times. If one also looks at the evolution of the Eurogroup, developments have gone in this direction, with a strong President, more formalised procedures and stronger coordination (this morning you heard from Thomas Wieser, who is the permanent chair of the Euro Working Group). Having a less fragmented interplay between monetary and fiscal authorities has proved to be extremely helpful during the crisis and it is the way forward.

III FROM THE EMI TO EMU AND BEYOND

PRESENTATION OF THE BOOK

“ALEXANDRE LAMFALUSSY: THE WISE MAN OF THE EURO. A CONVERSATION WITH CHRISTOPHE LAMFALUSSY, IVO MAES AND SABINE PÉTERS”.

JACQUES DE LAROSIÈRE

It is a privilege and a great pleasure for me to present to you this afternoon the book: “Alexandre Lamfalussy, the Wise Man of the Euro”.

This book has been written by three authors: Sabine Péters, Doctor in History and Civilisation at the European University Institute in Florence, Professor Ivo Maes, a senior advisor in the Research Department at the Nationale Bank van België/Banque Nationale de Belgique, and, last but not least, Christophe Lamfalussy, a journalist with *La Libre Belgique* and the oldest son of Alexandre Lamfalussy.

This is a book of conversations that cover his whole life; it actually documents eighteen conversations of an hour and a half each. Alexandre Lamfalussy read over the manuscript very carefully and provided a number of clarifications.

Alexandre Lamfalussy is one of the most important figures in international finance today. Indeed, as a central banker he has had a major impact on Europe’s monetary history. A committed European from the start, he employed all of his intelligence and energy to further this cause.

In parallel, Alexandre Lamfalussy pursued a career as a professional economist. Having gained a DPhil in Economics from Oxford University, he went on to teach at the Catholic University of Louvain and at Yale. He has published a large number of books and articles that are regarded as authoritative in the fields of financial stability, globalisation and its impact on the weakening of the system, as well as on the imperfections of the international monetary system.

Moreover – and this is also what sets him apart – Alexandre Lamfalussy was a practising banker: he spent 20 years at the Banque de Bruxelles, where he became Chairman of the Executive Board in 1971. These years in banking gave him an intimate and practical knowledge of markets and risks.

It was in 1976 that he entered the world of central bankers that he would never leave. He was called on by the Bank for International Settlements (BIS) to take up the key post of Economic Adviser. He was then the institution’s General Manager from 1986 to 1994. During the 18 years he spent at the BIS, Alexandre Lamfalussy was at the heart of all of the major discussions in the economic and financial sphere: the deregulation of the exchange rate system,

the international credit boom, the effects of financial innovation and the efforts undertaken by Europe to create a zone of monetary stability. On all of these subjects, Alexandre Lamfalussy expressed himself with lucidity, and often adopted controversial positions. In the light of subsequent events, we are compelled to acknowledge that his assessments were generally correct and far-sighted.

Having taken part in the work of the Delors Committee on Monetary Union, he became the first President of the European Monetary Institute, holding the post between 1994 and 1997. He consequently played a fundamental role in the creation of the European Central Bank (ECB). Prior to the ECB's establishment, the national central banks had to be prepared for the unification of monetary policy with all that it entailed in terms of IT systems, the harmonisation of settlement systems and human cooperation between teams of experts who did not know one another, and so on. This meticulous preparation meant that the ECB was able to start operating without any hitches.

In 2000 the European Council called on Alexandre Lamfalussy, as the Chairman of a "Committee of Wise Men", to make proposals to improve and better coordinate the mechanisms governing decision-making with respect to regulation in Europe. The Committee's proposals – which set out four levels of procedure from the directive through to the technical documents – were adopted in 2003 and helped to bring some order to what had in fact been a regulatory jungle.

But what I have just referred to, while useful to recall in this presentation, is inevitably a little dry and technical. "Where is Lamfalussy the man? Who is he?" People will ask me. The memories presented here in the form of dialogues answer these questions admirably.

Memoirs are a dangerous genre; more often than not they provoke antipathy rather than sympathy in the reader. And the reason for this is the pose the writer attempts to adopt.

Here there is no pose – just straightforward candour. The book covers the whole of Alexandre Lamfalussy's life from his earliest childhood up to the present day. His answers are considered, direct and modest, just like himself. We are taken back to his past in Hungary which has never entirely left this man who had the courage to emigrate clandestinely in 1949, at the age of 19, in order to escape the Soviet hold on hearts and minds.

So it was as a free young man that he arrived in Belgium just after the war. This simple and beautiful account reads like a novel. He had no money but was talented, intelligent and hungry for work. Belgium welcomed Lamfalussy, gave him many opportunities and never regarded him as a foreigner. He was definitively assimilated into Belgian society, where he had an exceptional career and a happy family life.

The different stages of this life are recounted with great freshness and without a trace of pretension. The result is that instead of reading a technical and dull account we are plunged into the narrative of a "real" life that takes the reader

on an adventure, full of twists and turns in which the characters mentioned are conjured up with a few brushstrokes and where there is often humour.

I recommend the reading of this account not only to those who are interested in international finance, but to anyone who is interested in a human story, to anyone who reflects on what the “righteous” can do to welcome in the “Other”, and to anyone who sometimes gives up the hope that another life is possible even for the most disadvantaged.

I would like to add the following to my presentation since these elements are not emphasised in the book on account of the author’s modesty.

Like all of us, Alexandre Lamfalussy sometimes made mistakes. But on the absolutely crucial issues his assessments were correct and he was the first to alert the community of decision-makers. I will provide three examples:

- In the 1970s he criticised the accumulation of debt, particularly in Latin America, and proposed international regulation to avoid excessive indebtedness (he was not listened to and a very serious crisis broke out in 1982).
- In the same vein, in 1979 he recommended a system of prudential supervision to prevent credit bubbles from forming, also without success. 30 years ahead of his time, Alexandre Lamfalussy invented the concept – now in vogue – of macro-prudential supervision of the financial system as a whole.
- He was one of the very first to be wary of the markets and financial innovation, whose dangers he could see. This former banker knew that the markets do not systematically regulate themselves and that financial integration is far from being a source of stability, given that it exposes cross-border institutions to increased risk.

IMPROVING EUROPEAN GOVERNANCE: TOWARDS AN ECONOMIC AND FISCAL FEDERATION BY EXCEPTION

JEAN-CLAUDE TRICHET

It is for me an immense pleasure to celebrate, here in Brussels, both the 20th anniversary of the European Monetary Institute and the lifetime achievements of Alexandre Lamfalussy. On a great number of occasions I had the honour of presenting Alexandre, in particular when I was President of the European Central Bank (ECB). I always said that Alexandre's life was a poignant illustration of the history of Europe since the trauma of the Second World War. His dedication to liberty led him to cross the Iron Curtain from Hungary to Belgium at a time when it needed audacity, personal courage and vision. His dedication to excellence led him to study at the Université de Louvain and at Nuffield College in Oxford. His passion for Europe and for European unity made him an activist for European reunification. As the first President of the European Monetary Institute (EMI), he was and is the founding father of the ECB.

I trust that, for the young man who, with immense sadness left his own country, which was under the iron rule of communism, chairing the EMI on 1 January 1994, with the extraordinary satisfaction of doing so after the fall of the Iron Curtain, would have been much more than a dream come true; it must have been an immense joy and he must have had the feeling of having accomplished a life's mission.

Dear Alexandre, consider the following presentation as a meditation on your own lessons, as I understood it since I had the privilege of working with you closely.

Since mid-2007 the advanced economies have experienced extraordinarily demanding and difficult times. We have experienced a succession of shocks that have not been seen in the industrialised countries since the Second World War. I remain convinced that the events that unfolded after the Lehman Brothers incident were potentially even more critical than those which triggered the 1929-1930 crisis. Had the central banks and the public authorities not embarked immediately on prompt and decisive action, I believe that we would have experienced not only a great recession but a very deep and rapidly unfolding great depression.

It is in this context of the gravest crisis of the advanced economies since the Second World War that I would like to concentrate on the European issues, and, more particularly, on the euro area issues.

When people seek a justification for European integration, there is a tendency to look backwards. It is always stressed in particular that European integration has banished the spectre of war from our continent. European integration has

indeed delivered the longest period of peace and prosperity in European history. This perspective is entirely correct, but it is also incomplete. There are many more reasons for striving towards “ever closer union” in Europe today than there were in 1945. And these are entirely forward-looking. The distribution of global GDP 68 years ago was such that Europe had only one role model for its single market: the United States of America. Today, Europe is faced with a new global economy, reconfigured by globalisation and by the emerging economies of Asia and Latin America.

It is a world where economies of scale and networks of innovation matter more than ever. By 2016 – that is, tomorrow – we can expect euro area GDP, in terms of purchasing power parity, to be below that of China while still being over and above the GDP of India. Together, these two countries will represent around twice the GDP of the euro area. Over a longer horizon, the entire GDP of the G7 countries will be dwarfed by the rapid development of the systemic emerging economies. Europe has to cope with a new geopolitical landscape, which is being very profoundly reshaped by these emerging economies.

Europe is also faced with new global challenges, such as climate change and migration, where effective solutions are possible only at the European and international levels. In this new global constellation, European integration – both economic and political – is central to achieving prosperity, stability and influence. The challenge is to set the correct path of European integration. Getting this right is essential in order to fully realise our continent’s tremendous potential. Let me therefore lay out some ideas for the Europe of tomorrow.

The creation of Europe’s economic and monetary union, in which Alexandre Lamfalussy played such a decisive role, is unique in the history of sovereign states. The euro area constitutes a “society of states” of a completely new type. We have progressively created a concept which goes far beyond the Westphalian concept of sovereign states. Like individuals in a society, euro area countries are both independent and interdependent. They can affect each other both positively and negatively. Good governance requires that both individual Member States and the institutions of the EU fulfill their responsibilities.

We have observed the functioning of the euro area for 15 years. As all advanced economies, we have experienced the shock of the crisis over the last five years. It is time now to draw lessons from these first years.

The acronym EMU – Economic and Monetary Union – is made of three letters E, M and U which means that we must have, and have indeed, two unions: a monetary union and an economic union. I will next assess how both the monetary and economic unions have performed.

I ACHIEVEMENTS OF THE MONETARY UNION

I will not expand too much on the successes of the monetary union. Let me only mention the following elements:

- First, the new currency, starting from scratch, has maintained price stability for an entire continent of 18 countries today and for 335 million people since 1 January. The average yearly inflation over the first 15 years has been around 2.03%.
- Second, savers and market participants trust the euro to keep its domestic value in the future. Taking into account risk premia, the inflation expectations that one can draw from the financial markets are around 1.9% to 2.0% for the next ten years, in line with the ECB's definition of price stability.
- Third, the track record of price stability and the anticipation of future price stability are not only in line with the mandate received by the ECB and the Eurosystem from the European democracies, but are also better than what had been experienced in Europe before the euro. For example, the Deutsche Bundesbank, exemplary in its capacity for ensuring price stability, displayed average yearly inflation of around 2.9% from 1955 to 1999.
- Fourth, this level of stability and of credibility has been attained despite several oil and commodity shocks and the impact of the worst crisis in the advanced economies since the Second World War.
- Fifth, this level of stability was not attained to the detriment of job creation at the level of the euro area as a whole. From the establishment of the euro on 1 January 1999 until the third quarter of 2013, the euro area created around 13 million new jobs (net) compared to the same amount of new jobs in the United States during the same period. This is certainly not to say that there is not a big and acute unemployment issue in Europe; we have a lot of hard work to do, particularly in showing great determination to eliminate youth unemployment, which is a disgrace, as well as all structural obstacles to growth and job creation. Moreover, in the United States an episode of very active job creation took place in the 1990s. Nevertheless, this little known comparison shows that, over a period of around 15 years, there has been no obvious inferiority on this side of the Atlantic; all large advanced economies have to dramatically improve their employment situation.

The achievements of the currency and the success of the euro itself – which has kept its credibility during the worst financial crisis of the advanced economies since the Second World War – make it difficult to understand why Europe has been, since 2010, at the epicentre of the present crisis of the advanced economies. This phenomenon started when the financial crisis – the epicentre of which was in the United States (sub-prime loans, the Lehman Brothers bankruptcy) – morphed into a sovereign risk crisis. To understand that, one has to concentrate on the weaknesses of the economic union.

2 WEAKNESSES OF THE ECONOMIC UNION

It is not the euro area as a whole, on a consolidated basis, that presents major weaknesses; the current account of the euro area is in surplus, the public debt outstanding as a proportion of GDP is well below that of Japan, and the annual public finance deficit is below the equivalent figures for the United States, Japan and the United Kingdom. Nevertheless, several factors, in particular the absence of effective surveillance inside the euro area, have led to large differences between countries with regard to fiscal soundness, competitiveness and, therefore, the creditworthiness of the countries' signatures. This explains why some countries were considered by investors and savers as vulnerable.

The weaknesses of the euro area's economic governance can be summed up in six points:

- First, the Stability and Growth Pact (SGP) that was designed to ensure sound fiscal policies in the euro area has not been correctly implemented. Furthermore, in 2003 and 2004 major countries, namely France, Italy and Germany, engaged in a dramatic move to weaken the Pact. The defensive measures taken by the Commission, the ECB and the small and medium-sized countries helped prevent the dismantling of the “letter” of the Pact. However, the “spirit” of the Pact has been critically damaged.
- Second, from the outset the governance of the euro area did not include any serious monitoring or surveillance of competitiveness indicators, of nominal evolutions of prices and costs in any particular country or of national external imbalances within the euro area.

A single currency area is, by construction, a single “nominal currency” area. The main challenge of any such area is to remain, over time, close to a single “real currency” area through a close monitoring of possible excessive deviations of national competitiveness. On behalf of the Governing Council, in 2005, long before the crisis, I called for the appropriate surveillance of a number of national competitiveness indicators associated with national current account imbalances, including the evolution of unit labour costs.

- Third, the high correlation between the creditworthiness of the commercial banks of a particular country and the creditworthiness of the signature of the sovereign creates an additional vulnerability, which is particularly damaging within the euro area, and calls for an effective banking union at the level of the euro area as a whole.
- Fourth, no crisis management tools were envisaged at the start of the euro. This might appear to be a serious initial mistake with the benefit of hindsight. Yet one has to recognise in this respect that “benign neglect” of possible acute crisis challenges was generalised at the global level when the euro was conceived. This was particularly the case in the advanced economies.

- Fifth, another weakness of the euro area has been the unsatisfactory completion of the single market in the domain of goods and, more particularly, services. This weakness of the single market comprising all 28 European Union countries is particularly felt in the euro area where it hampers the appropriate functioning of competition, an essential channel through which the economies concerned can achieve a commensurate and timely adjustment.
- And sixth, the slow and hesitant implementation of the structural reforms foreseen in the Lisbon agenda and in the 2020 programme, which were, and are, committed to by all the Member States of the European Union, is equally proving to be a very significant hindrance to the smooth functioning of the euro area.

Now let us look at what has been done up to now to correct these weaknesses and what is presently envisaged in the medium term by the European institutions.

First, I would like to stress the fact that, contrary to common belief, Europeans have been decisive and bold in designing new tools, imagining new concepts and working out new rules. These new decisions have been adopted precisely to cope with the weaknesses I have just mentioned. Furthermore, the European institutions are currently envisaging a number of promising avenues for the medium-term future. In order to have an idea of the creativity of the European institutions, I would recommend reading in particular two documents: the document entitled “A blueprint for a deep and genuine economic and monetary union. Launching a European debate”, published by the Commission on 30 November 2012; and the document published by Mario Draghi and the three Presidents of the European Council, the European Commission and the Eurogroup and reported to the European Council under the heading: “Towards a genuine economic and monetary union”.

The decisions already taken undoubtedly represent an important step in the right direction and address, with varying degrees of effort, all six weaknesses mentioned here. The “European Semester” and the so-called “six-pack” and “two-pack” are coping with the first two weaknesses: they very significantly reinforce the SGP, and give the Commission more clout in case the governments are inclined, as has been the case in the past, to be too lenient vis-à-vis loose fiscal policies. The same set of secondary legislation introduces a new framework for surveillance: the Macroeconomic Imbalance Procedure (MIP), which is designed to correct the second major weakness, namely the lack of surveillance of competitiveness developments and ensuing macroeconomic imbalances. The “Treaty on Stability, Coordination and Governance” (TSCG) significantly reinforces the effectiveness of the SGP by introducing its budget rules in national legislation. This new Treaty signed on 2 March 2012 by 25 EU Member States (all except the United Kingdom and the Czech Republic) is usually called the “fiscal compact”. It also sets out criteria for the reinforced surveillance of economic policies. A remarkable feature of the Treaty is that the euro area countries will support the Commissions’ proposals or recommendations if a euro area country is in breach of the deficit criterion, unless a qualified majority of Member States then opposes it. This reverse qualified majority voting (RQMV) is one of the major advances of the new Treaty.

Important decisions were made at the end of 2012 and during 2013 to deal with the third weakness, namely the absence of a banking union in the euro area. A Single Supervisory Mechanism (SSM), where the ECB plays a key role, has been created. From November 2014, every bank in the euro area will be part of the same system. This will permit supervisors to help prevent the boom-bust cycles caused by excessive cross-border lending. The European Single Supervisory Mechanism will involve centralised and decentralised elements. For the large, significant banks (around 130), the ECB will be the direct supervisor, while supervision will operationally take place at both the European and national levels. For less significant and smaller banks, the system will be decentralised, but will have a single supervisory model, which is currently being developed, and for all banks there will be a single rule book.

As regards the Bank Recovery and Resolution Directive, a political agreement was reached between the European Parliament, the EU Member States and the Commission on 12 December 2013, enabling the European legislation to be finalised.

As regards the Single Resolution Mechanism (SRM), there was a political agreement between governments on 18 December 2013, but the final decision has not yet been taken. The SRM will consist of a Single Resolution Board and a Single Resolution Fund. Its aim is to ensure the orderly resolution of failing financial institutions with minimal impact on the taxpayer and on the real economy. The Single Resolution Fund will enter into force on 1 January 2015. These decisions in principle will have to be very closely monitored to be sure that they are fully operational. As in many domains the devil lies in the details and it is necessary to be very vigilant to ensure that the decision-making process is fully operational, swift and credible. We are still only halfway there in respect of the banking union; it is crucial that a solution is found as soon as possible by the Parliament, the Council and the Commission.

As regards, the fourth weakness, namely the absence of crisis management tools, the European Stability Mechanism (ESM) has gradually been set up. It is, in my opinion, too modest in size and its management is too complicated because of its intergovernmental nature. It is nevertheless remarkable that the 17 European governments of the euro area were able to agree on a crisis tool that was not in line with the very strict interpretation given to the “no-bailout” clause by some of them (which goes beyond the legal Treaty requirements).

Several ways have also been imagined to improve the situation with regard to the fifth and sixth weaknesses, namely the non-completion of the single market and the insufficient implementation of structural reforms. For instance, Article 11 of the TSCG calls for systematic ex ante coordination of major economic policy reforms. One of the most imaginative possible instruments to be used to further structural reforms is the Convergence and Competitiveness Instrument (CCI) which would encompass contractual arrangements negotiated between a particular country and EU institutions and would be underpinned by financial support. This instrument would be activated in close connection with the MIP so as to foster the implementation of the corrective action plan. There is also an explicit recognition that the completion of the single market is essential in the present circumstances.

To sum up, what has been decided already – which has to be implemented as actively, comprehensively and swiftly as possible – is significant and a testament to the European reaction to the crisis. I have described above eight operational frameworks of diverse nature: the European Semester, the SGP, the MIP, the TSCG, the ESM, RQMG, the SSM and the CCI. Aside from the Stability and Growth Pact, seven of these eight frameworks are new and are the direct consequence of lessons learnt in the crisis.

That being said, all this is not sufficient. More has to be done in the medium term as has been recognised by the European institutions. Most of what remains to be done would call for Treaty changes (as, incidentally, has been the case for the ESM and the TSCG).

The ideas that are currently being suggested for the medium and long term by academics and by the European institutions – what Herman Van Rompuy calls “Stage Three” or what the President of the Commission refers to as “the medium term” and “the longer term” vision – could imply movement in three possible directions:

- First, embarking on a financial route, which would involve new euro area sovereign instruments, whether euro bonds with various functions (including the financing of a possible redemption fund), or euro bills (with the aim of stabilising short-term volatile government debt markets);
- Second, introducing a kind of embryonic federal budget. This could be done by creating a “shock absorption” function at the central level, which could be the equivalent of an insurance mechanism against asymmetric shocks (either through a pure macroeconomic approach or an approach based on cyclically sensitive expenditure such as unemployment insurance). This concept should avoid net transfers in favour of any one country over the economic cycle in order to ensure that it is a shock-absorption rather than a transfer mechanism. Another approach would be to give the euro area some specific fiscal responsibilities, with a dedicated budget and its own resources;
- And, third, reinforcing the democratic legitimacy and accountability of the European institutional framework. Several ideas are being floated in this direction, of which two deserve particular attention. The first is a new concept of very close cooperation between national parliaments and the European Parliament, explicitly mentioned in Article 13 of the TSCG: a “conference of representatives of the relevant committees of the European Parliament and of the national parliaments”. Secondly, new responsibilities could also be given to the European Parliament itself, particularly as regards the possible new “embryonic” federal budget. This would imply forming a particular sub-division of the European Parliament, restricted to the MPs that are members of the euro area countries. The legal difficulties associated with venturing down such an avenue should not be underestimated and it would call for important Treaty changes.

All these avenues are interesting and are worth exploring. What is particularly important, in my view, is that whatever new concept is envisaged, it should be designed with maximum clarity, so as to allow the assessment of its technical, economic and political feasibility.

3 THE ACTIVATION OF A POSSIBLE ECONOMIC AND FISCAL FEDERATION OF A NEW TYPE

As I found myself looking for possible significant additional advances in the direction of an “economic and fiscal federation” I wondered what kind of concept or process could meet the following four requirements?

1. Being bold enough and sufficiently powerful symbolically to suggest a great step forward – I already mentioned previously that the euro area needs to take a “quantum leap” towards truly achieving economic governance and towards an economic and fiscal federation. In exceptional circumstances, this would imply giving the various European institutions the kind of responsibilities they would have in a fully fledged economic and fiscal federation and checking their capacity to effectively meet their possible new responsibilities and new powers;
2. Being fully democratic and therefore giving the last word, as regards the decision, to the direct representatives of the European people, namely the European Parliament, within a framework of close liaison with the national parliament concerned.
3. Meeting the subsidiarity principle, i.e. being activated only in cases where it would be absolutely necessary for the sake of the euro area and for Europe as a whole;
4. And, last but not least, being effective in making sure that the kind of economic and financial destabilisation experienced during recent years would be prevented in a convincing way.

I think that there is a new concept that could possibly meet these four requirements. It would be based on the two present surveillance frameworks mentioned earlier: the SGP and the MIP. In the present secondary legislation, a country that behaves in an extraordinarily improper manner and consequently puts at risk the stability of the euro area as a whole must face sanctions in the form of fines representing a certain percentage of the country’s GDP. Experience has demonstrated that these possible fines are not effective. A country behaving very improperly does not seem to be deterred by fines, which would only add to the financial difficulties of its own making. This is the reason why I would suggest replacing the fines with an entirely new decision-making process.

This new process would be activated only when a particular economy appears to be unwilling to take or incapable of taking the fiscal and economic – including structural – measures required to avoid the destabilisation of that country and

consequently of the euro area as a whole. It would be activated either by the country concerned if it challenges the pertinence of the recommendations received from the Commission and the Council, or by the Commission and the Council in the event that the country refuses to act. Once this process is activated, the required decisions would be taken at the centre – by the European institutions – and not by the country itself. The Commission – in this case acting as a federal government – would propose the appropriate measures (i.e. a 3% increase in VAT, freezing categories of fiscal expenditure, etc.). The Council – acting as the equivalent of an upper chamber – would examine the proposed decision and make its own judgment. The European Parliament – acting as the lower chamber with its MPs elected directly by the citizens of Europe – would have the last word and would democratically decide on the proposed measures, after having engaged in appropriate and close dialogue with the national parliament concerned.

I would call this decision-making process – limited to absolutely exceptional cases and activated either by the country concerned or by the Commission and the Council – “the activation of an economic and fiscal federation by exception”.

4 THE DEMOCRATIC ANCHORING OF AN ECONOMIC AND FISCAL FEDERATION BY EXCEPTION IN THE EURO AREA

This decision-making process would meet the four criteria previously mentioned: it would be bold, effective, would meet the subsidiarity principle and would be democratic. The fact that the country concerned could challenge the wisdom of the Commission and the Council and appeal to the European Parliament reinforces the subsidiarity principle. Yet the main feature from the standpoint of our democracies is precisely its democratic anchoring.

The fact that sharing a single currency also means accepting limitations to fiscal sovereignty is not new. The limitation of fiscal sovereignty in exceptional cases was already included in the Maastricht Treaty: the SGP foresees the possibility of imposing sanctions – in the form of fines, including very significant ones – if a government, or a parliament, or both, do not meet the SGP provisions and do not respect the Commission and Council recommendations. The new concept I suggest draws its consequences from the fact that the fines have proved largely ineffective as a deterrent and as a practical method.

The most important element of the new proposed concept is its democratic anchoring. One has to be sure that the activation of the “federation by exception” is subject to a fully democratic decision-making process, and that democratic accountability is indisputable. This is the reason why the European Parliament should be called to play a fundamental role in the decision, on top of the role played by the Commission and the Council. More precisely, for the decisions to be effective, the European Parliament would have to approve, by a majority vote, the measures proposed by the Commission and approved by the Council. For as long as the euro area does not coincide with the European Union as a whole, only the Members of Parliament elected in the euro area member countries would be allowed to vote.

In my view, it would be necessary to organise the dialogue between the European Parliament and the national parliament of the country concerned in the best possible way. In these exceptional circumstances, where the stability and the prosperity of the euro area as a whole are at stake, the national parliament should have the possibility of explaining why it is unable or unwilling to implement the recommendations proposed. Similarly, the European Parliament should be able to explain why the stability and the prosperity of the euro area as a whole are at stake. In so doing, a deep and appropriate dialogue between the two parliamentary institutions concerned would be established before the decision of the European Parliament.

The legitimacy of the participation of all Members of the European Parliament elected in euro area countries seems to me very strong. It would indeed be their own electorates' stability and prosperity which would be put at risk in such exceptional circumstances, when one particular economy behaves dangerously.

This decision-making process would be fully in line with the concept of subsidiarity which has been applied since the introduction of the SGP. As long as the policy which is pursued is in line with the framework, or is being redressed according to the recommendations of the Commission and the Council, there is naturally no need for any new action. A country that is not only failing to respect the framework, but also not applying the recommendations received from the Commission and the Council could appeal to the European Parliament for an ultimate decision if it judges that the recommendations are inappropriate and/or inapplicable. In any case, whether at the request of the country or of the Commission and Council, the final decision would be taken by the European Parliament. It would only be when the policy pursued is threatening to contradict the rules so gravely that it places the stability of the whole in jeopardy that the procedure leading to possible sanctions would be activated.

The euro area has learned the hard way that the level of interconnectedness between economies inside a single currency area is such that even an economy of a modest size can significantly affect the euro area as a whole. This is precisely where the limit of the subsidiarity principle is drawn.

In a short to medium-term perspective, the concept of the “activation of an economic and fiscal federation by exception” might appear bold indeed. In a longer-term perspective, it might seem to be a more natural decision-making process that is better adapted to the kind of “deeper union” that Europe can envisage.

Taking into account the very nature of Europe – the fact that our nations have deep and ancient historical, social and political roots – it is likely that European countries will remain profoundly attached to the subsidiarity principle in the long run. So, even in a long-term historical perspective, it is possible that it will not appear appropriate for the future European federation to go much further than this “activation by exception” of economic and fiscal federal governance. The scope of intervention and the measures taken by the federal institutions would thus rely, even in the much longer term, on the principle of “as little as possible in normal times, but as much as necessary in exceptional times”.

5 CONCLUDING REMARKS

These are new ideas which might be worth examining. I suggested in 2011, on the occasion of the Karlspreis Speech, the establishment of a Ministry of Finance and the appointment of a Minister of Finance for the euro area. This Ministry would have the responsibility for activating the economic and fiscal federation by exception when and where necessary. It would be responsible for the handling of the crisis management tools, such as the ESM. It would also be responsible for handling the banking union within the limits of the executive branch responsibility. And it would represent the euro area in international institutions and informal groupings, such as the G7, G8, G20, etc. The minister in charge would be a member of the future executive branch of the European Union, together with the other ministers responsible for other possible federal departments.

In this perspective, the Commission would appear naturally to be the forerunner of the future European democratic government. As I said earlier, the Council appears to be the forerunner of the future European upper chamber. And we already have the lower chamber, elected by all fellow European citizens.

I am aware of the boldness of some of the ideas presented here, but I really think that it is necessary for Europeans to draw all the lessons from the past and from present events as resolutely as possible.

Jean Monnet once said: “People only accept change when they are faced with necessity, and only recognise necessity when a crisis is upon them”. I strongly believe that this is true of all advanced economies, through very different modalities, not only in Europe and in the euro area. I also trust that, more than ever, the right and appropriate communication and tireless explanations to our fellow citizens will be decisive in achieving support from all our democracies for the necessary reforms.

Allow me a final word. I stressed at the beginning of my presentation the remarkable resilience of the currency of our monetary union, the euro, in the worst crisis faced by the advanced economies since the Second World War. At the same time, I pointed out that the euro area – as an economic union – became the epicentre of the global crisis in 2010. Still, I would like also to comment upon the resilience of the euro area itself. In these dramatic circumstances all our European democracies have decided to preserve the integrity of the euro area. When Lehman Brothers collapsed, there were 15 countries in the euro area. Today there are 18 of us. Three more countries joined – Slovakia, Estonia and Latvia – during this terrible crisis. I will take this resilience as an illustration of the underlying strength of the historical process of creating a union which is ongoing in Europe.

I will apply to the present situation the lessons we learned from Alexandre Lamfalussy, when he was at the helm of the EMI. This is no time for complacency. The road towards European unity is a long-term, demanding and inspiring historical process for which history offers no model. The future of our continent, its stability and its prosperity depend on our resolve and on our imagination today.

FINANCIAL INTEGRATION AND BANKING UNION

MARIO DRAGHI

It is a pleasure to speak today at this conference marking the 20th anniversary of the establishment of the European Monetary Institute (EMI), and in particular to be part of this session that recognises and celebrates the contribution of Alexandre Lamfalussy.

The discussion today has naturally focused on the EMI, the euro and monetary policy, but I would like to take this opportunity to reflect on another issue which is vital for the single currency, and to which Alexandre has made an immense contribution – that is, financial integration.

Financial integration and the single currency are in many ways two sides of the same coin. One fundamental reason for the single currency was to maximise the benefits of the single market for capital. And, conversely, it was understood when the euro was conceived that integrated financial markets would be necessary for an effective single currency.¹

Alexandre's experience in academia, the private sector and central banking put him in a unique position to contribute to this process. He contributed intellectually, for example through his leadership of the SUERF² network set up to promote discussion of financial and monetary issues among academics, central bankers and market participants. He contributed practically, not least as chairman of Euro-MTS, the European electronic fixed income market, late in his career. And he made significant policy contributions, from overseeing the creation of the TARGET payment system at the EMI to launching what became known as the “Lamfalussy process” for supervisory and regulatory convergence in Europe.

For this reason, the ECB recognised and honoured his role by establishing about ten years ago a “Lamfalussy Fellowship” programme. It sponsors five young economists each year to conduct research on the integration, structure and performance of the European financial system.

However, we know – and to our cost – that ultimately the euro area did not succeed in achieving sustainable financial integration. While financial integration deepened significantly after the euro was introduced, the global financial crisis caused that process to go into reverse. And we can see the importance of financial integration for the single currency all the more in its absence.

1 See the “Delors Report” – Committee for the Study of Economic and Monetary Union (1989).
2 SUERF, the European Money and Finance Forum, is an abbreviation of the Association's original name “Société Universitaire Européenne de Recherches Financières”.

In the periphery, financial fragmentation has led to high interest rates for firms and households, and disrupted monetary policy transmission. In the core, it has led to exceptionally low interest rates for savers and potentially distorted asset prices. Consequently, the whole of the euro area would benefit from lasting financial reintegration – and indeed, addressing financial fragmentation has been one of the key tasks of euro area policy-makers, including the ECB, over the past years.

What I would like to focus on today is one aspect of reversing fragmentation that is perhaps underplayed – that is, the importance of raising the *quality* of financial integration in the euro area. My view is that the incomplete financial integration we achieved before the crisis made it susceptible to fragmentation. But I am confident that with a banking union we can create the pre-conditions for more sustainable financial integration in the future.

I FINANCIAL INTEGRATION BEFORE THE CRISIS: WHAT WENT WRONG?

Let me start by outlining how financial integration evolved before the crisis.

It was always understood that financial integration could have both stabilising and destabilising effects.³ Some of the main stabilising effects were expected to come from increased portfolio diversification. As banks and other investors became more diversified across borders within the euro area, they could reduce their exposure to domestic shocks, and this would be reflected in greater income and consumption risk-sharing.⁴ Indeed, global and European evidence suggested that financial openness and integration had reduced consumption growth volatility.⁵

Another benefit of financial integration was thought to come from improved allocative efficiency. Research suggested that large cross-border banks in Europe could improve overall economic performance, by making sure that productive capital was channelled towards the most efficient firms. This would in turn reduce the risk of crises stemming from mispriced investment risk.⁶

Destabilising effects of financial integration, on the other hand, were expected particularly through risk-taking and contagion. Asymmetric information problems associated with cross-border lending could lead to misaligned incentives and increased risk-taking. Similarly, savings imbalances abroad could compress risk premia and lower financing costs, allowing an increase in leverage in the domestic financial sector.⁷ And if negative shocks were to occur, contagion could quickly spread through the interbank market, and lending to the real sector across borders could be affected, too.⁸

3 For example, Ferguson et al. (2009).

4 Demyanyk et al. (2008).

5 Bekaert et al. (2006).

6 Giannetti and Ongena (2009).

7 Caballero and Krishnamurthy (2009).

8 Popov and Udell (2012).

As financial integration deepened, it was anticipated that the stabilising effects would overall be more important than the destabilising ones – that is, the welfare benefits of better diversification and improved allocative efficiency would offset the welfare costs of occasionally higher risk-taking and contagion effects.⁹ So why were the costs of the European crisis so high?

There are many reasons for this, but in my view one important factor was the incomplete nature of financial integration in the euro area. Price convergence in many asset classes created an appearance of financial integration, but it was in fact relatively shallow, in particular in the banking sector. According to the ECB's financial integration indicators, while euro area interbank markets became almost completely integrated, retail banking integration remained largely fragmented.¹⁰ This mismatch had at least three consequences.

The first was on the asset side of banks' balance sheets. A main channel through which retail banking integration is expected to improve allocative efficiency is by increasing the distance between the main shareholders and management of a bank and the vested interests in the country where the bank operates, i.e. by reducing so-called "related lending". But without meaningful foreign competition, these gains did not materialise in the euro area. In fact, the ability to borrow freely in interbank markets allowed local banks to increase lending towards favoured domestic sectors such as real estate. This is essentially what we saw in Spain and Ireland. In the process, financial integration concentrated rather than diversified risk.¹¹

The second consequence was on the liability side of banks' balance sheets. As banks' funding from abroad came mainly through the interbank market, the composition of their foreign liabilities was short-term and debt-based. This meant that funding could quickly dry up at the first sign of distress.¹² With a more integrated banking sector, however, this effect would have been less dramatic. As foreign banks would have equity stakes, they would have an incentive to maintain cross-border funding within the group. This is what happened, for example, in the Baltic countries where foreign ownership of the banking sector was high.¹³

These two consequences combined to create a third effect. As banks' assets were not well allocated, nor well diversified geographically, they were more vulnerable to domestic shocks. And as their foreign liabilities were mainly interbank, i.e. not equity-based and short-term, they could not share the subsequent losses with other jurisdictions. This meant that when the crisis hit, the cost of repairing their balance sheets fell largely on their domestic fiscal authorities. The result was the infamous bank-sovereign nexus that has perpetuated financial fragmentation in the euro area.¹⁴

9 Fecht et al. (2007).

10 European Central Bank (2008).

11 Fecht et al (2012).

12 Schoenmaker and Wagner (2011).

13 Gros and Alcidi (2013).

14 Acharya et al (2014) and Nikolov and Papov (2014).

My conclusion from this experience is as follows: the quality and comprehensiveness of integration matters. There are costs which can arise from a type of financial integration that is short-term and reversible; or from having perfect integration in one market and fragmentation in another. A key question for the euro area is therefore: how can we generate a higher quality of financial integration for the future?

2 MAKING FINANCIAL INTEGRATION SUSTAINABLE: THE ROLE OF A BANKING UNION

The pre-crisis experience suggests three changes are needed.

First, stronger *ex ante* supervision to mitigate the possible destabilising effects of financial integration. Second, an improved policy framework to maximise the stability benefits, namely by encouraging deeper cross-border banking integration. Third, better *ex post* risk-sharing arrangements, such as resolution frameworks, so as to prevent shocks from spilling over to sovereigns.

I see that a banking union – the Single Supervisory Mechanism (SSM) and the new European resolution framework – can make a significant contribution to these objectives. Let me address each in turn.

STRENGTHENING SUPERVISION

To begin with, the SSM will enable supervisors to better identify emerging risks and to act counter-cyclically. This is thanks to its independence, its incentives and its instruments.

The SSM has been designed with the necessary independence to lean against localised booms, being not only legally independent, but also independent of any single government or national financial system. And that independence is reflected throughout its organisational structure, for example by having mixed-nationality joint supervisory teams to supervise each significant bank.

By virtue of its accountability, the SSM also has incentives that are clearly aligned with its European financial stability objective – it has to answer for the failure of any bank in the SSM area. Compared with national supervisors, this gives it all the more reason to take account of excessive risk-taking and the cross-border externalities associated with it, and therefore to be proactive if local financial developments pose increasing systemic risk.

Finally, the SSM has not only micro-prudential powers but also new macro-prudential instruments to counter financial imbalances. For all the instruments in the EU legislation, it may apply stricter measures than national authorities if it observes emerging risks. This further strengthens the capacity at the European level to prevent financial instability.

DEEPENING INTEGRATION

The SSM can also help maximise the benefits of financial integration by providing a policy framework that is more conducive to cross-border banking integration.

Before the crisis, supervisory coordination mainly took place through the Lamfalussy process and committees, which were a major step forward and the best that could be achieved at the time. However, they were unable to fully iron out supervisory differences between EU jurisdictions.¹⁵ This presented cross-border banks with substantial compliance costs and reduced the economic synergies of integration.

For example, a Commission survey in 2005 found that opaque supervisory approval procedures were a major deterrent to cross-border banking M&As in Europe. The need to comply with different sets of rules and interact with several different authorities was also reported to be a barrier to cross-border activity.¹⁶

The lesson from this period was that, while financial integration is ultimately a market-driven process, policy plays a key role in creating the conditions for it to progress. To quote the Lamfalussy report, “the EU has no ‘divine right’ to the benefits of an integrated market – it has to build one¹⁷”. This SSM should help us in this building process.

A single supervisor automatically removes some of the dividing lines between jurisdictions that create compliance costs. For example, there will no longer be a distinction between home and host supervisors for cross-border banks. Instead, there will be a single supervisory model and eventually a single supervisory culture, rather than one per country. And cross-border groups will be able to report at the consolidated level.

Another benefit of the SSM – and perhaps a more important one – will be the lack of “hidden barriers” to cross-border activity linked to national preferences. With a European supervisor, borders will not matter. Issues such as protecting national champions or supervisory ring-fencing of liquidity will not be relevant. This means that banks will be in a better position to achieve the economies of scale that were promised by the single financial market – and that they also need to be competitive at the global level.

It is of course for banks to decide whether such integration makes business sense. And some obstacles to cross-border integration that lie outside the remit of supervision – like company law and tax – still remain. However, the low profitability and excess capacity of the European banking sector suggests that efficiency gains could be achieved, and without exacerbating the “too big to fail” problem.

15 European Central Bank (2007b).

16 European Central Bank (2007a).

17 Lamfalussy (2001).

IMPROVING RISK-SHARING

Even with a higher quality of financial integration, we know that shocks may still occur that cannot be contained within the private sector. The US, for example, has a well-integrated financial market, and the Federal Deposit Insurance Corporation (FDIC) still plays a prominent role in managing crises. Our challenge in the euro area is to ensure that, when banks fail and the public sector has to intervene, it does not result in a recurrence of the bank-sovereign nexus. The new European resolution framework will be key to achieving this.

This framework can help insulate sovereigns by improving private risk-sharing within the euro area. First, it will ensure that the costs of bank failure are borne first and foremost by the private sector, with sovereigns providing funds only in exceptional circumstances. The key innovation here is the Bank Recovery and Resolution Directive, which provides the legal underpinning for the bail-in of shareholders and creditors and other resolution tools.

Second, the new framework will allow resolution costs to be more evenly spread across the euro area banking sector, and less concentrated in the affected countries, thus enhancing the potential for cross-border risk-sharing. Specifically, the Single Resolution Mechanism (SRM) will introduce a single resolution fund that is funded by and available to all euro area banks.

Will this help break the bank-sovereign nexus today? In my view, the impact will certainly be positive. The fact that the costs of any bank rescue will fall less on sovereigns should lift expectations of government debt sustainability, thus improving asset quality for banks exposed to their governments. And the fact that bail-ins will precede bail-outs means banks' funding costs should be better decoupled from the fiscal condition of their sovereigns.

That said, in terms of breaking this nexus, there are some elements in the EU Council agreement on the SRM that I believe could be improved. The main problem is uncertainty about resolution financing arrangements. This is important, because if markets cannot ascertain *ex ante* how resolution will be financed, and in what quantities, they may find themselves having to price-in a residual risk of national government involvement, thus perpetuating the bank-sovereign nexus.

One issue that creates uncertainty is the protracted time period – currently 10 years – over which national compartments are to be mutualised into a single resolution fund. As legacy risks will be addressed by the ECB's comprehensive assessment, this seems an unduly long period. We would see merits in doubling the pace of mutualisation to have a genuine European fund within five years. To be clear, this would not imply that banks have to pay higher fees. The fund would still only reach its target level after 10 years, yet it would be a truly single fund after five years.

Another issue that needs clarifying is what backstop arrangements will be in place in this transition period, and also in the steady state. What makes resolution authorities credible is the knowledge that, when private sector solutions do not suffice, they can draw on temporary public bridge financing. This steadies expectations and supports financial stability.

Indeed, the job of a resolution authority could become more complicated if there are doubts about the adequacy of its resources in times of systemic stress. Even in the US, where such a public backstop is in place, the FDIC felt that its job was complicated during the financial crisis by media scepticism about its finances.

For this reason, we believe that a single resolution fund needs a solid public backstop – be it an ability to temporarily borrow from the market backed by guarantees from participating Member States, or access to a credit line, potentially from the European Stability Mechanism. This would not be a transfer system between taxpayers: as in the US, such borrowing would be recovered by additional levies on the banking sector in the future. Therefore, the only transfer would be an intertemporal one among banks.

3 CONCLUSION

To conclude, financial integration is essential for a well-functioning single currency, but it is not something we can take for granted. We have learned a painful lesson here. Incomplete financial integration is an Achilles heel: it creates vulnerabilities and is liable to fragment. With the banking union, I am confident we are laying the foundations for more complete financial integration in the future.

There are two final points I would like to make.

First, while I have spoken mainly about banking sector integration, a single financial market must also ultimately extend to capital market integration – a theme that was close to Alexandre’s heart. There are still several barriers to such integration, and these call for the attention of policy-makers. One example is barriers to high-quality securitisation of bank loans, whose removal may help to promote lending to households and SMEs, and reduce fragmentation. In the spirit of Alexandre, we need to begin addressing these issues in a pragmatic manner, while never losing sight of our goal.

Second, we should not forget that fragmentation also comes from the demand side. If less competitive countries undertake structural reforms that promote higher economic growth, their economies will converge towards more competitive ones, and finance will tend to follow.¹⁸ This is why, in addition to the banking union, the re-establishment of country competitiveness is essential to reintegrate financial markets. In other words, *all* participants have to help achieve and sustain financial integration.

¹⁸ Recall, for example, the early intellectual debate among economists about whether finance follows the real economy (e.g. Robinson, 1952) or drives the real economy (e.g. Schumpeter, 1911).

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CONCLUDING REMARKS

ALEXANDRE LAMFALUSSY

To be called “the wise man of the euro” – and to be remembered as such in the title of one’s biography – is a great honour, but a mixed blessing: flattering, yes, but also a little frightening, because it means I’ll have to watch my words even more carefully than when I was the President of the EMI addressing the European Parliament. This is especially true now that the euro has remained, in the eyes of some, or has become, in the eyes of others, a dubious if not downright unwise undertaking.

Fortunately I have not been asked to comment on current or even recent events, since what we are celebrating today happened 20 years ago, and I definitely feel on safer ground trying to draw lessons from the past than analysing the present or – unwisely – attempting to forecast the future. This – drawing a few lessons from the past and from my experience at the helm of the European Monetary Institute – is what I propose to do in the next few minutes.

The bold venture called the EMI could indeed, from the start, have seemed a dubious undertaking. In an article I wrote in 2005 and which came out in a book published in 2008, I recalled that the EMI’s beginnings provided “a propitious environment for bitter conflicts. Specifically, for conflicts between the central banks operating within the EMI structure (...) on the one hand, and the member governments of the European Union on the other. But also for conflicts within the central banking community as well as among governments, and for conflicts with the Commission, guardian of the Treaties”.¹

So a lot of things could have gone wrong in this process, but, amazingly, they did not. “I myself was not excessively optimistic about the outcome when I was appointed President of the EMI, but I became gradually more and more confident, and by the winter of 1995-96 I had acquired the conviction that we were on the right track. Market sentiment was also beginning to change at that time; witness the downward convergence of long-term interest rates”² that was observed: “considering the initial EMU participants, the mean yield spread over the German yield fell from 218 basis points in 1995 to 111 in 1996, 39 in 1997 and 19 in 1998”.³

How was it that Murphy’s Law (“If anything can go wrong, it will”) was so blatantly defeated? In the same article I referred to an “exceptional convergence of several facts and influences”, which I described. I will not repeat them all here, but will single out four which seem to me to have been especially important because they were part of what was quite clearly an institution-building process and as such were perhaps less dependent upon the vagaries of the economic or political environment.

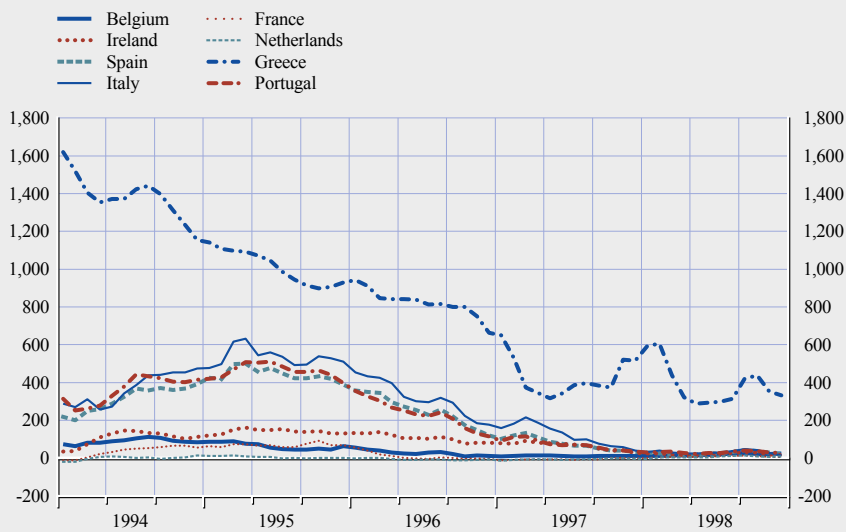
1 Lamfalussy (2008), pp. 155-156.

2 Ibid. p. 156.

3 Pagano and von Thadden (2004).

Yield differentials on ten-year public loans in relation to German bonds, 1993-1999

(monthly data; basis points)



Source: BIS, calculations by NBB.

The first factor – not necessarily in importance – was the fact that the initiators of the EMU project, as well as those who, at crucial moments, propelled it forward, were the governments themselves, and at the highest level: the Heads of State or Government. This was the case at The Hague Summit in December 1969, in Copenhagen in April 1978, in Hanover in June 1988 and in Maastricht in December 1991, just to name a few important milestones on this “long and winding road”. So the initiative was clearly a political one, not simply because the initiators were Heads of Government but also because, at decisive moments, political motivation played a major role. “With such a political commitment, the highest political authorities acquired a vested interest in a successful implementation process”.⁴

Reflecting now on the more recent past, one may wonder whether all the political leaders in the euro area at present are in a similar frame of mind with regard to EMU: to the extent that, when they came to power, they no longer had to make, or to renew, vis-à-vis public opinion, a similar political commitment. I think they are unlikely to have so strong a vested interest in the successful continuation of a project that was initiated by their predecessors.

Another factor which played a part in preventing conflicts from arising, both between the central banks and member governments, and within the central banking community, was the fact that political leaders entrusted the central bankers right from the start with a major role in the preparation of the Maastricht Treaty; this already began when they decided to set up the Delors Committee, the membership of which was overwhelmingly of central banking extraction. In addition, “Jacques Delors was not only a good chairman, but he also possessed the political wisdom

4 Lamfalussy (2008), p. 158.

to accept that the majority of the meetings, and practically all the preparatory work for the meetings would take place at the BIS, with both rapporteurs being central bankers. Subsequently, the Dublin Summit (June 1990) mandated the Committee of EC Governors to draft a statute for the European System of Central Banks to be submitted to the Intergovernmental Conference on EMU”.⁵

A third factor is to be found in the fact that “the institution-building process was governed by the Maastricht Treaty, which set out a roadmap in great detail, clearly described what should be the division of labour between the Council, the Commission and the central bankers of the EMI and of the ECB, and, most importantly, set 1 January 1999 as the latest date on which the single monetary policy should start operating. This time constraint – as I, and later Wim Duisenberg, had the privilege of learning – turned out to be a barbarian, but most effective instrument for finding compromises on matters that were not regulated by the Treaty”.⁶ One such matter was, of course, the scenario of the changeover to the single currency, the story of which provides a good illustration of how it was possible to achieve decisive progress in an area that the Treaty had left undecided, while avoiding spectacular conflicts between the Council, the Commission and the EMI, which all had their part to play.

The fourth factor, and this was decisively important in avoiding major disruptive conflicts among the central banks participating in the EMU process, was the institution called the EMI itself. The discussions both among central banks and between them and the governments, as well as the search for constructive compromises, received increasingly powerful support from the EMI staff, which grew from about two dozen members taken over from the secretariat of the Committee of Governors of the central banks of the Member States of the European Community when we began, to more than 400 by the time I left the EMI in mid-1997. “Most of the staff, and all those in key positions, came from the member central banks, but within months they had acquired the multilateral frame of mind so indispensable for making realistic proposals to reconcile conflicting views held by member central banks. (...) Achieving progress would have been impossible if, instead of a solid institutional structure, the work had had to be carried out within a cooperative framework”.⁷

This last observation gives me the opportunity to praise, and to thank, all those who took part with me in this adventure as members of staff of the EMI and who quickly acquired the pioneering frame of mind and the team spirit which made it succeed. Quite a few of them are here tonight, and I wish all of them were present to hear the expression of my admiration and of my deep gratitude for their personal commitment. I remain extremely proud to have sailed, for three and a half years, as commander of such a fine ship as the European Monetary Institute, with such a fine, well-trained, competent, committed and responsive crew, from the lowliest ship’s boy to the first mate.

5 Ibid.

6 Ibid. pp. 158-159.

7 Ibid. pp. 159-160.

Although it belongs to the same class of vessels as the EMI, the European Central Bank is a different ship, bigger than the EMI, with great firepower and plenty of ammunition. It has also proved, in the treacherous waters of the international economic environment these past six or seven years, that it can be highly responsive to swift changes of course. It has fortunately been blessed with a succession of highly skilled commanders. However, their job has become even more difficult since, as an outcome of the financial crisis, central banks have received, in addition to the traditional mandate governing their monetary policy, a macro-prudential mandate as well, and this, I believe, may even put central banking independence at risk. Allow me to quote here, by way of conclusion, a remark I made in October 2011 at the conference celebrating the 100th anniversary of the birth of Robert Triffin.

“The risk arises from the obvious fact that having to comply with two distinct mandates pushes the central banks into a much more complex world. The modalities of their independence in their monetary policy function do not follow necessarily the same model, but, once agreed, the content of independence can be reasonably well defined. In the case of macro-prudential independence this is much more difficult. Once it appears that the initial liquidity problem is shifting toward a solvency problem, and especially when the latter implies the risk of systemic meltdown, the central bank has to operate hand in hand with the government. (...) The macro-prudential mandate requires for the central bank a type of relationship with – and therefore a type of independence from – the government that is different in substance from the one governing monetary policy. The rules of the game on both sides have to be spelled out. The complexity of the current situation – and the likelihood that it will remain such – means that central banks will have to continue their navigation in uncharted waters. There is no way of opting out of this complex world”.⁸

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