Helmut Schlesinger

Helmut Schlesinger, former president of the Deutsche Bundesbank, is professor at the Post-Graduate School of Administrative Sciences, Speyer, a guest professor at the University of Karlsruhe, and will teach in the fall at Princeton University. This article is taken from the Eighth Annual Homer Jones Memorial Lecture, delivered at the Federal Reserve Bank of St. Louis on April 14, 1994. The author's comments do not necessarily reflect the views of the Federal Reserve Bank of St. Louis or the Federal Reserve System.

On the Way to a New Monetary Union: The European Monetary Union

LOOKING BACK IN HISTORY over the last two centuries, we will find only a few cases of a successful creation of a monetary union but a far larger number of cases which failed. As far as the final goal is concerned, it means having only one single currency for all the nations in the European Union and replacing the individual national currencies; it is a very big undertaking. It means that one has to create a monetary union ultimately encompassing nearly 400 million people and a region which would have the highest gross domestic product (GDP), the most extensive foreign trade, and so on, in the world. In other words: It is an ambitious goal which has not yet been reached, but we are on the way to reaching it.

A MONETARY UNION: IN THE BEGINNING

The goal of a monetary union must be seen as one specific objective along the road from the European Community (EC) created by the Treaty of Rome in 1957 and the European Union shaped by the Treaty of Maastricht which was ratified in 1993. The long way we have come from the beginning to the present state of the European Union is impressive; this holds true not only of the progress made, but also of the time span which has been necessary to make it, and it has not been without a number of crises, set-backs and periods of stagnation.

From the beginning, the way went along the economic integration of the national economiesin direction of a single European economy. But the real target was a political one. This was very clear at the outset. The first step was the creation of the European Coal and Steel Community in 1952. At that time, three politicians were of particular importance: Robert Schuman, Alcide de Gasperi and Konrad Adenauer. It is worth remembering that these three statesmen all came from border regions, between France and Germany or between Italy and German-speaking Austria. Schuman and de Gasperi were both bilingual, that is, they spoke French and German, and Italian and German, respectively. Adenauer came from the western banks of the Rhine River and was, to a certain extent, French-oriented. These three men, who had all experienced the two big wars in Europe between the nations which actually belonged so close together, had the courage to create this European Coal and Steel Community as the first Community organization. To a certain extent, coal and steel were considered to be the most important strategic materials. In Germany at that time, the production of such materials was limited and under the control of the Allied Forces. Later, the production of these materials came into surplus and lost its particular strategic importance. But the Coal and Steel Community, which exists even today, fulfilled the role of a nucleus for the development of the European Common Market.

The subsequent steps towards the European Community should be well-known. I mean the creation of the Community of six nations, West Germany, France, Italy, the Netherlands, Belgium and Luxembourg, in 1957. The next important step was the extension of the Community to include the United Kingdom, Denmark, Ireland and later Spain, Portugal and Greece. At the beginning of 1993 the target to create a so-called single market had been reached. Since that time, no government barriers have been in place between the member countries as far as the trade in goods and services is concerned, as well as the movement of labor and capital. After the extension of the Community from six to 12 countries, the so-called deepening of the Community had reached an important point.

Now, Europe is on the brink of doing both: an extension of the Community to include new members comprising the Scandinavian countries and Austria, and the deepening on the way to a monetary union. Even now, the primary target is a further strengthening of the economic integration. It means achieving a large, single market for the western and central European countries and, at the end, to use only one currency in that market.

But one should not forget that the target even now is political. It should bring the European countries with a rather stable democratic constitutions closer together and allow them to develop into a political union. The end of the Cold War has given them more freedom to do so. Before that, Austria and Finland, in particular, had to take care not to provoke the Soviet Union. The development of free and democratic societies in Poland, the Czech Republic and Hungary is another new element which must be handled with care.

CONFLICTS IN MONETARY POLICY: "MONETARISTS" VS. "ECONOMISTS"

From the beginning of the EC there were differences in the attitudes in the various countries, especially in France and Germany, as far as the role of monetary policy in the economic integration was concerned. The dispute was seen as a conflict between "monetarists" and "economists," which means something different in St. Louis. The "monetarists" believed that monetary integration has to start first and that economic and political integration would follow. The "economists" believed that economic convergence between the national economies must occur before any move into very close monetary integration and a monetary union.

At the end of the 1960s and the beginning of the 1970s, the "monetarists" gained stronger influence. An EC Community study, the so-called Werner Plan, described a step-by-step introduction of a monetary and economic union. But the first step under this plan, that is, the obligation to have fixed but changeable exchange rates between the national currencies, was rather unsuccessful. The times were characterized by the end of the Bretton Woods system, and later by the first oil price hike and a world-wide recession in 1975. Only the core of hard-currency countries were able to stay together without interruption, specifically, Germany and the Benelux countries.

The real reason for the failure of this first attempt to have a system of fixed but adjustable exchange rates for all countries was the strong deviation in the rates of inflation. Between 1973 and 1979, for instance, the annual rate of inflation was 11 percent in France and 16 percent in Italy, but only 4.7 percent in Germany. For the Federal Republic of Germany, however, this was the highest rate of inflation in a medium-term average in four decades. The heavily engaged politicians in this field were following the doctrine of the so-called monetarists: Giscard d'Estaing in France and Helmut Schmidt in Germany tried to base the integration in the monetary field on a stronger institutional platform than before. They created the European Monetary System (EMS), which came into effect in March 1979 and is practically existing up to now. I do not think it is unfair to explain the common interest of the French president and the German chancellor, d'Estaing and Schmidt, respectively, apart from very important points, with one common motive: The dominance of the deutsche mark was of particular concern for Giscard and the dominance of the Bundesbank seemed to be a big concern in the eyes of Helmut Schmidt, even though this was not actually true.

The EMS was constructed as a system of fixed but adjustable exchange rates between the EC countries, which allowed fluctuations of these exchange rates only within a relatively narrow band. And which, secondly, established a large framework of partly unlimited credit facilities for the member central banks. This credit mechanism was to make it possible to keep the exchange rates stable, even under strong pressures on one particular currency, through the obligation of central banks to intervene in the foreign exchange markets, if necessary, with unlimited amounts.

THE INHERENT WEAKNESS OF THE EMS

Looking back, the creation of the EMS was a very important step towards a European monetary union at a later date. It worked in two directions. First, all countries learned what is possible under given conditions in Europe and—where necessary—how these conditions had to be changed. Second, all member countries learned that a fixed exchange rate can stimulate the integration of trade and other transactions across the borders of the member countries of the Community. We observed that the member countries felt a systemic pressure to try to orient their own domestic development, especially as far as the price developments were concerned, to that of the best-performing countries. Taking the same countries which I have mentioned before, for the period from 1979 to 1990, we can see that the annual increase of prices in France then was only 6.9 percent, compared to 10.7 percent in Italy and 2.9 percent in Germany. The inflation rate differentials had diminished, and the average rate of inflation in the EC was lower. In the years after 1990, these differences were smaller still and partly the other way around.[1]

But we also experienced that even those smaller differences—whenever they existed over a longer period of time—create a need for a change in the exchange rate structure. In other words, they result in the need for a realignment. If one counts exactly, we have had 16 bigger and smaller realignments since 1979, namely 11 between 1979 and 1987, but there were no general realignments up to September 1992, the rest later. This seems to be a relatively good experience of a system of fixed exchange rates aimed at achieving a convergence of the economies.

But even in the period from 1987 to 1992, price differentials accumulated, with the consequence that those countries which kept their nominal exchange rates stable experienced an increase in their real exchange rates. Italy, for instance, recorded a real appreciation of its currency vis-à-vis the deutsche mark and other hard currencies in an amount of nearly 15 percent between 1987 and 1992, and the same was more or less true for the pound sterling. Such real appreciation leads to a loss of the competitive position of a country, and it depresses its exports and the overall domestic situation. The latter is aggravated by the fact that it becomes necessary to increase the interest rates in these countries far above the level in the hard-currency countries. The solution to eliminate these tensions was not ideal: The United Kingdom and Italy withdrew from the ERM in autumn 1992.

These events show the real weak flank of a fixed exchange rate system. To avoid these events, a realignment would have been necessary at an earlier stage, a devaluation of the more inflationary currencies vis-à-vis the rather stable currencies, that is, the deutsche mark, the Dutch guilder, the French franc, and so on. But realignments are highly political affairs—at least the politicians have made them into that. My long-standing experience with this—reflected by Oscar Wilde, who wrote: "Experience is the sum of the failures"—is that realignments are made only under the strongest pressure in the foreign exchange market, not on the basis of any profound backward and forward-looking analysis. This was also the case in the Bretton Woods system and one of the reasons why it broke down. In other words, this is the inherent weakness of the EMS or, to be more precise, of any system with fixed but adjustable exchange rates.

[1]See Fischer (1994).

One solution to ease the problem—having a change of the exchange rates but not necessarily a political decision about a realignment—was found by widening the band of fluctuation of the exchange rates. This was done in August 1993 by widening this band to ±15 percent, instead of ±2.25 percent and ±6 percent, respectively. In fact, since we have had this wider band, the exchange rates of the EU countries have been behaving rather calmly. No country was forced, or prepared, to use the wider band for a stronger devaluation or revaluation. Each country now has a clear responsibility for its own currency and for the exchange rate of its currency. In my opinion, this is a rather good basis for further developments on the way to a European monetary union. After a longer period, in which the exchange rate structure of the EMS currencies would have come into a longer-lasting equilibrium, the fluctuation band could be diminished somewhat.

THE CONCEPT OF THE ECONOMIC AND MONETARY UNION (EMU)

The Treaty of Maastricht, called the Treaty on European Union, the most important extension of the Treaty of Rome, is rather clear about the different steps needed for a monetary and economic union, but rather vague concerning the elements of a political union, that is, a common foreign policy, defense policy, harmonization of laws or social policy. By the way, a new intergovernmental conference is to take place in 1996 to implement the political part of the Union. Coming back to my earlier remarks, however, the Treaty of Maastricht contains more of the ideas of the "monetarists" than of those of the "economists." But this type of victory was easier to reach than anything in the purely political field. A monetary union means that all member countries have to give up their national sovereignty in this area. It means monetary union first and political union later. A monetary union is a sacrifice of sovereignty for each country. And, as French President Mitterand said before the referendum in France in 1992, the biggest sacrifice is in Germany, the country with the anchor currency in the EMS and, therefore, the country with the monetary policy that is most independent from the policies of the other member countries. Having said this, however, I should add that Germany has never been completely independent from the others in the past and that it has usually had to take into consideration the consequences of its own policy decisions for the partner countries. But, nevertheless, this has been done on its own judgment.

In the other political areas, the national sovereignty is not given up. There are some limitations, some common rules, some Community directives, but there is no direct interference, for instance, in foreign policy decisions. Even in the case of fiscal policy, the national governments are sovereign. They agreed to a process of multilateral surveillance and they agreed in the Maastricht Treaty on some soft sanctions for misbehaving countries, but each state decides in full sovereignty on its own taxation system and on tax rates and public expenditures. Of course, some rules have been formulated, but only for the public sector deficit and for the level of government debt. Agreement on common European foreign and defense policies is very difficult and can be seen in the role which the European Union played—or did not play—in the breakdown of the Yugoslav Republic and the consequences that followed.

Having said this, the monetary union described by the Maastricht Treaty is not an illusion. It takes into account many of the experiences gained in the EMS period, and it proclaims a path toward the EMU in three stages. Stage I means freedom for international capital movements; this is given now. It also calls for membership in the EMS, preferably in the ERM, but—as I have said before—the latter is not yet given for all countries. For example, the United Kingdom, Italy and Greece are not in the ERM.

Stage II started at the beginning of this year. It includes the establishment of a European Monetary Institute (EMI) as the forerunner of EMU and the European Central Bank. The Institute has started with its work and now definitely has its seat in Frankfurt, the financial center of Germany and the place where the Bundesbank has its headquarters. The EMI has to clarify the technical and operational questions for the coming European Central Bank; it has to continue and intensify the coordination of the monetary policies of the member countries and it has to control the EMS and the development of the ECU.

In the final stage, the heads of state of the European Union will meet and decide if EMU can start, in 1997 or 1999. This decision is to be made on the basis of which countries fulfill the so-called entry criteria. This will be a very important exercise. The Treaty gives indications of how to proceed in this process of examination. They have to clarify which countries have enough and sustainable price stability, have sound public finances, and have no strong tensions as far as the exchange rates of their particular currencies are concerned.[2]

The purpose of this examination is to ensure that only those countries which fulfill these criteria can join the EMU at the beginning, thereby guaranteeing that only countries with a sound economic basis can be founding members. This means also that, at the beginning, presumably not every member country would qualify for membership in EMU. In other words, the Treaty opens the way for a two- or three-speed solution. Those countries which are not in EMU at the beginning can come in when they fulfill the entry criteria. The United Kingdom and Denmark, however, have the right to stay out under any circumstances, even if they fulfill the criteria.

I think the idea of entry criteria can be considered a "victory" on the side of the "economists," on paper at any rate. One cannot forget that the politicians will have a certain degree of discretion in their final judgement about which country should join the EMU and which should not. By the way, the room for discretionary assessment is strongly limited for the German government, because the German Parliament as well as the Federal Constitutional Court are forcing the government to be very strict in its judgements in this. Nevertheless, it is a highly political issue. Everyone knows it cannot be solved solely on the basis of statistics, and even the interpretation of the statistical criteria is now under dispute.[3]

In my opinion, the Treaty of Maastricht is a rather well-balanced document. The question is whether this concept can be filled with real life and whether this life could satisfy the wishes and hopes which many are connecting with it. If I were to try to give an answer as far as the whole content of this new European Union, the political Union, is concerned, I would have to be very vague. I would have to start with the question of whether the nations are prepared to give up their identities. Are they prepared to forget the experience which they have had with each other during for the past hundreds of years? Can they give up whatever judgments and prejudgments they may have made and—especially—can they forget all the injustices they have inflicted on each other?

Other open points are the consequences of widening the European Union from 12 to 16 states, and what consequences would be for opening for membership for the central European states, that is, Hungary (which has already applied for membership), Poland, the Czech Republic, and so on. All these are important questions and not really new. More than 35 years ago in Germany, Ludwig Erhard, the Minister of Economics who contributed so much to the "German revival" (Henry Wallich, 1955), was strongly engaged in the European debate. Even then, he was against a Europe of only six countries. He published an advertisement in newspapers, writing only:

$$6 + 7 + 5 = 1.$$

He meant that six alone would not comprise one Europe; the seven EFTA countries and the rest of the non-communist countries in Europe should be included. In 1995, presumably 16 countries will form the European Union—only Switzerland and Iceland will be missing to complete the Erhard formula.

I do not want to go into this grand design of European questions, even if I have indicated that I have always been inclined to be on the side of Ludwig Erhard. Let me come back to the question as to how a European Monetary Union can function. The center piece of the EMU is the establishment of the European Central Bank, the only central bank which could issue the single

[2]See: "Protocol on the Convergence Criteria Referred to in Article 109j of the Treaty Establishing the European Community," Office for Official Publication of the European Communities (1992).

[3]For instance, "price stability" is given if a member state has an inflation rate not more than 1.5 percentage points higher than "the three best-performing member states." The question is, does it mean the average of these three states or that of the worst (or the best) of these three states?

European currency. In many respects, this Bank will be modeled on the German Bundesbank, which means that it will have the priority target of keeping the value of the currency stable and, for that purpose, it will:

- be independent from the national and supranational governments (not accepting orders nor being allowed to ask for any);
- have a Central Bank Council consisting of the governors of the national central banks and six members of an executive board who cannot be dismissed during their term in office for decision-making;
- be granted the necessary instruments for monetary policy, that is, open market policy, interest rate policy, minimum reserve requirements, if necessary, and so on; and
- the European Central Bank will not primarily be responsible for banking supervision, but it is possible to transfer corresponding tasks to it.

CENTRAL BANKING GOALS AND MONETARY AGGREGATES

As I have already mentioned, the monetary union is well constructed on paper and a European Central Bank could work. The European Central Bank is to be established as a federal institution, much like the Bundesbank in Germany, which has the federal elements of the United States as its "grandfather," so to speak. Why should it not be possible for such an institution to fulfill its tasks for Europe? Many people are asking whether such a new central bank comprising people from different countries with a somewhat different "culture" of monetary policy could really work. I have to answer that monetary policy decisions are never made on the basis of a full conformity of opinions among the decision makers. This is not the case in the Central Bank Council of the Bundesbank with its 16 members, nor is this the case in the Federal Open Market Committee (FOMC) of the Federal Reserve System, as we can all see from the record of policy actions. Both Councils are democratic institutions in which decisions are made through majority, but certainly these institutions have a basis of a common attitude, and have a certain consensus about what to decide and how to work.

Take the U.S. case. David Mullins, the former vice chairman, says that 4 percent inflation is unacceptably high. And Wayne Angell, a longstanding member of the Board of Governors, wrote in his letter of retirement to the President of the United States that "I am pleased... [that] the Board of Governors was enunciating a goal of zero inflation. But if the quest for price-level stability is replaced by an acceptance of an inflation rate stabilized at say 2-1/2 percent per year, then we are accepting the fact that the domestic value of the dollar will be cut in half every generation, 28 years." Thus, there is a consensus, with some room for interpretation, between both (ex-)members.

In the German case, the Bundesbank is sometimes attacked because part of its intermediate monetary target—the growth of M3—is derived on the basis of a so-called unavoidable increase of about 2 percent in the price level. Presumably, Wayne Angell would also be a little bit disappointed about this.

Which price level target will the European Central Bank formulate, if it were to formulate one at all? The 1.5 percentage points over the average of the best-performing countries cannot be a target, it is the entry criterion. Up to now, there seems to be no discussion about a price stability target for this future Central Bank. The core countries would presumably agree on a figure like that of the Bundesbank, and—if that were done—one would be also in agreement with Professor Stanley Fischer, who recently wrote "that anyone should be comfortable with a 1-3 percent target".

I do not want to go into the details of the use of a declared price stability target. Canada and New Zealand are using one, and have indeed reached and kept to it up to now. It is worth noting that the last Governor of the Bank of Canada, whose bank was successful, had to resign when a new government came into power. Price stability targets in the sense of a stable consumer price level are a very ambitious exercise. So far, New Zealand's central bank keeps it at 0-2 percent inflation, even against opposition.

Nobody would be surprised—especially not at the Federal Reserve Bank of St. Louis—if I were to suggest that the European Central Bank should start immediately with targeting on the basis of a money supply target. I must admit that this would be rather complicated at the beginning, because nobody could know exactly how the European money supply, the money demand function, and so on, will behave. But, in my opinion, it is indispensable that this new central bank has an idea of how strongly the money stock should grow and, especially, of how far the monetary basis should be extended, the money which this new European Central Bank System will create itself. This question reminds me of the fact that after the deutsche mark had been introduced in 1948, the military government prescribed that any additional increase of currency in circulation, exceeding a total circulation of $10 billion, needed a very restricted procedure of agreements by a three-fourths majority of the Central Bank council and had to be approved by the Länder Governments. This was a primitive way of control, but it made clear that any extension of money must be limited, especially if it is a new money, which does not inspire the same confidence at the beginning than a well-proven old currency.

The discussion of whether or not to have money supply targets will be a point of controversy in the EMI. The President of the EMI, Baron Lamfalussy (1994), has formulated the different positions that will presumably be held, for example, using the money supply as an intermediate target, as is practiced in Germany and some other countries. Or, having no intermediate target but a concrete price stability target, such as New Zealand. Or neither of them, which he seems to prefer—reading between the lines—by saying "can one not use monetary aggregates at least as an information variable?". This seems to be a new formula which was described, for instance, by Benjamin Friedman (1994). I find this new label sounds good but I have to add that such eclecticism, as a matter of fact, is not new. I think that advanced central banks follow the development of the money supply aggregates everywhere and at all times, because they value the information that monetary aggregates provide and their importance to the economic developments, but they also take other factors into account.

CONCLUSIONS

When the EMI has completed its work of preparing the future European Central Bank, when the examination of the entry criteria has been made and the heads of state of the European Union have decided that the monetary union can start, then the adventure will begin. At the beginning, only the exchange rates between the different national currencies of the member countries have to be fixed without any margin and without any possibility of changing them in future. In a later stage, the single currency can replace these national currencies: This would be the fulfillment of the European Monetary Union.

It may seem to you that the way to EMU is a relatively long one, that many preconditions which have been formulated give the impression that the fathers of this program are themselves not sure about the success of the whole plan. And you could add that Europe needs too much time to find solutions comparable with the dynamics in the United States. But even here in the United States, it took quite a long time before you got a Federal Reserve System, even though one currency existed. Now, in Europe, we have central banks. In quite a number of our countries we have currencies which are relatively stable and we have a situation in which the exchange rates are no longer fluctuating very strongly, although they could. In other words: The integration of the economies in Europe and, especially, in the European Union can and will continue to progress toward more complete economic integration. For this purpose, it is not so important—either for our countries or the rest of the world—whether the European Monetary Union starts in 1997, 1999, or even a little later. What is decisive is that we replace the different European currencies with a single currency that is as stable as the best-performing national currencies.

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