

**FUJITSU RESEARCH INSTITUTE
ECONOMIC RESEARCH CENTER**

1-16-1-11F Kaigan, Minato-ku

TOKYO 105-0022, Japan

Phone: +81 3 5401 8392

Fax: +81 3 5401 8438

schulz@fri.fujitsu.com

Dr. Martin Schulz

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**Europe's Answer to Globalization:
Reforming Macroeconomics First**

Martin Schulz, Senior Economist

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Europe's Answer to Globalization: Reforming Macroeconomics First

Summary*

When preparing and entering the European Monetary and Economic Union (EMU), most European countries turned their longstanding approach to integration upside-down. As a reaction to the increasing significance of international capital flows, they switched from a trade-oriented emphasis on ever-increasing (de-) regulation (but poor macroeconomic stability), to a regime of strict rules for monetary and fiscal policy.

Beyond short-term distrust and policy deadlocks, this concept of macroeconomic stability and reduced interference in private markets should unlock growth perspectives by providing room for (regional) capital flows and private market initiatives. This conceptual turn from microeconomic to macroeconomic harmonization offers an important example for other countries in need of stability and growth – although the currency union itself cannot directly be used as a blueprint for economic stabilization in most other regions.

* I thank my former colleagues Michael Bolle and Ulrich Brückner for many discussions during joint work (see Bolle/Brückner/Schulz 1997) and seminars on EU topics at Freie Universität Berlin.

Contents

1	INTRODUCTION	4
2	FROM AN EEC OF MICROECONOMICS AND TRADE TO AN EMU OF MACROECONOMICS AND POLICY	7
3	A NEW APPROACH TO EUROPEAN INTEGRATION?	10
4	EMS EXCHANGE RATE RESTRICTIONS AS AN EARLY BUT INSUFFICIENT STEP TO MACROECONOMIC COORDINATION	14
5	MONETARY RESTRICTIONS AS A REQUIREMENT FOR A STABLE CURRENCY REGIME	19
6	FISCAL RESTRICTIONS AS THE REAL DEPARTURE FOR THE MAASTRICHT REGIME	23
7	NEW RULES APPLY WITHIN A CURRENCY UNION	28
8	CONCLUSION	33
9	LITERATURE	36

FIGURE 1	OECD EXCHANGE RATE CHANGES RELATIVE TO THE U.S. (1974-1993) AND REAL INTEREST RATES (1993)	15
FIGURE 2	OECD PRICE AND EXCHANGE RATE CHANGES RELATIVE TO THE U.S. (1974-2000)	17
FIGURE 3	OECD: INFLATION AND REAL INTEREST RATES (1983-1992 ANNUAL AVERAGE)	19
FIGURE 4	OECD: (MODIFIED) PHILLIPS CURVE RELATIONSHIPS (1983-92 AND 1993)	20
FIGURE 5	OECD: REAL GROWTH RATES AND REAL INTEREST RATES (1993)	21
FIGURE 6	CONVERGENCE CRITERIA: INFLATION AND INTEREST RATES 1992, 1997 AND 2000	22
FIGURE 7	OECD: CURRENT ACCOUNT (1985-1994 AVERAGE) AND REAL INTEREST RATES (1993)	24
FIGURE 8	OECD: FISCAL DEFICITS (1983-1992 AVERAGE) AND REAL INTEREST RATES (1993)	25
FIGURE 9	EMU CONVERGENCE CRITERIA: DEBT AND DEFICIT 1992, 1997, AND 2000	26
FIGURE 10	YEN, DEUTSCHE MARK, AND EURO EXCHANGE RATES TO THE U.S. DOLLAR (1980-2001)	31

1 Introduction

The step towards a European Economic and Monetary Union (EMU) taken at Maastricht in 1991 marked a major departure from the former European integration approach of trade and market reform, and shifted the focus to macroeconomics and policy reform. The creation of the EMU should therefore be primarily viewed as a new approach to fitting economic policies to the demands of globalization and growing international capital flows, and not as a linear step to European integration in line with the (de-)regulatory attempts from the 1951 European Coal and Steel Community to the European Single Market Act of 1993.

It is important to recognize this change, because it cuts through the lines of two standard models for economic integration. First, it contradicts the policy oriented “crowning” or “catalyst” approaches, which claim that a monetary union is just a natural step on the path towards economic integration that will end in the final and dominating goal of political union. In contrast to these ideas, I will show that the step to an EMU was not (necessarily) dominated by teleological political goals, because proper economic considerations were pointing into the same direction, and because the EMU will not directly lead to further political integration. Second, the Maastricht Treaty is positively inconsistent with the standard economic theory for analyzing currency unions, the model of “optimum currency zones” (Mundell). It was therefore often suspected that the EMU is lacking economic logic. The paper will show, however, that the Maastricht Treaty indeed turned the concept of optimum currency zones upside down, but still followed economic logic.

By consolidating and integrating major parts of macroeconomic policies first, and hoping for the microeconomic effects to follow, the EMU concept follows a classic line of political economy (not even far from the optimum currency zones concept), which asks for a consistent governmental market framework in which private markets can thrive. But, as will be argued in section 2, the most important ingredient of a political economy approach to stability and growth is not the trade-based idea of sophistication through common standards and harmonized regulations anymore. Instead, the increasing flows of capital from and to regions – and

their accompanying exchange rate changes – have to be considered as the major determinants for economic success today; and these flows are much more sensitive to national and regional policies, than to trade harmonization. It was this insight, which made the 1992 decision of European policy makers possible, to first bind the expansionary use macroeconomic tools with the “Maastricht Criteria” externally, and to shift monetary responsibilities completely to an independent institution in another step (section 3).

It remains undisputed, however, that a monetary union is no necessary precondition for adopting the “rules of the game” (McKinnon 1993) of globalization. On the contrary, any state should be able to set the macroeconomic conditions “right” and become successful on its own. But most European countries seem to have not been able to establish a sound macroeconomic environment without outside restrictions.

To demonstrate this, section 4 follows earlier European attempts along the lines of the European Monetary System (EMS; a crawling peg exchange rate system). To keep the currency system running, it became necessary to complement it by effective monetary restrictions (section 5), which found their final incarnation in the institutionalization of the European Central Bank. The real departure for the EMU from earlier attempts at macroeconomic coordination (i.e. the EMS), however, became the acknowledged necessity to introduce a concept of fiscal restrictions in the final stage of the EMU (section 6).

Finally, section 7 outlines some of the new (macroeconomic) rules of the EMU, and section 8 concludes with a discussion of the applicability of a European-type monetary union to other parts of the world – especially to Asia. Judging from the arguments put forward in this paper, the example of the EMU as a tool for “Reforming Macroeconomics First” is extremely pertinent to policy makers in Asia as well. This does not mean, however, that the introduction of a monetary union as a new currency regime plus economic union is an economically sensible option for Asia. On the contrary, given the different historical and regional developments, countries in Asia will not be able to employ effective outside forces or anchors for

their internal adjustments. They will have to reform their (macro-)economies on their own.

2 From an EEC of Microeconomics and Trade to an EMU of Macroeconomics and Policy

The Maastricht Treaty (1993), the EMU, and the underlying general approach of macroeconomic harmonization and integration are not the result of a linear or pre-determined approach to European integration. In contrast, from its very beginnings in 1951 as a European Coal and Steel Community (ECSC; a cartel to control the production of iron and steel), the union's governments and its common bureaucracy (the European Commission) had concentrated on microeconomic harmonization and market reforms by developing an ever-increasing set of regulations and deregulations.

In legal terms this approach was extremely successful, and became crowned with the signing of the European Single Market Act in 1993, which constituted a common European Market. The economic results of this approach, however, were rather disappointing. After a firm start in the 1950s, when European trade and income growth resembled an economic miracle, the European approach of developing trade and production by building an increasingly harmonized and integrated ("perfect") market through common regulations seems to have become more of an obstacle to international competitiveness than an advantage for the attractions of the region. By the 1990s, European regulations and common policy guidelines had developed from meager steel to agricultural regulations to the enormous current set of the 80,000 pages "acquis communautaire."¹ The underlying economies, however, slowed to growth rates well below many Asian countries and the U.S. Even worse, the newly developed European institutions, which were meant to ef-

¹ The *acquis communautaire* (community heritage; or existing set of regulations and agreements) covers 80,000 pages in the English edition, and most of them refer to the Common Agricultural Policy. Although this body of regulations and agreements falls short of being a constitution, it has to be accepted by any new member of the union. This effectively means that any entering member would have to adapt its national rules and regulations to the agreements of the union intended to solve specific topics under often very different circumstances. The need for written consent on a body of rules and regulations notwithstanding, this type of constitutional development "sui generis" often raises the question of whether a structured and revised formal constitution would not provide a better basis for further development and enlargement of the union.

ficiently replace the inefficiently diverse and scattered regional authorities, were regarded as remote, powerless, poorly controlled, overpaid, even crony-like and corrupt, and its policies became infamous for producing import barriers, high prices, complicated controls, a network of incentive dependencies, and huge public sectors throughout Europe. This was, of course, quite the opposite of their objectives.

What went wrong with this approach, which should have been successful by – in its final form – targeting and superseding most protectionist national rules, harmonizing 100,000 national standards, and scrapping 60 million customs and tax formalities? Judging from today, basically two important ingredients miscarried the textbook approach:

- First, the trade-based idea that common standards and harmonization of regulations would be necessary for enhanced competition and growth resulted in the opposite (Kregel 2000). National polities and bureaucracies kept growing but paralyzed themselves by negotiations on such (obscure?) issues as how to harmonize the brewing of beer, and developing common standards for the size of condoms. European citizens, and their highly regional communities, on the other hand, were left out of the race by seeing their regional identities gradually being sidelined and (national) central states growing. Consequently, they blocked where the national bodies could finally agree.²
- Second, during the 80s, it became very clear that capital flows were starting to dominate trade flows. Capital flows to and from the regions, and their accompanying exchange rate changes, however, are much more sensitive to national and regional macroeconomic policies, like the control of inflation or fiscal prudence, than to trade harmonization. Increasing capital flows therefore began to dilute any possible success from regulatory trade improvements.

² Up to today, not even segregated and highly regulated European capital markets have been deregulated to an extent in line with the spirit of the treaty. The Lamfalussy Commission (in charge of proposals for a regulatory framework), for example, described the situation as “Kafkaesque.”

Consequently, capital flows became very much concentrated in Germany and the Deutsche Mark, while the developing financial hierarchy shifted the focus of European integration to macroeconomics and policy. Ironically, the endeavor to deal with these shortcomings of integration policy by departing from the long-standing track of “market optimization” to “policy optimization” started almost at the same time when the regulatory Single Market Act was finally signed in 1993.

3 A New Approach to European Integration?

The Maastricht Treaty on European Union, drafted in 1991 and signed in 1993, turned the approach of trade and market harmonization but economic policy diversity upside down. With the “subsidiarity” principle³ it placed emphasis on competition and diversity in the microeconomics of regulation, but enforced harmonization in the macroeconomics of politics by introducing the “Maastricht Criteria.”⁴

It is most important to stress the novelty of this approach to European integration because it shifts the basis of understanding and the research agenda in a number of ways.

- First, the EMU is not the result of a historically unique – and often incomprehensible – master plan or long-run design rooted somewhere in the post- or even pre-war history of Europe. Even the famous Werner Plan of the late 60s, which placed a monetary union on the European agenda for the first time, targeted trade and market harmonization instead of (monetary) policy issues as its objective.⁵

³ The principle of subsidiarity was officially agreed and signed only in the 1997 Amsterdam Treaty. Effectively, its content became a major pillar of the community policy already embodied in Maastricht (Treaty on European Union, Article G, par. 5), however. The principle implies that the public authorities do not take action when citizens can do this adequately and effectively. The principle also introduces the concept of gradation, i.e. higher levels of government act only when lower levels cannot do so satisfactorily.

To ensure and protect the body of already existing regulations, however, the Maastricht Treaty also stressed the already mentioned *acquis communautaire* (community heritage) as a body binding existing regulations. It became an explicit objective of the Union “to maintain the *acquis communautaire* and build on it.”

⁴ At the intergovernmental conference in Maastricht in 1992 the entrance criteria for the EMU were set to a record of exchange-rate stability, defined as having observed the “normal” EMS margins for two years, a low rate of inflation not higher than 1 percentage point above the three best EU performers, interest rate convergence to the lower limit not beyond 2 percentage points of the three best EU performers, net new indebtedness below 3%, and total (government) debt below 60% of GDP projected on the basis of the 1997 official statistics, and to be decided in 1998.

⁵ Because the monetary union was thought to be a merely necessary vehicle, it has to be regarded as more of a coincidental forerunner than the source of an ongoing project. The brief history can be told as follows:

The EEC Summit of 1969 in The Hague set up a group under the Luxembourg Prime Minister, Pierre Werner, to report on the possibilities of an economic and monetary union. The Council of Ministers adopted the Werner Plan in 1971, and committed themselves to harmonizing their budgetary policies and reducing the margins of fluctuation between their currencies until a full union would become possible in 1980. However, the point of

- In contrast to the trade-based approach of the European Single Market Act, which uses direct intervention, regulation, and deregulation to harmonize the historically grown set of national market regulations, the Maastricht concept of an EMU marks the start of a regime of general policy rules intended to initiate microeconomic reactions with less direct intervention. By restraining the use of private funds for public interventions it is binding the hands of national governments, and thus hopes for an enforcement of market demands for clear-cut, undistorted structural reforms.
- It defines a case where national governments recognized their inability to adapt fast enough to structural changes by purely national policy and negotiations. It is, to use a Japanese term, the European way of “gaiatsu,” or the politics of using outside pressures for internal reforms.
- Binding the hands of national governments with no (at least) equally powerful supranational replacements shifts national decision-making power to regional bodies. The move to an EMU must therefore be seen as an empowerment of the regions, and not as a process of centralization. As the following sections will show, the restrictions on national monetary and fiscal policy within the EMU will increase the pressure to carry out effective structural reforms and deregulations. Regional bodies will therefore have the chance and obligation to fill this gap by competing for European capital with their own profiles of attractive infrastructures and skilled human resources.

The echo of these changes to European integration work, which resulted in almost two decades of frenetic negotiations and reform proposals, but yielded little results valued by the European public, was enormous. The changes to the European agenda were touted as a “highly sophisticated attempt on the part of European countries to have the maximum possible influence over their future in a world of globalized economic activity” as the former Vice-President of the European

departure of the Werner Plan was Keynesian inspired social and labor market politics, and monetary and fiscal policy were only thought to be useful tools to reach goals like full employment. Consequently, the plan was able to initiate corporatist trade initiatives like

Commission, Lord Brittan, has put it. And it was said to be “an alternative to the vain attempt to retain the hollow shell of total national sovereignty in a world where the purported exercise of such sovereignty is in important respects no longer effective” (Lord Brittan’s Cambridge University Lecture, 20th February 1997).

Academic analysts and commentators, however, were less optimistic about the approach. Especially the more intervention and regulatory oriented camp was opposed to the departure from the course of implementing regulations and deregulations finally enshrined in the Single Act. They saw the new emphasis on monetary issues as a neo-liberal attack on the bureaucratic integration policy tools that governed harmonization through common norms, institutions, and structural funds. Ironically, liberal observers developed almost the same objections from a very different perspective. Based on a concept of efficient markets with no or little political intervention, a monetary union only made sense if it would be implemented in an “optimum zone.” Only in an optimum currency zone, where flexible prices, high mobility of capital and labor, and free competition guarantee a uniform transmission of supply and demand signals from and to the single central bank, could a single currency do some good by reducing transaction costs while not disrupting regional monetary neutrality. Obviously, these conditions were not given in Europe, and the liberal position therefore joined the more regulatory oriented by asking for further policies of market harmonization before venturing into any far-reaching monetary experiments.⁶

the European Trade Union Confederation in 1973, but any further attempts in the direction of a monetary union were buried under a mountain of inflation.

⁶ Along the same lines, the Maastricht criteria were criticized as being inconsistent because of their competing goals of exchange, monetary, financial, and fiscal stabilization.

- These goals were considered as mutually exclusive, or irresponsibly disruptive to economic growth when targeted at the same time.
- Also, the (arbitrarily) chosen target values were found to lack analytical foundation, and be insufficient to provide necessary economic harmonization.
- Last but not least, many academics thought the treaty would be inefficient, and no union would be reached in the end, because of a lack of binding constraints and enforcements in international agreements and regulations in general.

Between these two poles, however, the private sector – from major (business) lobbies to households who voted for the EMU in the end – decided to ignore academic reservations, and made the Maastricht policy possible by supporting the move to an EMU. As became clear with the unlikely success of the public votes for the union after 1992, the demand for a change of national governance and more open markets proved to be a so widespread and common interest in Europe, that even the highly complex means of building an extended supra-national union to accomplish a higher level of private and regional sovereignty became accepted. From a liberal economic model point of view, or from the perspective of a country with rather open markets, small public sectors, and rare public interventions, such a strategy of “gaiatsu,” or using outside pressures for inside reforms, and the strong emphasis on macroeconomics instead of microeconomics must look odd, of course. But from a European perspective, limiting the might of national polities seemed to be the best way of breaking up and renegotiating the numerous, often inherited, deadlocks of stagnant corporatist agreements, even if the chosen strategy would result in losses of income and wealth in the short-run.

Beyond the Maastricht Criteria, it was thought that the Euro, if finally introduced, would become an “artificial currency,” lacking the “real” economic foundation of a national economy, and therefore not accepted in or outside Europe. This skepticism – though theoretically questionable – drew on the disillusiones from earlier attempts to institutionalize new “synthetic” international currencies. As forerunners, the “Bancor,” proposed by John Maynard Keynes during the negotiations on the new financial order after the Second World War at Bretton Woods, and the also unsuccessful plan to expand the use of the IMF’s Special Drawing Rights (SDR) up to a level feasible for an international currency, demonstrated the handicaps of currencies with no backing tax authorities as guarantors of last resort.

4 EMS Exchange Rate Restrictions as an Early But Insufficient Step to Macroeconomic Coordination

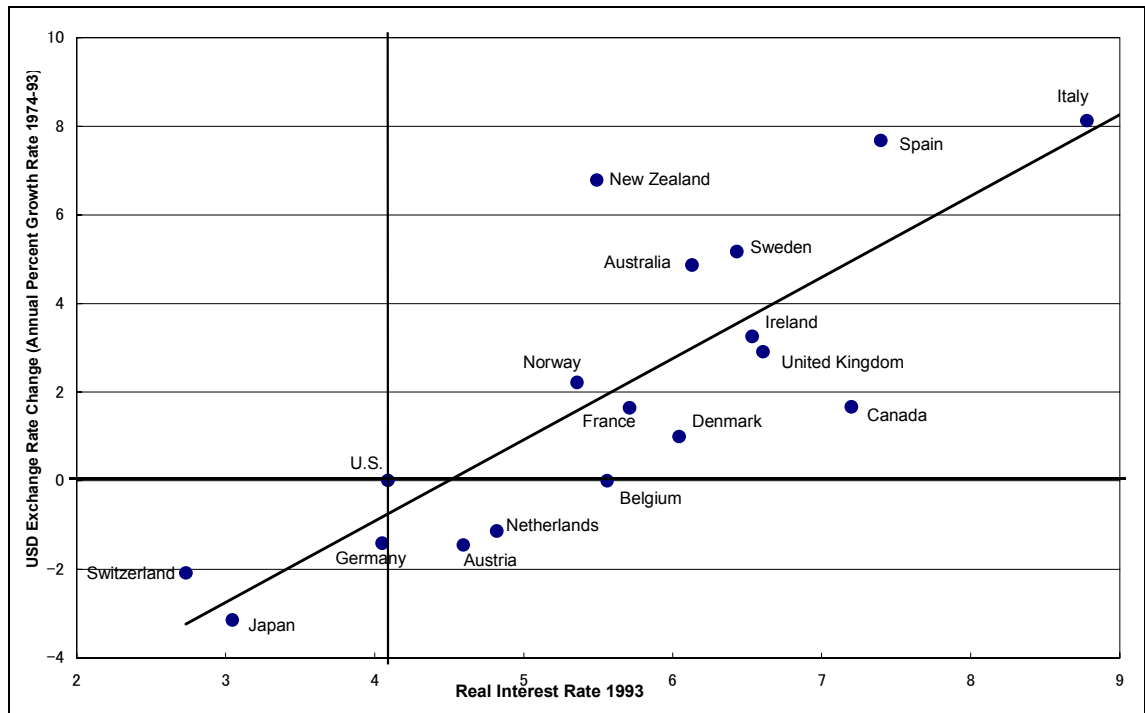
The Maastricht Treaty was not the first serious attempt to international macroeconomic coordination, of course. In Europe, following the Bretton Woods tradition of exchange rate agreements, the most significant of such attempts was a multilateral system of exchange rate bands against the U.S. dollar. The system, starting with agreed common bandwidths against the dollar, developed into the EMS (European Monetary System) during the 70s, and finally became the basis of the EMU from an exchange rate perspective.⁷ The background of this commitment was the correct analysis that after the turbulence following the breakdown of the Bretton Woods dollar-standard in 1972 only a stable exchange rate would attract sufficient capital for investment and growth.⁸

Figure 1 demonstrates this basic correlation between exchange rate stability and low capital costs in terms of real interest rates for the twenty-year period before the signing of the Maastricht treaty. Any country that deviated strongly from the level of the “world currency” U.S. dollar was punished by high real interest rates.

⁷ The 1979 introduced European exchange rate system (EMS) with the ECU (European Currency Unit) in its center did not develop into a monetary union directly. It remained a crawling peg system with a rather meaningless unit of accounting, which became prone to crises especially from the late 80s.

⁸ With the establishment of flexible exchange rates and capital flows to the U.S. dollar or competing currencies like the Japanese yen, they concluded, international capital investors would avoid keeping their capital in a country known for its depreciations. The consequences would be an increasing scarcity of capital and rising interest rates with the likelihood of further depreciations, or, even worse, a ‘vicious circle’ of capital flight, inflation, and depreciation. At the time, such consequences could easily be observed in South America.

Figure 1 OECD U.S. Dollar Exchange Rate Changes (1974-1993) and Real Interest Rates (1993)



Note: The percent change of the countries' USD exchange rate is calculated by dividing the 20-year nominal bilateral forex growth rate by 20.
 The plotted line in the figure is the result of a simple OLS regression ($R^2: 0.73$).
 Source: IMF, IFS.

The choice of a crawling peg currency regime to establish such stable exchange rates had, however, little to do with the ongoing negotiations for further trade integration or of the regular calls for further political integration. It was, as in most other regions of the world linked in one way or the other to the U.S. dollar, the result of the inability of national political bodies to deal with the consequences of international monetary independence and increasing capital flows by themselves. Most of these countries, in Europe and elsewhere, were unable to establish an independent national monetary policy, which could anchor their currencies domestically against the changes of the worlds' currency markets, because they could not shield their central banks from political quarrels, and were unable to protect their fiscal policies from expansionary requests.

Instead, most European countries chose to peg their currencies to the traditionally stability oriented monetary policy of the German Bundesbank, which became a forerunner for independent monetary policies with a clear-cut monetarist monetary

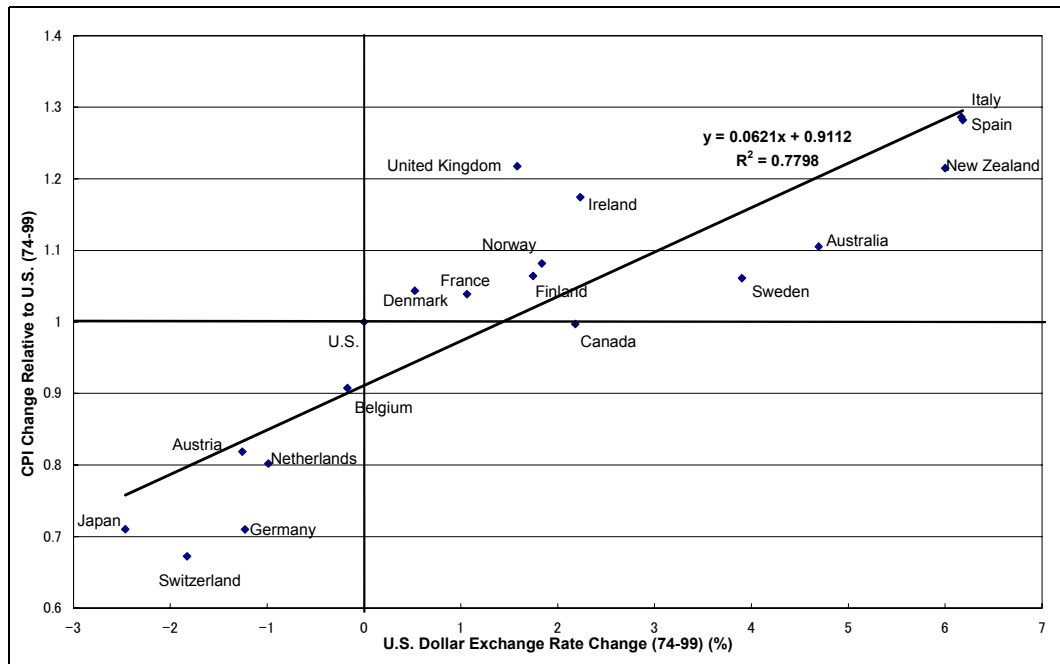
targeting concept. The result was the introduction of the EMS in 1979, which used the Deutsche Mark (DM) as an anchor for a float against the U.S. Dollar and the rest of the world.

Unfortunately, this commitment to a “fixed” exchange rate system could neither offer the hoped for monetary stability nor the targeted exchange rate stability, as Figure 2 demonstrates. This situation, which made it very clear that exchange rate stability can only be gained by (at least) successful domestic monetary stabilization, evolved because most dependent countries thought that important degrees of freedom for an independent national monetary and fiscal policy were still preserved by capital controls and exchange rate realignments – the commitment to the EMS notwithstanding.⁹ The intended ‘automatic’ monetary stabilization policy, created by effectively linking to the policy of the German Bundesbank, therefore never materialized, and inflation rates as well as the U.S. Dollar exchange rate still deviated largely within the EMS.¹⁰

⁹ The preserved capital and exchange controls were thought to drive a wedge between domestic and international interest rates to permit the central bank to use its domestic and international assets as two fairly independent instruments, one to pursue domestic policy goals and the other for exchange-rate management (Wyplosz 1988). Furthermore, capital and exchange controls have also been necessary in the ERM to avoid speculative attacks on the system when markets anticipated a realignment (Hagen 1993).

¹⁰ Between 1974 and 2000, any country with higher inflation than the U.S. found its currency severely depreciated.

Figure 2 OECD Price and Exchange Rate Changes Relative to the U.S. (1974-2000)



Note: The plotted line in the figure is the result of a simple OLS regression ($R^2: 0.78$).
 Source: IMF, IFS.

This lack of commitment to the “rules of the game” had easily destabilized the exchange rate system already during the 80s, when growing international capital flows and the advancements of the internal market project made capital controls increasingly inefficient or even unavailable. By the early 90s, the system therefore became vulnerable to successful speculative attacks like the ones on Britain and Italy in 1992.¹¹

As a result, and instead of providing a final solution to exchange rate instability or monetary unreliability, the system resulted in a quite different development. It gave an overwhelmingly important role to the Bundesbank with the DM as a key currency in Europe. This became obvious during the crisis in 1992. Any country within the EMS would have to adapt to the stance of German monetary policy –

¹¹ When the British pound faced speculative attacks betting on a probable devaluation after a period of monetary expansion in Britain and restrictive policy in Germany, the only way to avoid depreciation or exiting from the EMS in 1992 would have been a significant increase in interest rates. But raising interest rates through a restrictive monetary policy would have diminished income growth, which was so desperately needed after the Thatcher reforms. After some ineffective exchange rate interventions, Britain therefore opted out of the EMS in September 1992.

no matter how diverse the economic situation in a country (especially after the shock of German unification) might be – or leave the system and its promise of stability.

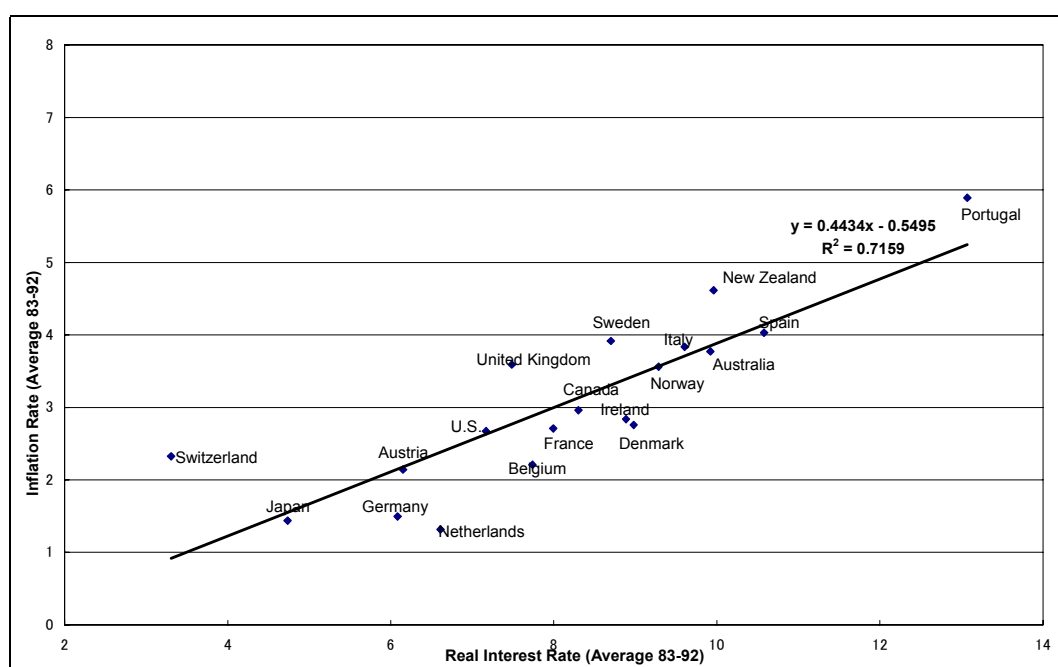
In 1992, Britain therefore opted out of the EMS because it thought it would be able to build up a reputation for stability on its own. Based on its market reforms from the Thatcher-years in the long run, and by collecting some initial short-term gains from devaluation, it hoped to establish its currency as a counterweight to the DM. The other countries of the EMS, in contrast, did not see this option for themselves and chose to stick to the system (or promised to reenter it later) while finally adding monetary and fiscal restrictions to their national policies. On top of this, they even developed into strong supporters of a new currency regime, which promised the chance to tame the might of the German central bank, while restricting the unreliability of national monetary and fiscal policies at the same time.

Finally, however, the main lesson for the European countries with their more or less “fixed” exchange rate systems after four decades became the following one: exchange rate stability can be gained only by monetary stability, which is not an automatic result of an exchange rate commitment but the cumbersome result of internal stabilization from the short to the long run.

5 Monetary Restrictions as a Requirement for a Stable Currency Regime

By the time of the Maastricht negotiations, and after two decades of experience with hollow exchange rate agreements, most politicians and economic agencies of OECD countries had come to recognize the close link between national inflation rates, exchange rates, and the flow of international capital. Figure 3 demonstrates this link by plotting average inflation rates as an indicator for monetary stabilization, and real interest rates for financing costs during the decade till 1992.

Figure 3 OECD: Inflation and Real Interest Rates (1983-1992 Annual Average)

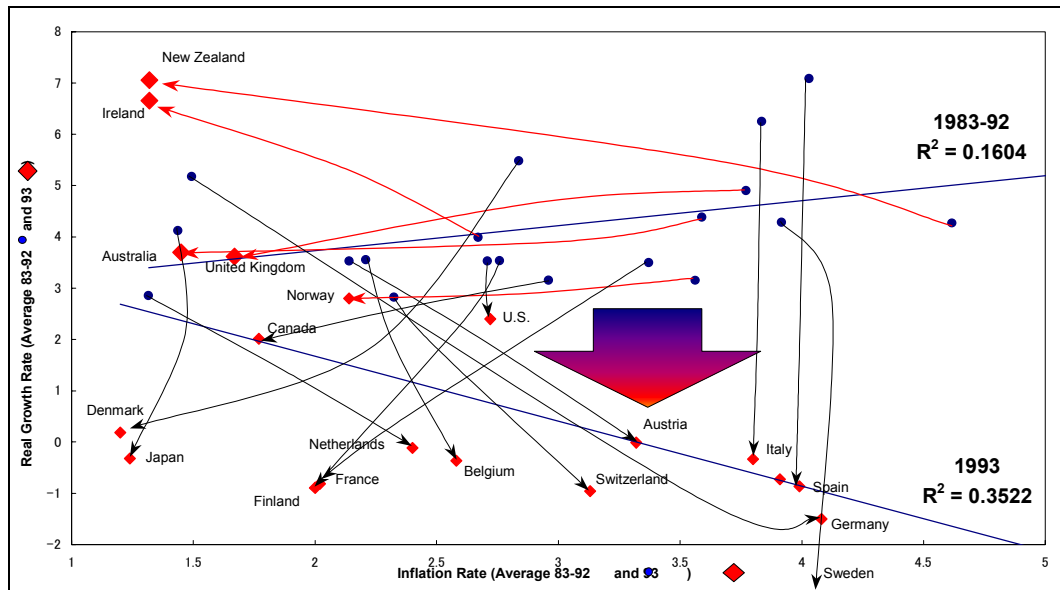


Note: The plotted line in the figure is the result of a simple OLS regression ($R^2: 0.72$).

Source: IMF, IFS.

The experience of high capital costs was not the only driving force to finally accept far-reaching monetary stabilization measures, however. During the 80s, most OECD countries also had to learn that their old Keynesian economic policies, which tried to exploit a “Phillips Curve” relationship between monetary expansion and increasing real growth rates (with only slowly reacting, “sticky” prices) became increasingly inefficient. Instead of producing “1% of inflation for 1% more employment and growth” (the 70s’ German Chancellor Helmut Schmidt), most countries became victims of agonizing stagflation (Figure 4).

Figure 4 OECD: (Modified) Phillips Curve Relationships (1983-92 and 1993)

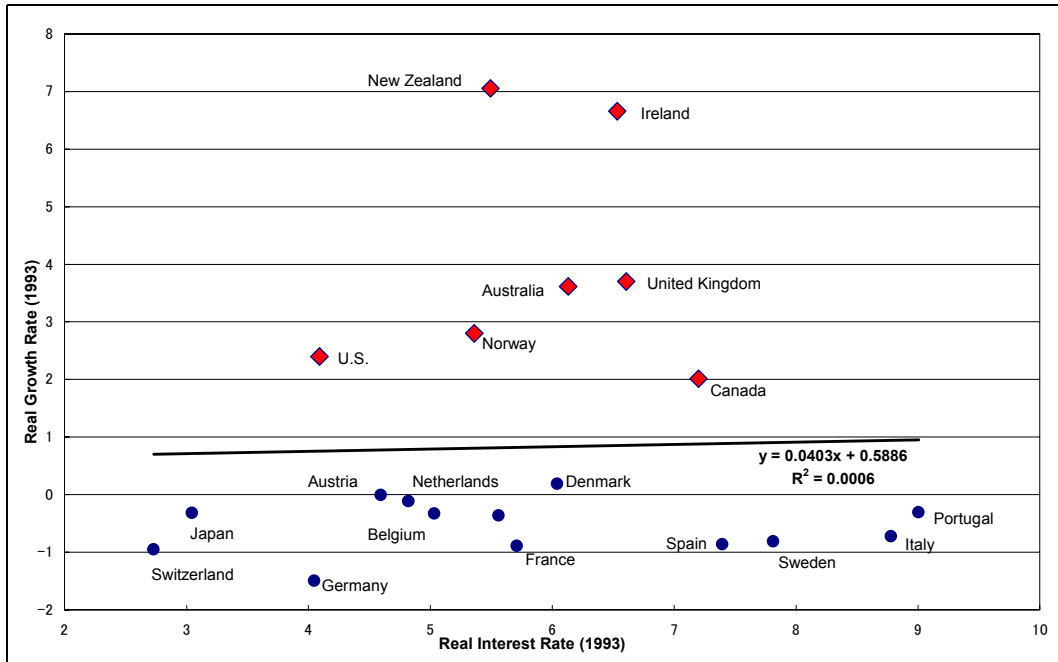


Note: The plotted lines in the figure are the results of simple OLS regressions for the two periods (1983-92 R^2 : 0.16; 1993 R^2 : 0.35).

Source: IMF, IFS.

As Figure 4 demonstrates, the link – if any – between expansionary monetary policy, as evident in higher inflation rates, and real growth rates was already extremely weak during the 80s (see the upper estimated correlation). By 1993, however, the relationship – if any – broke down completely, or even reversed to a high chance for low growth in countries with high inflation rates (the lower correlation estimate). At the time, most OECD countries already experienced lower or even negative growth with high or even increasing inflation rates. The few successful countries, as diverse as England, Canada, and New Zealand, on the other hand, which brought down inflation with stable or even increasing growth rates, were countries that had already initiated serious structural reforms, and ventured into transparency enhancing stability oriented monetary policies like inflation targeting. By means of their attractive economic models they managed to mobilize enough resources to gain high growth rates without pushing real interest to unbearable heights (see Figure 5).

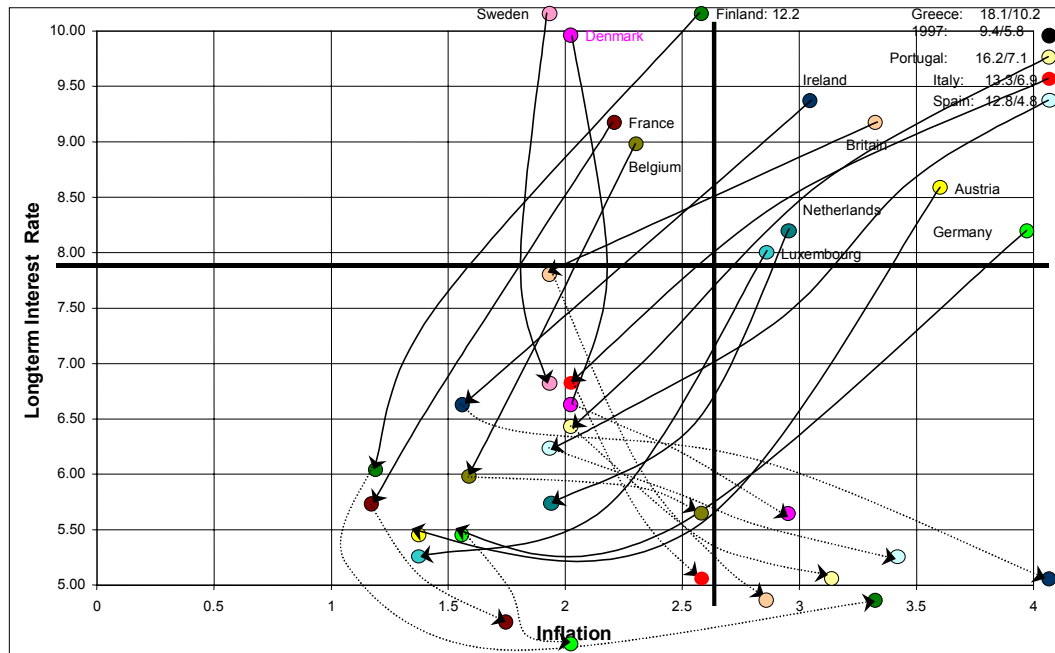
Figure 5 OECD: Real Growth Rates and Real Interest Rates (1993)



Source: IMF, IFS.

Given these experiences and examples, and because the EMS had already severely limited the degrees of freedom for national monetary policies, the monetary “Maastricht Criteria” were met by almost all candidates at the time of the May 1998 beauty contest (Figure 6).

Figure 6 Convergence Criteria: Inflation and Interest Rates 1992, 1997 and 2000



Note: The values for long-term interest rates and inflation in 2000 are: Belgium: 5.58/2.54; France: 4.89/1.72; Spain: 5.2/3.42; Italy: 5.13/2.54; Germany: 4.67/2; Netherlands: 5.51/2.57; Finland: 4.77/3.44; Sweden: 5.82/2.
Source: IMF, IFS.

The convergence of inflation and long-term interest rates during the five years between 1992 and 1997 is impressive indeed, and it underlines the strong determination of most countries that signed the Maastricht Agreement. To regain some more freedom in terms of monetary decision-making, and to become attractive locations for global capital flows again, the 15 candidates – except Greece – drew very close to the three countries with the lowest interest and inflation rates (7.9% long-term interest rate and 2.6% inflation at the time). After the start of the Union, this picture changed again, however. Due to higher energy prices, inflation rates started to increase all over Europe; but due to the otherwise still quite different economic conditions in the countries of the Euro area, inflation rates also started to deviate again. With only one common monetary policy, it will depend on the handling of national fiscal policies (see section 6), and further microeconomic integration (see section 7) if this trend will proceed, elevate, or be broken.

6 Fiscal Restrictions as the Real Departure for the Maastricht Regime

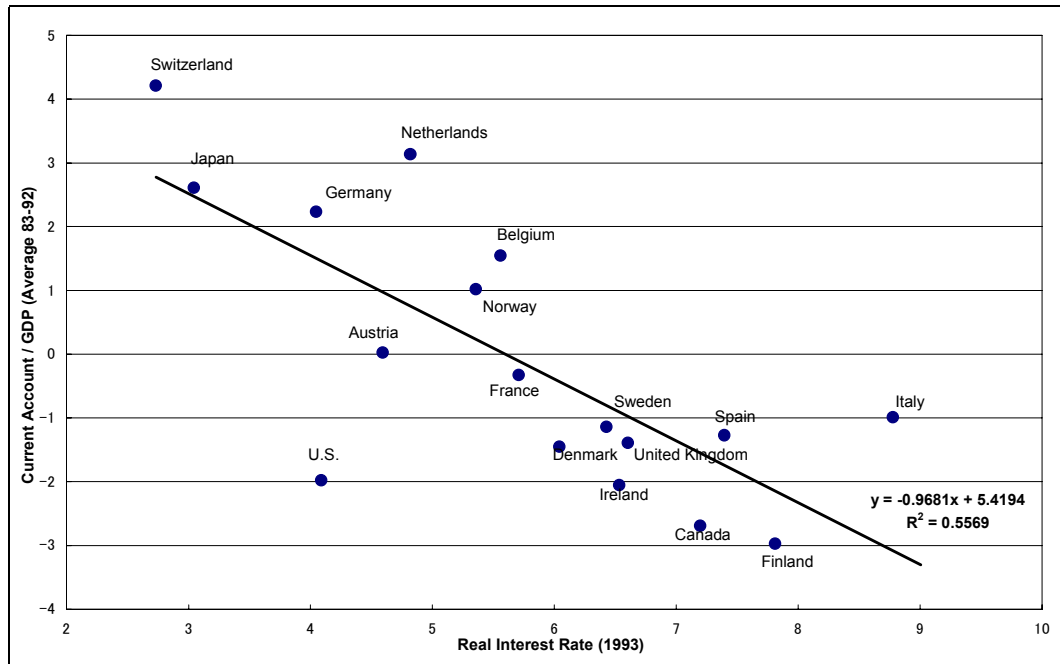
At Maastricht, the “fiscal criteria” produced the most interest and controversy because they constituted the real departure from the EMS in the short run, and seemed to be only indirectly related to the monetary core of the agreement. Furthermore, most governments were well aware that they would have major difficulties in passing an austere fiscal barrier, and the weaker ones suspected the arbitrarily chosen levels of 3% budget deficit and 60% public debt to GDP to be more of a tool for politically inspired sorting, than for establishing broadly accepted standards for “best policy.”

After considerable struggles fiscal austerity was finally recognized as a prerequisite for an independent monetary policy at the new central bank, which would otherwise easily fall victim to cash-starved national governments. The acceptance of the fiscal criteria went far beyond simple monetary arguments, however, because most European countries had already recognized that they had lost high degrees of fiscal independence to financial decisions of international investors on the world's capital markets, and that only a tamed public sector could help to regain their international competitiveness in general.

An important “eye opener” for such insights was the French “Mitterrand experiment” of 1981. Against the background of a restrictive monetary policy in Germany after 1980, the French government under Francois Mitterrand decided to lift the economy out of recession unilaterally by trying expansionary demand management. But although the government could still rely on some capital controls at the time, the capital and the current account quickly deteriorated, the exchange rate came under severe pressure, and inflation was shooting up. Already by late 1982 the French government was forced to realize that a more restrictive policy along German lines was unavoidable. If nothing changed, France would have to leave the EMS due to the high pressure on its exchange rate. Also, with its policy stance out of sync with the rest of Europe, the government realized that the current account deficit turned capital flows against France. A development, which would

finally materialize in higher real interest rates and crowding out of the public efforts to set the economy on an expansionary course. Most importantly, however, the government realized that this would happen inside or outside the EMS (Figure 7).¹²

Figure 7 OECD: Current Account (1985-1994 Average) and Real Interest Rates (1993)



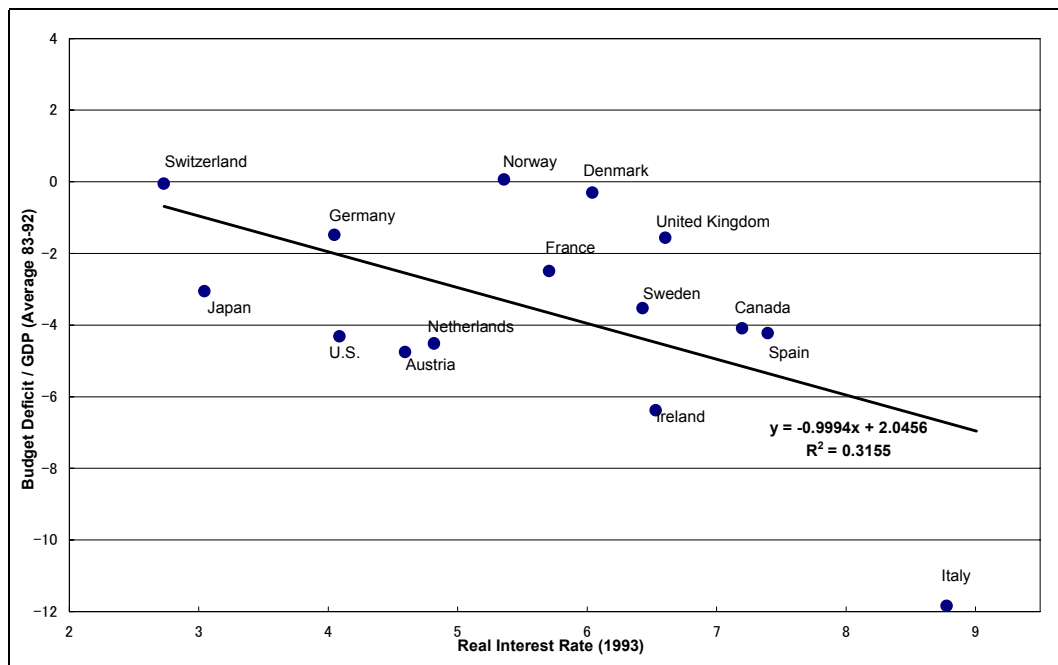
Note: The plotted line in the figure is the result of a simple OLS regression ($R^2: 0.56$).
 Source: Data from IMF, IFS.

Figure 7 demonstrates the close relationship between current account deficits and the real interest rate for the decade after the Mitterand experiment and before the Maastricht Agreement. The (almost) only exception in this picture is the U.S., which was able to maintain low interest rates despite a high current account deficit because of its role as the provider of the international key-currency, and its by far most attractive capital markets. All other countries with high prices and demand beyond their resources in the long-run were punished by much higher real interest rates.

¹² Thus, the relevant political question was not whether or not a correction should take place at all, but whether or not it should occur inside or outside the EMS. A review of the case in the OECD (1988) argues that, based on the French experience in the 1970s, the authorities expected adjustment under a flexible exchange rate to be even more harmful than adjustment within the EMS (Hagen 1993).

The current account as an indicator for a national expansion out of sync with the developments of the countries' major trading partners – regardless of the source of the expansion – presents only half the picture, however. Especially in countries where monetary policy is not independent and unreliable, but also in situations when it is bound by outside sources, as in the EMS or – even stronger – within the EMU, fiscal policy and the budget deficit become indicators and sources of interest rate and exchange rate developments (see Figure 8).

Figure 8 OECD: Fiscal Deficits (1983-1992 Average) and Real Interest Rates (1993)



Note: The plotted line in the figure is the result of a simple OLS regression ($R^2: 0.32$).
Source: Data from IMF, IFS.

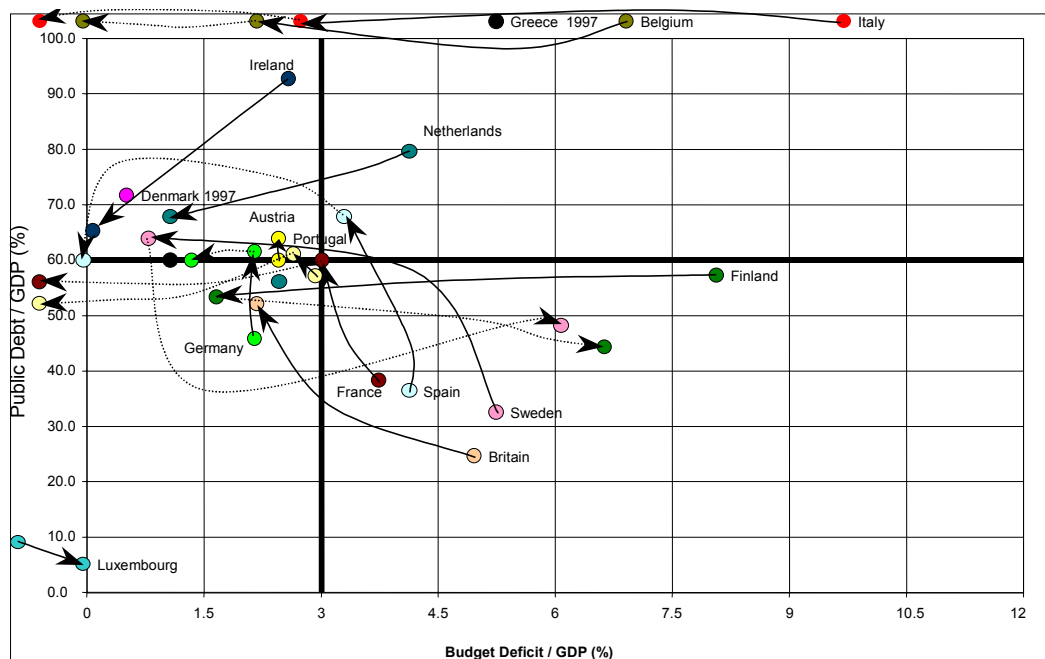
The link between budget deficits and capital costs is not very close, even for countries with public sectors the size of Europe. But the already mentioned fiscal policy disasters of the 80s underlined its significance, and most countries understood that fiscal policy would grow in importance within an EMU. When monetary policy and the exchange rate are bound in one way or the other, fiscal and budgetary policies become the most important policy tools. Many commentators of the Maastricht Agreement therefore claimed the introduction of additional fiscal goals to be optimistic at least, or outright contradictory at their extremes. They therefore recommended deleting the fiscal criteria from the

recommended deleting the fiscal criteria from the Maastricht agenda (De Grauwe 1994).

However, to become an efficient policy tool, fiscal policy had to be freed from paralyzing skyrocketing public debt, and from the many demands of the national networks of vested interests. Based on this insight, the sincerity with which most candidates followed a fiscal austerity course during the Maastricht regime became one of the most remarkable developments of economic policy in Europe during the 90s. Many countries such as Germany, France, Austria, Portugal, Spain, and the especially troubled Italy undertook considerable efforts, and even ventured into special measures like window-dressing and one-time “Union-taxes” to reach the goal for entering the Union.

Figure 9 shows the race below the 3% budget deficit line until 1997 (straight line), but also demonstrates that most countries were unable to reach their debt-target at the same time.

Figure 9 EMU Convergence Criteria: Debt and Deficit 1992, 1997, and 2000



Note: The values for deficits and debts in 2000 are: Belgium: 0/111; France: -1.3/58; Spain: -0.3/60; Italy: -0.3/110; Germany: 1.3/60; Netherlands: 2/56; Finland: 6.7/44; Portugal: -1.4/53.8; Sweden: 6.0/48.
Source: IMF, IFS.

Obviously, in 1997 most critics of the Maastricht Criteria were right: not all entrance criteria could be reached by most member states. Given the five targets,

exchange rate stability, reduction of inflation rates, interest rate convergence, and low deficit and debt levels, it was rather clear from the beginning that these goals could only be reached under the most favorable conditions, which hardly prevailed because of external factors like the costs of German unification and crises in Russia. Having their exchange rates bound within a tunnel, and their monetary policies on a restrictive course, most countries therefore used their budgets to buffer the impact, but remained able to set their 1997 deficits right into the target zone. The goal that became sacrificed during the run for the EMU was therefore public debt, and, at the time of the decisions for “Ins and Outs,” even countries with extreme public debts of over 120 percent of GDP like Belgium and Italy were allowed to enter the union based on their convergence records for the other targets.

Unlike inflation, and although a great deal of “artistic accounting” efforts was mobilized to reach the goal of EMU membership, budget deficits did not just snatch back to higher levels after 1997, however. Only the Nordic countries, Sweden and Finland, fell back to high budget deficits to deal with their ongoing economy-wide restructuring programs. Almost all of the other countries continued on their Maastricht paths, and produced the first European budget surplus in decades.

7 New Rules Apply within a Currency Union

After entering the Monetary Union on January 1, 1999, the policy regime changed for the 11 member states again. The most visible sign was the shift of monetary decision powers to the new European Central Bank, which was built upon the model of the German Bundesbank and from the basis of the European Monetary Institute in Frankfurt. With this step, all national central banks became members of the European System of Central Banks (ESCB). They lost their competence to define national monetary policies, and to set their individual interest rate and quantity targets. But they also gained voting power on common European policy issues by sending their central bank presidents as board members to the new institution.

In contrast to the fears (and hopes) before the start of the Union, the impact of this shift in monetary competence was much more limited than initially expected. As already explained above, real monetary and exchange rate steering powers in Europe became centered in Frankfurt at the German Bundesbank long before. Most EMU countries therefore lost little, but gained by exchanging their low degree of national monetary control with some voting power on the course of the Euro. The same is true for exchange rate policy. The limited chances for each country to intervene in the foreign exchange market (often on the initiative of the Bundesbank or required by EMS regulations) were traded for the participation in an international key currency. This gain, however, is limited by the independence of the ECB, which is unlikely to fall victim to the interests of any single member country.

But also the losses of national monetary bureaucracies in terms of empowerment and influence have been quite limited so far. The national central banks have barely started to reorganize in line with their new, much more limited duties (i.e. shrinking in size) while the ECB is building up its capacities. This persistence is not only due to an institutional reluctance to downsizing, though. Within the heavily banking oriented Euro Area, the whole body of specific and locally developed banking, financial, and capital market regulations and supervision procedures re-

mained almost unaffected by the changeover to the ECB. The central banks, often at the very center of these regulatory networks, are therefore still busily managing their economies in terms of regulatory control and guidance. Only as recently as the Stockholm summit in March 2001, the first steps in the direction of a more unified financial market in Europe have been taken, and even the most adventurous plans are not expected to involve any major changes before 2004 (see Lamfalussy 2001).

At least in the mid-run, the ECB is expected to focus its policy on the developments and interests in its major member countries (Germany, France, Italy, Spain). It will have almost no chance to react to or influence specific developments in periphery parts of the Euro Area.¹³ Often, the ECB is therefore claimed to be more of an institutionalized “monetary policy rule” than a central bank. As has been argued throughout this paper, focusing on macroeconomic objectives intentionally created this situation which is in stark contrast to optimum currency area setting. The policy of getting the macroeconomic framework right to induce microeconomic change by freeing market forces and increasing competitive pressure on national regulators now urgently requires tackling, however. With centralized monetary decision-making, and a “Kafkaesque” bundle of different national regulations and regulators, even the macroeconomic financial framework remains incomplete in the Euro area.

In the current state, few market players will have an incentive to restructure their business on a European level, because they are still bound by national regulations. At the same time, the still lacking credibility of the ECB, and the inevitable regional disequilibrium caused by its common policy might easily reinforce the recent European trend to integrate financial corporations into national oligopolies, and to drive foreign investment into the U.S. capital markets. Clearly, the current row about the regulatory responsibilities of the ECB, the creation of a powerful,

¹³ Interestingly, however, the policy of the ECB during its first 2 1/2 years seems to be too strict for the German economy, more or less fitting to the surrounding smaller countries,

common European Financial Services Agency (FSA), and the reluctance of national central banks and financial bureaucracies to adjust their structures to an integrated financial market with European and global players, demonstrates the limits of the “macroeconomics first” approach to European integration. Inevitably, the ghosts of the unsolved issues of financial integration of the Single European Act are back to haunt European regulators, and the rather powerless ECB will not be able to work any miracles on this important issue.

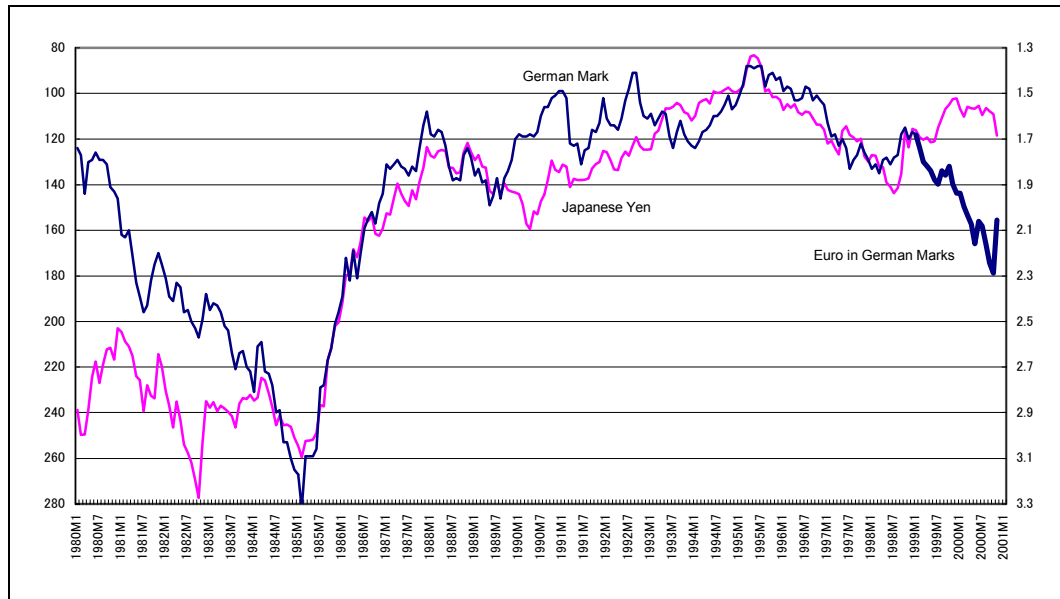
Interestingly, the EMU will therefore have its strongest effects on a less obvious but probably even more important issue: fiscal policy. Already the “Maastricht regime” has turned out to have its strongest impact on fiscal policy. After decades, it converted most European governments into practitioners of fiscal austerity, and in 2000 the EU saw its first fiscal surplus. The EMU will result in a further loss of national sovereignty in financial and fiscal policy. Because of the “no bail-out clause” (the agreement that no government failing to be able to repay its public debt will be bailed out by the central bank or other member governments), interest rate pressure on ailing national bonds will increase much earlier than indebted governments have been used to before. This “no bail-out” clause will discourage the owners of capital to meet requests for excessive net new indebtedness in the financial markets, and will enforce the tendency of international market players to evaluate national debts and policies as they evaluate the debts and policies of major corporations. As a result, even without formal regulations, chances are that the excessive uses of Keynesian deficit-spending policies won't thrive any more.

At first, however, the start of the EMU caused the opposite in many countries. For most countries, the start of the EMU came as a relief as compared to the severe austerity regulations of the Maastricht regime, which brought the first fiscal surplus of the Euro Area in decades. The first two years of the Union therefore saw a “benign neglect” of austerity issues, which – together with other issues – spread into the international perception of the Euro as a new and unproven currency of a

and probably too expansionary for countries at the periphery (like Ireland). Domination by the major countries (like Germany) seems therefore not to have materialized.

set of infighting, spendthrift countries. The effect on the exchange rate was considerable, driving the Euro down 30% from its initial value to the U.S. Dollar and the Yen (Figure 10).

Figure 10 Yen, Deutsche Mark, and Euro Exchange Rates to the U.S. Dollar (1980-2001)



Source: IMF, IFS

Figure 10 shows that the Euro declined for almost two years after its start, and approached a level much below the otherwise likely level of the Deutsche Mark. For the same basket of currencies (which make up the Euro), it declined to the lowest level in 15 years (after the Plaza interventions against the U.S. Dollar), and was down 30% to the U.S. Dollar and the Yen before it recovered temporarily at the end of 2000.

But, looking beyond this first phase of the Euro, the independent and stable monetary policy, and the credible restrictions on fiscal policy in the medium- and long-run, seem to have finally convinced European governments that the flexibility of factor prices and the mobility of labor and capital have become the necessary means of economic stability. The long-run projects for structural reform, from market regulations to tax systems, which have been stuck for so long, have therefore gained speed again. Some countries – like Germany – have even started to implement their fiscal reforms, which took decades of discussions with almost no

results before, and are now beginning to overhaul their financial structures along the lines of the Lamfalussy commission recommendations.

The remaining obstacle for open, integrated markets will be the low level of labor mobility within Europe. As critics note, labor mobility will limit the flexibility of prices and production costs throughout the Union, and the EMU will not solve this issue as long as culture, languages, and politics remain different throughout Europe; a situation, which will not change for the foreseeable future. But by increasing transparency and capital flows the EMU will limit counteracting wage policies, and will increase the flexibility of regional labor markets. In strong contrast to the private perception of closed European labor markets before, the differences in price and wage levels between regions will therefore become rather transparent, and the differences will develop into discountable mark-ups for the choice of living at one location of Europe instead of another.

8 Conclusion

It has been argued that it made sense for Europe to switch from a strategy of regulatory harmonization and (de-)regulatory market integration to a strategy of “Reforming Macroeconomics First.” In stark contrast to the theory of optimum currency zones and earlier attempts at integration, this concept targets a sound macroeconomic market framework by coordinated government intervention first, and hopes for the private market players to utilize this framework later.

But it has also been argued, that any country should have been able to adapt to the macroeconomic conditions for international competition and globalization (or to adopt the “rules of the game”) on its own. As has been demonstrated by the – internationally very common – example of the earlier crawling peg currency system (European Monetary System; EMS), however, most European countries did not succeed for internal political reasons. They seem to have been in need of an external anchor or external pressure to comply with the stability requirements of internationally growing capital flows. As an external anchor, however, the EMS was not sufficient because it left too many degrees of freedom for shortsighted and purely nationally oriented monetary and fiscal policy. Even worse, the local key-currency system concentrated international capital flows in the local anchor-currency (the Deutsche Mark), and invited a monopolization of internationally relevant monetary and exchange rate decisions at the German Bundesbank.

With the installation of the ECB and the introduction of the Stability and Growth Pact, the EMU effectively provided a resolution to these two important macroeconomic problems. The union, however, will not offer the hoped for free lunch in terms of automatic improvements of microeconomic market conditions. Joining the union, was only a (seemingly) “necessary” step to effectively bind monetary and fiscal policies, which ran out of control during the 70s and 80s. To build on this achievement, “sufficient” conditions for further growth and employment have to be implemented by supporting market players to fill the common market with private initiatives and capital flows instead of state intervention. It remains to be seen if European governments will be able to follow up the EMU leap forward

with further market reforms (as visible in current progress of tax-system reforms), or if they will fall back into old habits of intervention and the negotiation of regulatory deadlock (as in the Nice Treaty).

One important question remains to be answered: Does this European concept of a currency union offer insights or even a blueprint for Asia, where it is currently often discussed?

In my view, it indeed offers the insight that it is most important for governments to develop sound macroeconomic conditions, instead of trying to micro-regulate everything from infrastructures, to information technologies, to finance. Unfortunately, this basic insight seems to have been forgotten in many (south-east) Asian countries during the course of their fast development. In many Asian countries macroeconomic conditions deteriorated well before the Asian crisis, and the following capital flows against Asia presented the bill. Even more unfortunate is, that after the crisis the focus remained on microeconomic regulatory reforms, instead of macroeconomics and policy – the original field of economic policy makers.

In Asia, this example of the EU de-emphasizing the microeconomic role of the government by focusing on macroeconomic stability is backed up by the contrasting Japanese example of “how to get the macroeconomics wrong” after the “bubble” of the 80s burst. In Japan, for a decade now, most economic policy debates have focused on microeconomic issues like “becoming an IT society,” or adopting “international corporate governance rules” etc, while macroeconomic conditions (with public debt equivalent to more than 130% of GDP and ongoing deflation) were allowed to deteriorate to the worst level of any developed country with almost no positive impact on growth or income. Unfortunately, it has to be feared that this situation will not change soon, and that major parts of Asia will follow this example of over-regulation, instead of consolidating their fiscal and monetary balances.

The EMU itself, however, does not offer any direct blueprint for Asia, although important similarities seem to exist. As in Europe, many Asian countries seem to be in need of effective (regional) international agreements and systems as external anchors for their internal political inabilities. As in Europe, many Asian countries

therefore ventured into unsuccessful crawling-peg currency systems, and experienced poor results with capital flows turning against them. But at least for two reasons an Asian currency union does not offer the hoped for cure. First, most Asian countries pegged their currencies to the U.S. dollar, but unlike the Deutsche Mark in Europe, this key-currency cannot be internalized into an Asian union. The only local contender, on the other hand, the Japanese yen, has not yet developed into a local key-currency or possible external monetary anchor. A local key-currency – in contrast to the much stricter requirement of a fully developed “optimum currency area” – is a necessary precondition for any currency union, however. No currency regime can do without a stable and proven currency basis at its center.

Second, it has also been argued that a political union as a teleological long-run target is no necessary precondition for a monetary and economic union. But during the course of the last decades, most European countries have learned how to constantly talk together, developed instruments and institutions to discuss and solve disagreements, and harmonized their economic and political means and targets. In Asia, however, this type of political consolidation, which is a precondition for running a common economic area, is still a very long way off in comparison with Europe (which is far from perfect itself).

As a consequence, most Asian countries should seriously consider “Europe’s Answer to Globalization” and try to reform their macroeconomics before venturing into further microeconomic market (de-)regulation. Unfortunately, however, they will not be able to use the European tool of (regional) international agreements as an outside-pressure device for consolidating their monetary and fiscal policies against internal (political) resistance and deadlock.

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