

Ten Years of European Monetary Union

Peter B. Kenen

**Walker Professor of Economics and International Finance, Emeritus
Princeton University**

It is a pleasure to return to the Graduate Center and a particular pleasure to join you in marking the 10th birthday of the European Monetary Union

Permit me to begin on a personal note. My own association with EMU began much earlier than the start of EMU in 1999. As early as 1969, I presented a paper at a conference at the University of Chicago, in which I sought to amend Robert Mundell's seminal paper on the theory of optimum currency areas – the theoretical framework which is still used to assess the benefits and costs of a monetary union.

In 1991, moreover, I was appointed to the Houblon-Norman Fellowship at the Bank of England and was planning to pursue my own research agenda. But I was highjacked by the Bank's staff committee that was advising the UK Treasury on the work of the forthcoming Maastricht Conference that would prepare the plan for monetary union. I spent almost all of my time on that task, reading and comparing the various national plans for the proposed monetary union. I even reviewed the briefing book that Prime Minister John Major would take to the Maastricht Conference. In my remaining months at the Bank, I used my notes and memoranda to draft a monograph on EMU, which was, of course, reviewed by my colleagues at the Bank, who did not ask me to make any significant changes but did suggest that I indicate explicitly what was in fact quite obvious – that the views expressed in my monograph were my own, not those of the Bank or UK Treasury.

All this is my way of saying that I know what I'm talking about – but that's really for you to judge when I have finished my remarks. Let me move then from autobiography to the biography of EMU itself.

In 1973, the Bretton Woods system of pegged exchange rates collapsed completely, and exchange rates began to fluctuate more or less freely. But large exchange-rate fluctuations were seen to threaten the cohesion of the European common market, especially the common agricultural policy. Hence, Europeans began considering ways to limit intra-European exchange-rate fluctuations.

In 1978 Chancellor Schmidt of Germany and President Giscard d'Estaing of France called for the creation of a "zone of monetary stability" in Europe, and in 1979, the European countries established the European Monetary System (EMS) which was in effect a regional version of the Bretton Woods System. Intra-European exchange rates were to be kept within a narrow band, and central banks would intervene in the foreign-exchange market to keep them within the band. There were in addition arrangements under which a strong-currency country would intervene on behalf of a weak currency or would lend its currency to the central bank of the weak-currency country. These arrangements were meant to make the system more symmetric than the Bretton Woods System, under which the obligation to defend a weak currency resided entirely with the weak-currency country.

But the EMS proved to be less symmetric than in practice than it was in principle, largely because the Bundesbank had become the *de facto* central bank of the EU but set its monetary policy to deal with economic conditions in Germany, not in the EU as a whole, and partly because the EU countries were committed to abolishing all of their remaining capital controls by 1992, which would make it far harder for EU countries to maintain the quasi-fixed exchange rates of the EMS. In fact, the EMS suffered a major exchange-rate crisis in 1992 and it was decided thereafter to adopt much wider bands within which exchange rates would be free to fluctuate.

In 1989, however, well before that crisis, the EU had created a committee comprising the central bank governors of the EU countries and chaired by Jacques Delors, the President of the European Commission. The committee was asked it to design a full-fledged monetary union for the EU – but was not supposed to make any formal recommendation regarding adoption of the plan that it devised. Plans of that sort had been made before were not implemented, and the Delors Committee began its work without knowing whether its recommendations would be adopted – which leads me to one more personal note:

I was at that time Director of the International Finance Section at Princeton, which published Essays and Studies on international monetary issues. When the Delors Report was about to be published, I phoned someone involved in the work of the Delors Committee, to ask whether we should plan to publish a symposium on its forthcoming report and, if so, whether he would contribute the introductory chapter. I won't tell you his name, so as not to embarrass him, because he told me that the Delors Report would have no long-lasting effects, and it was not worth organizing a symposium.

We know, of course, that he was wrong: In 1991, an Intergovernmental Conference was convened at Maastricht with the aim of converting the European Community into the European Union and establishing a full-fledged monetary union to replace the EMS, with a European Central Bank at its center.

The Treaty did not create EMU immediately. Instead, it set out so-called convergence criteria that each EU government would have to satisfy in order to qualify for membership in the monetary union. These included low inflation, a small budget deficit, a moderate public debt and a low long-term interest rate; as well as previous participation in the exchange-rate mechanism of the European Monetary System without having devalued its national currency unilaterally within the previous two years. (The treaty also contained an opt-out clause for Britain (which my colleagues at the Bank of England had urged me to describe in my monograph as an opt-in clause – a change that I declined to make.)

The Treaty also created a European Monetary Institute to prepare for the creation of the monetary union, and it did a remarkable job under the leadership of Alexandre Lamfalussy. Its biggest achievement was the design of the interbank settlement system known as Target to link the national banking systems of the euro-area countries *via* the balance sheet of the European Central Bank.

As you know, EMU came into being on schedule in 1999, which is why we are now marking its 10th birthday, and euro notes and coins were issued two years later, after plans had been made to substitute them for the member countries' national currencies. This was a massive task. It was necessary to redeem all of the member countries' national currencies and replace them with euro notes and coins, to reissue all government documents, such as tax returns, and replace every reference to the country's currency with a corresponding reference to the euro and to alter every ATM and vending machine to handle the new notes and coins.

I will not dwell at length on the institutional structure of EMU, but let me mention five differences between it and the Federal Reserve System in the United States:

First, the Governing Council of the European Central Bank includes the President and the five other members of the Executive Board, as well as the Governors of all of the National Central Banks, and it is the main policy-making body of the monetary union. In the United States, by contrast, monetary policy decisions are made by the Federal Open Market Committee, which comprises the seven members of the Board of Governors, the President of the Federal Reserve Bank of New York, and the Presidents of four other Federal Reserve Banks serving in rotation.

From the very start, moreover, the first President of the ECB, Wim Duisenberg, insisted that debate within the Governing Council focus on economic developments in the euro area as a whole. Members may make reference to developments in individual countries, including their own, but only insofar as they have significant implications for the economic outlook in the whole euro area. This was perhaps Duisenberg's most fundamental contribution.

Second, the European Central Bank has its own balance sheet and implements its main monetary policy decisions, whereas the assets of the Federal Reserve System are held by the 12 Federal Reserve Banks, with the Federal Reserve Bank of New York implementing the main monetary-policy decisions of the Federal Reserve System.

Third, the European Central Bank does not supervise commercial banks in its member countries, not even cross-border banks, whereas the Federal Reserve Board is one of the main bank supervisors in the United States. In fact, the ECB is barred from playing any role in bank supervision unless it is explicitly instructed to do so. The draft of the ECB's Statute prepared by the governors of the national central banks had proposed that the ECB "would participate as necessary in the formulation, coordination, and execution of policies related to prudential supervision," and would "formulate, interpret and implement policies relating to the prudential supervision of credit and other financial institutions for which it is designated as competent supervisory authority." But the Maastricht Conference adopted more restrictive language:

Under Article 25 of the ECB's Statute, it "may" offer advice and be consulted on matters pertaining to prudential supervision and may undertake supervisory tasks, but only when the Council of Ministers "acting unanimously on a proposal from the Commission, and after consulting the ECB, and after receiving the assent of the European Parliament, confer upon the ECB specific tasks concerning policies relating to the prudential supervision of credit institutions and other financial institutions with the exception of insurance undertakings"

It would be hard to erect a higher set of hurdles! And those hurdles may stand in the way of reforms, the need for which has become very apparent in the course of the current financial crisis. At the very least, the ECB should be included in the so-called colleges of supervisors that will in future oversee large cross-border banks operating mainly within the euro area.

But let me go on with my list of five differences between the ECB and the Federal Reserve:

Fourth in my list of five differences, the European Central Bank has primary responsibility for intervention in the foreign-exchange markets, whereas the Secretary of the Treasury has that responsibility in the United States.

Fifth, the European Central Bank has a single primary objective, price stability, whereas the Federal Reserve has a dual mandate to maintain price stability and maximum employment.

All of which brings me at last to my main task – telling you what has gone right and what has gone wrong.

What has gone right is quite remarkable: the system is up and running and has defended its operational independence from its members' governments and from the Council of Ministers of the EU. Nevertheless, there are some reasons for concern:

Although the dual mandate of the Federal Reserve can pose a dilemma for it, the primary target of the ECB, maintaining price stability, can do so too. Recently, for example, the current President of the ECB, Jean Claude Trichet had to justify the ECB's interest-rate cuts in a rather convoluted way. The interest-rate cuts were clearly intended to deal with the current financial crisis and the sharp fall in economic activity in a rather convoluted fashion. But he felt compelled to justify those cuts by citing a fall in *expectations* of future inflation.

Furthermore, the huge appreciation of the euro in 2006 and 2007 impaired the external competitiveness of some euro-area countries, including Italy and Spain (although most of their problems were home-made). To be sure, the pound also appreciated sharply during those two years, but there was, believe, a strong case for concerted intervention by the ECB, the Bank of England, and the US Treasury.

My third concern has been underscored by the current financial crisis. To its credit, the ECB, like the Fed and Bank of England, created special facilities to pump cash into the financial system during the crisis, even when inflation was still above the ECB's comfort zone, although, as I said a moment ago, it had to invoke expectations of falling future inflation to justify its actions.

Finally, a constitutional problem looms on the horizon as the countries of Central and Eastern Europe qualify for membership in the European monetary union. Only three relatively small countries have qualified for membership in the ten years since EMU began (Slovenia, Cyprus, and Malta), but other much larger countries are waiting in the wings, such as the Czech and Slovak Republics, Hungary, and Poland. With the addition of these and other EU countries, the ECB's Governing Council will become unmanageably large, and the plan adopted by the ECB

for rotating membership is, in my view, unsatisfactory.

So how do I grade the ECB's performance during its first decade? It has, I believe, been very successful, and I would therefore give it a solid A-. But don't tell my friends at the ECB, who would not be satisfied with anything less than a straight A.