1 Introduction

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The inter-governmental conference convened to revise the Treaty of Rome, initiated at the end of 1990 and concluded at the Maastricht summit one year later, signalled the formal beginning of the process towards economic and monetary union (EMU). The Maastricht approach favoured gradualism over a rapid transition towards the adoption of a single currency. Gradualism was justified on the grounds that convergence of macroeconomic variables is a pre-condition of EMU and that time would be needed to set up new European monetary institutions.

The events that occurred during the summer of 1992 have cast a shadow over the Maastricht approach. The Treaty was first rejected by the Danish voters, and later won a wafer-thin majority in France. Meanwhile, the uncertainty about the outcome of these votes, and the lack of progress of some countries in implementing their convergence programmes, combined with the uncompromising attitude of the German monetary authorities, put pressure on the European monetary system. After 13 years of steady progress during which the system had expanded from eight to eleven members, and almost six years since the last realignment, the exchange rate mechanism eventually broke up. In September 1992, the United Kingdom and Italy withdrew from the exchange rate mechanism and Spain and Ireland resorted, albeit temporarily, to exchange controls. Most importantly, the Bundesbank indicated that it no longer felt obliged to comply with the rules of the system – i.e. the commitment to central bank intervention whenever a currency reached its fluctuation margin.

What happened is reminiscent of the events that 20 years ago brought about the abandonment of the Werner plan, the first attempt in the post-war period to create a European Monetary Union. At the time, in the early 1970s, what was left after the crisis was the ‘snake-in-the-tunnel’, essentially a Deutschmark-zone extending no further than Amsterdam and Brussels.
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Both episodes raise doubts about gradualism as a way of achieving monetary union. The Maastricht approach, as the Werner plan 20 years earlier, is a product of the French vision of money being the driving force in politics and in economic fundamentals. But gradualism is inconsistent with that vision: if the fait-accompli of a single currency is deemed to provide sufficient discipline to force economic convergence, then waiting for fundamentals to converge is wrong. If the ability to use the same banknotes throughout Europe, and to understand foreign prices without having to undertake cumbersome computations, is enough to influence the median voter, then the adoption of a single currency should be accomplished swiftly rather than gradually.

Following the autumn crisis, the Maastricht process has now formally resumed, but the momentum seems to have been lost, and the doubts about the desirability of a single currency for Europe have come to the fore.

The essays in this volume provide excellent analyses of such doubts. When they were first presented at a conference in the weeks between the political agreement on Maastricht and the formal signing of the Treaty, they seemed to be out of step with current events in Europe. A year later their timing seems almost perfect.

The essays discuss the arguments for and against EMU from a long-run perspective. The contributions of both authors and discussants centre on two broad issues:

(i) the rationale for ‘convergence criteria’ and the ability of a number of countries to meet these criteria as well as the desirability of their doing so; and (ii) the effect of the adoption of a common currency together with the completion of the internal market upon the overall rate of economic growth in the EC and its convergence across countries.

1 Fiscal policy, geography and politics

A central question for these two issues and for the entire process of monetary union is the role of fiscal policy both at the national level and at the EC level. In Chapter 3, Corsetti and Roubini discuss the trade-off between the benefits of fiscal rules and the ability to use fiscal policy as a stabilization instrument.

Behind the idea of fiscal rules is the thought that they will provide an incentive to enable fiscally-weak countries to avoid ‘excessive’ or ‘structural’ deficits. These deficits may be politically motivated and may endanger, through the insolvency of the public sectors, the monetary stability of the entire union.
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But rigid fiscal rules do not allow tax-smoothing in the presence of transitory shocks: they may thus prevent governments from running adequate deficits during recessions.

One of the most difficult issues in the management of economic policy in EMU is thus the ability of individual countries to respond to external shocks once they can no longer use the exchange rate as a means of adjustment. It is sometimes argued that fiscal policy must play a greater role in cushioning the impact of shocks, which seems difficult to reconcile with the Maastricht convergence criteria.

If shocks are distributed asymmetrically across countries and if national fiscal policies are constrained by binding rules, then there might be a case for either a two-speed EMU (core countries versus peripheral countries) or for an increase of fiscal funds at the federal level. The case for fiscal federalism (as in the US) and/or global tax incentives, may become stronger in the long-run, when there is no other available instrument to offset region-specific business cycles and/or excessive industry concentration.

Tamim Bayoumi and Barry Eichengreen describe and compare in Chapter 7 the underlying shocks to supply and demand in Europe and the USA since 1963. They find that shocks in Europe were significantly more differentiated among countries than shocks among regions of the USA, which suggests that Europe may find it harder to conduct a successful common monetary policy. For an ‘inner core’ of Germany and its closest neighbours, however, they found that shocks were notably more symmetrical than for the Community as a whole.

As pointed out during the conference, however, the greater coherence of the shocks affecting the USA is not surprising – precisely because it is already a currency union. What matters is how the United States would have behaved if it had not been a currency union and how Europe will behave when it is. It may be that Europe will form a more natural common currency area than the USA: its countries are less specialized in production than US regions so shocks should be less idiosyncratic.

In Chapter 8 Paul Krugman examines how Europe might respond to a regional shock similar to the recent recession in New England. US regions are more specialized in production than European countries, so the specialization of the latter may increase as integration proceeds. Specialized regions are more vulnerable to shocks, especially those caused by shifts in tastes away from their exports. Moreover, capital movements in an integrated area may amplify shocks rather than attenuate them. A disturbing aspect of US growth is that regions appear to diverge over long periods, with no evident tendency to return to any historically ‘normal’ level of relative output or employment. This suggests that the EMU,
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together with the single internal market, will make US-style regional crises more common and more severe within Europe.

Krugman also argues that shocks will pose greater difficulties for Europe as labour mobility increases: as regions in recession lose labour more readily, temporary shocks will become permanent. Bayoumi and Eichen- green argue that it is precisely the lack of labour mobility that will make Europe’s shocks harder to accommodate, as regions in recession suffer income reductions that further aggravate inter-regional disparities. One important difference between the two approaches is that, for Krugman, employment divergence is definitely more than a short-term phenomenon.

Although most of the economic integration that Europe could expect to achieve has already taken place, there are still obstacles to trade to be elimi- nated. Therefore it is argued that further European integration resulting from economic and monetary union will spur growth if, for example, specialization and geographic concentration of economic activities create beneficial externalities that promote faster growth. In Chapter 6 Giuseppe Bertola argues that such externalities need not imply that concentration is socially optimal. He distinguishes between the aggregate scale economies required to sustain endogenous growth, and local scale economies which may lead to privately optimal – but socially excessive – concentration. The ensuing policy conclusion is that both geographic and inter-temporal dis- tortions must be considered in the planning of a unified European tax struc- ture. While further integration may in theory lead to excessive special- ization, there is a greater risk – it was argued during the conference – that attempts by governments to freeze existing production patterns will prevent the restructuring that is needed for EMU to deliver all its potential benefits.

2 Inflation convergence in fixed exchange rate regimes

Marcus Miller and Alan Sutherland, in Chapter 4, note the surprising persistence of inflation differentials in the countries belonging to the ERM, given the perceived lower likelihood of realignments in the period from January 1987 until 1992. They developed a model to assess the effects on inflation convergence of contract structures, speed of learning, shocks and perceived rules for realignments. They first found that with overlapping wage contracts and a fully credible exchange rate peg, there was some inflation inertia, but not enough to account for the sluggishness observed in practice. Second, overlapping contracts with a currency peg that is less than fully credible produced subdued inflation and protracted recessions after the adoption of the peg. Third, introducing informational asymmetry among agents increased the pace of adjustment.
If a large overvaluation is undermining the credibility of the peg, a devaluation may increase the credibility of the new rate provided the devaluation is perceived to be the last. A revaluation of the Deutschmark against the other ERM currencies at the moment of German unification might have met this criterion: German reunification is no everyday occurrence. Could this have prevented the crisis of 1992?

Sérgio Rebelo, in Chapter 5, examines, using data for Portugal, the extent to which the slow convergence of inflation could be the result of real forces that produce an appreciation in the relative price of non-tradables. Portugal’s overall inflation rate fell by less than two percentage points towards the average of the exchange rate mechanism after the escudo began to shadow the ERM narrow band in 1990. Inflation in the traded-goods sector converged, while inflation in the non-traded-goods sector did not; so an essential part of the story was the persistent rise in the relative price of non-tradables to tradables.

The credibility story of Miller and Sutherland may partly explain the lack of inflation convergence in Portugal. The commitment to an exchange rate policy which provides for the ERM rate to be shadowed is by definition less credible than overt participation in the ERM, which Portugal joined only in April 1992.

Rebelo focuses on a different explanation: he suggests that the process of transition toward the steady state of an economy with low capital stock can also be responsible for an appreciation of the relative price of non-tradables.

It was pointed out during the conference that Japan’s inflation rate had consistently remained five or more percentage points above that of the USA throughout the 1950–70 period, without any loss of competitiveness. In fact, consumer prices may not be a very good indicator of competitiveness; the prices of traded goods — or unit factor costs — may give a more accurate picture.

According to this explanation, the convergence of inflation of tradable goods should be a sufficient condition for membership of a fixed exchange regime such as the European monetary system. In other words, higher rates of inflation associated with movements in the relative price of non-tradables caused by real factors are compatible with a fixed exchange rate regime.

An economy with a high inflation rate will have a relatively low (or even negative) non-tradables real rate of interest while the tradables real interest rate will be the same in both countries. This real interest rate configuration does not in itself fuel the inflation process and undermine the fixed exchange rate regime.
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3 Financial market integration and capital taxation

Recently many economists have drawn attention to the changing character of the exchange rate mechanism. Governments were, until the summer of 1992, evidently reluctant to seek realignments in circumstances that would earlier have prompted them to do so: the exchange rate mechanism, between 1987 and 1991, became more 'credible' than formerly.

In Chapter 9 Jeffrey Frankel, Steven Phillips and Menzie Chinn use both direct survey evidence of exchange rate forecasts and interest rate differentials to test how the credibility of the ERM’s target zones has changed over time, and in particular whether the markets have regarded the currency bands as more credible since the last realignment of parities in the 1980s.

Their results indicate that the ERM was indeed more credible between 1987 and 1991 than before. Not surprisingly, the guilder’s target exchange rate against the Deutschmark was the most credible. The credibility of other currencies was ‘less than perfect’ but had increased recently, and especially since the beginning of 1990. The failure of the simple target zone model to account for the behaviour of ERM members’ exchange rates could not be attributed to errors in the measurement of expectations, as is often supposed, because the results which the authors obtained from survey data were no more supportive than those based on interest rates. The model’s failure is more likely due to its implicit – and implausible – assumption that the credibility of exchange rates is constant.

It was pointed out during the conference that the main weakness of the simple target zone model was the assumption of rational expectations in the foreign exchange market, for which there is no evidence in favour and a great deal against.

As the internal market proceeds together with increased goods and financial market integration it may be possible that, even well before the introduction of a single currency, domestic money markets will not survive without perfectly synchronized national monetary policies. In fact, recent events within the European monetary system are a good illustration of that point. The current status of Stage II is therefore unlikely to remedy the present situation and may even further heighten exchange rate instability. The possibility of currency substitution may, on the other hand, be further aggravated by a vicious circle – countries trying to meet the convergence criteria will experience a higher degree of exchange rate instability making it harder for them to converge.

That possibility emphasizes the potential conflict between the gradualism envisaged at Maastricht and the stability of the entire EMU process. This instability in turn may affect all countries embarked on the
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EMU course and not only the countries catching up with the convergence criteria. The latter already face the stringency of some of these criteria and therefore the trade-off between the need quickly to accomplish sufficient convergence and the aim to attain sustained economic growth during the convergence process and subsequently when full membership of the EMU has been accomplished.

Although typically consumers hold foreign as well as domestic currency, and a rise in the cost of holding one currency leads them to move smoothly to another, many commentators have asserted that currency substitution will jeopardize Europe’s financial stability as EMU approaches. Conventional money demand equations do not permit an unambiguous definition of currency substitution. In Chapter 10 Matthew Canzoneri, Belzad Diba and Alberto Giovannini describe a model that explicitly accounts for money demand in terms of market organization and transactions imperfections. If goods and factor markets are integrated but governments continue to run divergent monetary policies, as is currently the case in Europe, the currencies that are relatively costly to carry will disappear, as will the corresponding financial intermediaries. Indeed, the corresponding firms will disappear as they will no longer be able to sell their output. The authors conclude by recommending that no effort be spared to ensure the convergence of monetary policies among the member countries during Stage II. Possible measures to achieve convergence include a narrowing of the ERM bands to secure the tighter synchronization of national discount rates and supplies of domestic credit.

Increased financial market integration may cause investment to flow to countries with the least demanding tax regimes. An example of competition forcing capital taxes to zero is Germany’s experience in 1988-89 when an attempt to impose a withholding tax on interest income had to be abandoned to prevent further outflows of capital. The extent of this effect will depend on how far the existing tax systems distort investment, whether competition alone will achieve the necessary convergence in tax regimes or whether inter-governmental cooperation will be required, and how much harmonization of capital taxes is needed. The European Commission hopes to harmonize the tax base and set minimum tax rates in order to facilitate tax competition, reduce divergences in tax rates, and hence reduce the cost of distortions. In view of the difficulties in assessing the current situation, this looks like a reasonable approach. In Chapter 11 Peter Sørensen presents an exhaustive review of Europe’s corporate tax systems, which indicates that intra-European tax distortions are now not very large and that most of the gains from Europe’s economic and financial integration can be achieved without complete tax harmonization, although certain tax obstacles to cross-border investment should
be removed. Tax competition among EC member countries is probably not strong enough to eliminate differences in corporate income tax; but the harmonization of personal taxes on capital income may be necessary to protect the integrity of the system of personal taxation.

4 The Maastricht Treaty

The European union envisaged in the new Treaty will adopt, at the latest by 1 January, 1999, a single central bank.

Countries wishing to participate in EMU have to satisfy some conditions (the convergence criteria) put forward in the Treaty. These are: the convergence of inflation and interest rates; the fluctuations of the respective currencies not exceeding the narrow ERM bands for at least two years without any central parity changes; a budget deficit not exceeding 3% of gross domestic product; and a gross public debt not exceeding, or converging to, 60% of gross domestic product.

Niels Thygesen examines the role of Stage II of EMU in the following chapter. The Treaty has unambiguously set 1 January 1994 as the starting date for Stage II and has relaxed the conditions to be met by that date. All 12 countries can now embark on Stage II, although this is to be ‘less qualitatively different’ from Stage I than initially envisaged. The European monetary institute (EMI) will oversee the exchange rate mechanism, promote the use of the Ecu during the transition and prepare for Stage III.

The most important institutional innovation of the Treaty is to decree that the head of the EMI will be appointed, not elected by the governors of the national central banks; it cannot be judged in advance whether this will raise the public profile of the post.

Maastricht also resolved uncertainty about the end of Stage II: a majority of EC countries can move to Stage III if they meet the convergence criteria by the end of 1996; otherwise EMU will begin in January 1999 for those countries (whether a majority or not) that fulfill the criteria by mid-1998. Relaxing the requirements for Stage II and setting a binding terminal date will make it harder to make a straight move from something like the present voluntary and decentralized operations to the highly centralized system designed for Stage III, which will force the EMI’s agenda beyond the tasks specified in the Maastricht texts.

It was suggested that the point of the Maastricht summit had been to provoke such instability; in other words, to threaten countries that were already unlikely to meet the convergence criteria.

These are the issues currently at the centre of the European policy debate. We hope that this volume will contribute to a better understanding of these problems.
2 Economic and Monetary Union: Critical notes on the Maastricht Treaty revisions

NIELS THYGESEN

1 Introduction

The inter-governmental conference (IGC) on economic and monetary union (EMU) which started in Rome in December 1990 and was concluded in Maastricht one year later had two main tasks. The first was to define, as precisely as possible, how collective authority over economic policy will be exercised in the final stage of EMU. This entailed setting out the legal and institutional framework for full monetary union and taking the necessary steps for the implementation of the non-monetary policies which will accompany the irrevocable locking of parities among the participating currencies and the subsequent introduction of a single currency. Preparations for the IGC, notably the draft statute proposed by the committee of EC central bank governors in November 1990, and early work in the IGC on EMU focused on this task. The institutional design which has emerged is the main achievement of the past year’s negotiations. It has revealed a degree of support, which could not have been expected when the EMU debate started, among the policy-makers in the Community for entrusting joint monetary policy to a central banking institution which is (i) committed to the primary objective of price stability, and (ii) remarkably independent, through a number of safeguards, from short-term political pressures. It also revealed a readiness to go further than foreseen in giving the Council of Finance Ministers (ECOFIN) authority to monitor national budgetary deficits and government debt positions and to apply graduated pressures to member states with ’excessive deficits’.

This major accomplishment will not be analysed further in this chapter, although it has direct implications for the transition. The clear signposts regarding the final stage in the Treaty revision now submitted for ratification are of obvious significance. Clear rules and procedures for the final stage of EMU should ideally inspire national central banks and other
policy-makers to behave voluntarily as if these provisions were already in place or imminent.

But the second task of the IGC was no less essential. It was to clarify how the EC member states can achieve transition to full EMU by a mixture of entry requirements and procedures for reaching decisions. For much of the second half of 1991 it seemed highly doubtful whether a sufficient degree of consensus could be achieved in the IGC to assure that the transition would not be of indefinite duration, hence making the accomplishments with respect to the content of the final stage rather academic. Most of the modifications (to the text prepared under the Luxembourg Presidency) introduced in the draft Treaty by the Dutch Presidency in September–October 1991 tended to enhance such concerns.

Particularly worrying was the prospect of a generally-worded clause which would allow individual countries to opt out of the commitment to EMU. This clause had the potential of quietly adjourning EMU sine die. Although originally inspired by the need to accommodate the difficulties of the United Kingdom in undertaking any such commitment at the time of signature of the revised Treaty, the opting-out clause turned out to hold attractions for politicians, particularly in national parliaments, in several other countries as well, including Germany. The clause was finally dropped in an ECOFIN meeting just before Maastricht when 10 out of 12 Finance Ministers declared that they did not want it. At Maastricht the United Kingdom and Denmark asked for, and were granted, separate protocols to retain the right to join the full EMU only if they obtained a positive decision in parliament (in the UK case) or in a referendum (in the Danish case).

A second source of concern was a continuing erosion of the institutional arrangements for the temporary central banking institution – the European monetary institute (EMI) – to be set up for the transition. This weakness was only partly remedied at Maastricht; it is discussed below.

A third concern was whether the member states were in the process of tightening the entry requirements to full EMU so much with respect to the consolidation of national budgetary policies, that only a few countries could hope to qualify within the present decade. This concern was also eased somewhat at Maastricht, both by the clarification of some flexibility in the interpretation of the formal criteria and by admitting that a smaller number of countries than originally envisaged – even a minority of member states – could move to full EMU including the adoption of a single currency.

Finally, some leading participants in the negotiations, notably the German Chancellor, linked their acceptance of EMU to significant progress in the parallel IGC on political union. It is not obvious on economic