ONE

The euro in 2008

Today, in 2008, the euro is the common currency of fifteen EU countries with around 320 million inhabitants, and most other member states are aiming to join the euro area in the near or not-so-distant future. With the issuance of euro-denominated banknotes and coins at the beginning of 2002, the former national currencies were taken out of circulation, their names henceforward consigned to the history books. The fact that isolated attacks by populist politicians fail to elicit much support for a return to the national currency only serves to confirm that the common currency has become an irreversible reality, and that going back is not really an option.

Globally, too, the euro has become firmly established as the second most important currency after the US dollar. By some measures, for example in terms of its share of global official reserves, the euro still lags a long way behind; but in other respects, notably in its role as currency of denomination for credit, the euro has more or less drawn level with the American currency. Investors all around the world put their faith in the euro and buy euro-denominated long-term paper. Confidence in the stability of the euro is reflected in inflation expectations that are firmly anchored at low levels, helping explain what are, historically, exceptionally low long-term nominal interest rates.

Cambridge University Press
978-0-521-73186-7 - The Birth of the Euro
Otmar Issing
Excerpt
More information

2 • The euro in 2008

Over the nine years that have passed since its birth on 1 January 1999, the euro has been a striking success. With an average annual rate of inflation of around 2 per cent, it can deservedly be called a stable currency, both in historical terms and internationally.

This success story stands in marked contrast to many of the forecasts made before its introduction. The doomsayers either ruled out the currency union getting off the ground at all, or predicted its early demise, or at the very least thought it would lead to inflation – none of which actually materialised. So were all the concerns unfounded? Can one simply assume that the euro's success story will continue?

The fact remains that for sovereign states to cede their authority in the monetary sphere to a supranational institution, while retaining a greater or lesser degree of autonomy in other policy areas, is historically unprecedented. It is no coincidence, therefore, that observers speak of an experiment, an experiment whose outcome seems likely to remain uncertain for a considerable time to come.

The future offers excellent scope for speculation. But what are the reasons that lay behind the euro's good start and its success to date, and where do potential vulnerabilities lie? This book attempts to provide an answer to such questions.

Cambridge University Press
978-0-521-73186-7 - The Birth of the Euro
Otmar Issing
Excerpt
More information

TWO

Historical background

The rocky road to monetary union

The idea of creating a monetary union in Europe can be traced back a long way. Indeed, in the first century AD, a merchant could pay with the same money, the denarius, throughout his long journey from Rome via Colonia Claudia Ara Agrippinensium and Lutetia Parisiorum to Londinium – that is, via Cologne and Paris to London. Sixteen centuries later, however, the same journey involved an unending sequence of money changing and conversion. Trade was heavily hampered by high tariffs between countries and even broke down in the frequent times of war. In Germany alone, if one may call it that, a hundred different territories exercised the right to mint their own coinage. The number of customs borders in this region in 1790 has been estimated at some 1,800. It was only with the establishment of the customs union in 1834 that most trade barriers disappeared in Germany. And it was only following political unification within the German Reich in 1871 that the multiplicity of coinages was fully abolished and the Mark introduced as the common currency.

What lessons might we draw from comparing these epochs of European history?

There were two conditions that characterised the common currency period:

- The stability of the currency was ensured by the natural scarcity of the metal.
- A common currency went hand in hand with political union under the Pax Romana.

The loss of monetary stability due to the persistent debasement of coinage and the disintegration of the Roman Empire undermined the old system. There was no single currency in Germany again until the adoption of the gold standard and the establishment of political union under the German Reich in 1871. Elsewhere, other nation states such as France and Great Britain had brought about a single currency much earlier. The notion of a common *European* currency was aired now and again by individual authors or groups, often in conjunction with ideas for the political unification of Europe. But for a long time, there were no serious, still less promising, attempts towards such an objective.[1]

It was only after the horrors of two world wars that the project of European integration was given a new and decisive impetus. This is not the place to depict the various stages in this process, starting with the establishment of the *European Coal and Steel Community* in 1952. If at all, the goal of a common currency played only a background role.

Just a few years after the start of the *European Economic Community (EEC)* in 1958, there were occasional suggestions that work should also be undertaken towards monetary integration. A concrete first step was taken by the heads of state or government assembled at the summit conference in The Hague on 1 and 2 December 1969. They agreed that 'on the basis of the memorandum presented by the

[1] In 1712 Abbé de Saint Pierre, for example, published an essay, 'Projet de traité pour rendre la paix perpetuelle entre souverains chrétiens'.
On the history of money in Europe see F. Berger, *12 into One: One Money for Europe* (Frankfurt, 2001).

Commission on 12 February 1969 and in close collaboration with the Commission a plan by stages should be drawn up by the Council during 1970 with a view to the creation of an economic and monetary union'. In autumn 1970, the 'Werner Group', named after the then Prime Minister of Luxembourg who chaired it, presented its report, which essentially contained a plan for the establishment of economic and monetary union in three stages. A short time afterwards, it was considered that this project should be completed over a period of ten years.

This ambitious aim was basically doomed to failure from the outset. For one thing, the international environment was to be affected in the years that followed by major turbulences: the floating of the D-Mark on 19 March 1973 signalled the final collapse of the Bretton Woods system of fixed exchange rates, and the European partner countries differed markedly in their views on fundamental exchange rate issues. For another, although the Werner Plan was the first to elaborate on the need for progress on the economic and institutional front in parallel with monetary convergence, the positions taken were still relatively vague and marked by controversy. What was missing above all, however, was the political will to press forward with this parallel approach in a concrete manner.

The years that followed were dominated by exchange rate risks both at the global level and in the European context.[2] Following a Franco-German initiative to break the deadlock, the Council on 5 December 1978 concluded the agreement establishing the *European Monetary System (EMS)*, which came into effect on 13 March 1979. With hindsight, this date marks a watershed in the process of monetary integration, confirming as it did the 'monetarist position'

[2] For a detailed documentation of the process from its beginnings to Stage III of economic and monetary union, see H. Tietmeyer, *Herausforderung Euro* (Munich, 2005); A. Szasz, *The Road to European Monetary Union* (London, 1999).

For another perspective and a somewhat different assessment, see T. Padoa-Schioppa, *The Road to Monetary Union in Europe* (Oxford, 1994).

supported above all in French circles and based on the assumption that, with monetary agreements in place, consequences would follow in their wake. In a nutshell, the argument ran: once exchange rates are fixed, further monetary convergence is more or less bound to follow. The exchange rate crises that ensued, however – a seemingly never-ending series of revaluations and devaluations, generally combined with hefty political altercations – testified to the relevance of the 'economistic position', whose proponents included prominent politicians such as Karl Schiller as well as virtually all leading German economists. On this view, the (premature) fixing of exchange rates inevitably creates tensions that ultimately generate sudden, major exchange rate movements. Lasting exchange rate stability can only be achieved if at least national monetary policies are in proper accord.

For an understanding of the further development of monetary integration, it is important to note the following characteristics of the EMS:

1. The European Currency Unit (ECU), though formally at the heart of the system, played a much more limited role (as a unit of account, etc.) than originally intended by the French.
2. Exchange rates were determined between the member currencies (the 'parity grid').
3. Compulsory interventions were correspondingly tied not to the ECU, that is, to a currency basket, but to the parity grid.

It soon became apparent that the EMS was a system founded on the strongest currency; in short, it was a 'DM bloc'. In the wake of the strong price pressures exerted by the second oil shock in 1979/80, the consequences of this currency system quickly came to light. The Deutsche Bundesbank fought against the inflation risks with a clear, stability-oriented monetary policy, thereby sparing Germany a repetition of the sequence of inflation and stagflation that had marked the period after the first oil price shock in the 1970s. Those countries that were unable or unwilling to join in this disinflationary process were forced into repeated devaluations of their currencies as their attempts to defend the parities reached crisis point. Under this system, there was no other alternative than to align monetary policy with the Bundesbank or to devalue one's own currency.

The increasing tensions within the EMS then escalated in the crises of 1992 and 1993.[3] Unlike the oil price increase, German reunification caused an extremely asymmetrical individual 'German shock', to which the Bundesbank reacted in accordance with its mandate by pursuing a monetary policy that first quelled the upward price pressures and then gradually brought prices back towards stability.[4]

The prospect of future monetary union lent support to the Bundesbank in its stability-oriented policy course. I wrote at the time:

> If one takes seriously the timetable for establishing monetary union in Europe in the future with a single, stable currency, one should not delay in fighting inflation; from this perspective, the end of the decade is closer than it might appear from a glance at the calendar. In Germany in particular, the fears among the public that the future European currency might prove a less stable store of value than the D-Mark need to be allayed. Keeping the value of the currency stable is therefore more than ever not just in the national interest, but is at the same time an important and indispensable contribution towards realising monetary union in Europe.[5]

The experience of this period confirms the theory of the so-called 'uneasy triangle', according to which only two of the three goals of stable exchange rates, stable prices (or monetary policy autonomy) and free movement of capital can ever be attained at the same time. Since restrictions on capital movements are incompatible with common market principles – disregarding other major objections

[3] See Szasz, *The Road to European Monetary Union*.
[4] See O. Issing, 'Economic prospects and policy in Germany', Institute of Economic Affairs, *Economic Affairs*, 15:1 (Winter 1994).
[5] O. Issing, *Frankfurter Allgemeine Zeitung*, 16 January 1993.

such as the practicability of capital controls – the only choice remaining is between the other two objectives. The option of flexible exchange rates was never seriously entertained in the context of European integration.[6] However, the regime of fixed exchange rates that were nonetheless subject to sudden upward or downward revaluations, as embodied in the EMS, had over time proven to be so vulnerable to crises that it appeared to be only a matter of time before another crisis entailed even bigger abrupt changes in exchange rates. Both the magnitude and the flexibility of international capital flows went far beyond anything experienced in the past.

In the 1992–3 turbulences, the devaluation of the Italian lira by more than 30 per cent against the D-Mark had changed competitive positions in bilateral trade at a stroke, leading to serious discussion at national level on the need to take countermeasures. There was an increasing risk that the next exchange rate crisis might jeopardise major achievements of economic integration such as the free movement of goods, services and capital.

Thus, out of the set of three objectives, it was basically 'only' monetary policy that remained on the table.[7] The solution whereby one country's currency took the lead was obviously untenable in the long run. For one thing, there were political arguments against it. The larger EMS member countries in particular were unwilling to accept a lasting necessity to act more or less in lockstep with the monetary policy of the Bundesbank. For the Bundesbank, conversely, it was not possible to pursue a monetary policy oriented towards 'European objectives'. On the one hand, this would not have resolved the sovereignty issue for the other countries; on the other, the Bundesbank would not have been able to fulfil its national mandate under the law,

[6] On this discussion, see O. Issing, 'Integrationsprozeß, Währungspolitik und Wechselkurse in der EWG', *Kredit und Kapital* (1969).

[7] On this analysis, see O. Issing, 'Europe's hard fix: the euro area', *International Economics and Policy*, 3:3–4 (2006).

nor would there have been any reasonable political, empirical or theoretical basis for such a policy orientation.[8]

The logic of the process meant that ultimately the only possible solutions were basically the two 'cornerstones', either flexible exchange rates or the path towards a common currency. Thus the creation of the EMS in 1979 had indeed laid the foundations for a common currency. In that sense, the proponents of the system of fixed exchange rates who had this ultimate aim in mind from the outset may feel themselves vindicated. Admittedly, looking back at the crises of the 1980s and 1990s one can see what huge risks had to be overcome in the process. Nor, by any means, does entry into monetary union mean that all the reasons for past crises have been, as it were, automatically eliminated. At the outset, the setting-up of a supranational central bank and the communitisation of monetary policy only initially resolve the trilemma of the 'uneasy triangle'. For the common monetary policy to be successful and for monetary union to be safely preserved, further efforts are needed. But more on that later.

The decision in Maastricht

The final decision on the shape and starting date of Stage III of European Economic and Monetary Union (EMU) was taken at the Maastricht summit on 9 and 10 December 1991. In the run-up to the summit, there had been intensive groundwork and negotiations at all levels, with two groups in particular playing a key role.

Firstly, there was the Committee of Central Bank Governors, composed of the governors of the central banks of the EU member states. Chaired by Bundesbank President Karl Otto Pöhl, the

[8] For a time, incidentally, those opposing the idea of a single supranational central bank discussed alternative solutions whereby monetary policy would remain with the national central banks but exchange rates would nonetheless be fixed once and for all, i.e. irreversibly. Such a 'system', if it may be called such at all, would have no anchor, and its inevitable consequence would be competition in inflation policies. The idea was therefore rightly dropped.

Committee of Governors had unanimously approved a draft statute for a European Central Bank that was modelled largely on the Deutsche Bundesbank Act. Inter alia, the Governors had advocated the principle of 'one person, one vote' in monetary policy matters.

Secondly, there was the so-called 'Delors Group', set up on the occasion of the Hanover summit on 27 and 28 June 1988. In addition to European Commission President Jacques Delors and the EU central bank governors, this group also included Alexandre Lamfalussy, General Manager of the Bank for International Settlements, Professor Niels Thygesen, Miguel Boyer, President of the Banco Exterior de Espagne, and Frans Andriessen, member of the European Commission. Unlike the Committee of Governors, the Delors Group was beset by controversy, in particular as regards the transition from the status quo to monetary union.

In its report of 5 June 1989, the Council of Experts at the German Federal Ministry of Economics (of which I was at the time an active member) summarised its reservations, which to a large extent mirrored the opinion of the vast majority of economists in Germany, as follows:

> The underlying idea of the Delors Committee regarding the path towards monetary union is for monetary policy in Europe to be gradually communitised. Many of the individual arrangements for the two preliminary phases during which the Community is to become ready for monetary union serve this end. With all due respect for the difficult task of giving the EC countries the necessary guidance (towards ever greater convergence in stability policy) during this readying process: the Council of Experts considers this idea wrong. In matters of monetary policy, the Community is presently being guided, and guided well, by the Bundesbank, as the Delors Committee also acknowledges. At a later date, the objective is that it shall be guided equally well by a European Central Bank. In the interim, it is unwise increasingly to entrust this guidance de facto to co-ordinating bodies at Community level, with the national central banks only formally retaining ultimate responsibility until the end of Stage II.