# The European Monetary Union on its Path to its Long-run Politico-economic Equilibrium

*Roland Vaubel*

Universität Mannheim

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## **The overture to the Euro-game in 1999:**
a very special historical setting

- The initial choice of the institutions, the rules and the persons governing EMU were largely determined by Germany because it had veto power.
- Even though Kohl had committed Germany to monetary union in December 1989 in principle, the implementation of that promise was a matter of negotiation up to the very end.
- The German conservative-liberal government was able to impose
  – the statute on the European Central Bank,
  – the Stability and Growth Pact,
  – the postponement of the redistribution of seigniorage,
  – the choice of members of the board of directors, including the first president,
  – their terms of tenure (Issing obtaining the maximum of eight years),
  – the distribution of policy briefs (Issing receiving the economic department and the research department).

On the choice of directors:
Even though seven of the eleven participating states had socialist-led governments in 1998, ECB president Wim Duisenberg was the only one of the six executive directors with a socialist background, and even he was known to be a monetary conservative.

## The game starts

- Once EMU had started, the German veto was gone.
- No participating country may leave EMU unless it leaves the European Union altogether.
- Appointments and policies were no longer determined by the most inflation averse member country – as they were under the EMS and floating – but by the median.
- The inflation median among the euro-11 had been France (Vaubel 2003 for the period 1976-98 or 1976-93).
- The median with regard to popular inflation aversion as expressed in opinion polls had also been France (Hayo 1998).
- A French saying: „Reculer pour mieux sauter“.
- Germany had had the lowest inflation rate and the highest inflation aversion – it was bound to be marginalised with regard to monetary policy.

„Die beiden deutschen Vertreter im Europäischen Zentralbankrat werden sich mit ihrer Stabilitätspräferenz am äußersten Rand des Meinungsspektrums befinden“.

*(Der deutsche Zentralbankrat geht auf Konvergenzkurs, Handelsblatt, 7.4.1998, S. 2)*

# The first wave of adjustments (2003-06)

- *May 2003*: the redefinition of price stability

In October 1998, the ECB had fixed an inflation target between 0 and 2 per cent with an implicit target point of 1.5 per cent:

– the reference rate of monetary expansion (M3): 4.5 per cent p.a.
– assumed real growth: 2.0 to 2.5 per cent
– assumed rate of change of velocity: -0.5 to -1.0 per cent p.a.
– according to the quantity theory: $\hat{P} = \hat{M} - \hat{y} + \hat{v}$
– $\hat{M}$ = 4.5 per cent implies $\hat{P}$ = 4.5 % - 2.25 % - 0.75 % = 1.5 %

In May *2003* (after the introduction of euro notes and coins in 2001), the target point within the band of 0 to 2 per cent inflation was raised to "as close to 2.0 per cent as possible", i.e. $1.9\overline{9}\ldots$

In 1999, Christian Noyer, at that time Vice-President of the ECB, had said in a speech to the European Parliament: "I also want to make clear that we don't just want to stick to a goal of 1.99 % when we say it's going to be below 2 %. We want to have sufficient margins so that we'll be safely within our objective range at all times."

Outlook: The inflation target may be raised further to 2.5 or 3.0 per cent as demanded by several authors (Buiter, Sinn, Krugman).
∴ It was a mistake not to define price stability in the ECB statute.

- *May 2003*: the monetary reference rate is demoted to second or lower rank as an indicator for policy analysis.
- *2003*: breach of the Stability and Growth Pact by Germany and France – no sanctions
- *March 2005*: The pact is watered down into insignificance.

- My prediction: „Sanktionen können nur verhängt werden, wenn sich dafür im Ministerrat eine qualifizierte Mehrheit findet. Die meisten Regierungen sind aber an einer großzügigen Auslegung der Bestimmungen interessiert… Der Ministerrat wird daher kaum jemals Sanktionen verhängen".

*(Kein Pakt für Preisstabilität, Wirtschaftsdienst 1997/1, S. 10)*

- The Bundesbank on the watering down of the Stability and Growth Pact:

  „Der Europäische Rat hat … grundlegenden Änderungen des Stabilitäts- und Wachstumspakts zugestimmt, die die in dem Pakt enthaltenen Regeln für eine solide Finanzpolitik entscheidend schwächen … Der eingeschlagene Weg, die Haushaltsregeln einem gelockerten Finanzgebaren anzupassen, führt daher in die falsche Richtung … Der Pakt war eine wichtige Voraussetzung für die positive Stellungnahme der Deutschen Bundesbank zur Einführung der gemeinsamen Währung. Er gehört damit zur Geschäftsgrundlage der Währungsunion" (Deutsche Bundesbank, 2005).

- „Up to now, the performance of the ECB has been tolerable but below average as compared with other industrial countries. In the long and medium term, however, there are considerable risks… Appointments and policies are no longer determined by the most inflation-averse member country (as under currency competition) but by the median. The effects are already visible. They are the beginning of a shift away from initial conditions and toward the long-run politico-economic equilibrium of the game”.

  *(The Future of the Euro: A Public Choice Approach, Cato Journal, Vol. 24, Nos. 1-2, 2004, pp. 160, 152)*

- *May 2006*: When Issing steps down, Stark loses the Research Department to Papademos. Papademos immediately organises a conference against monetary targets, starring Michael Woodford.
- *Spring 2008*: 10th anniversary of the choice of initial euro-participants:
  “Von Anfang an war nicht zu erwarten, dass die meisten Probleme, die sich aus der europäischen Währungsunion ergeben, innerhalb der ersten zehn Jahre auftreten würden. Die derzeitigen Lobeshymnen auf den Euro sind daher nicht nur weit übertrieben, sondern vor allem verfrüht“.
  *(Der Euro – eine kritische Bilanz, Wirtschaftsdienst 2008/6, S. 374)*
- *2002-09*: Greece and Portugal exceed the deficit limit of the Stability and Growth Pact in each single year.

# Budget balance/ GDP in percent (negative values = deficit)

| | 2002 | 2003 | 2004 | 2005 | 2006 | 2007 | 2008 | 2009 | 2010 | Average |
|---|---|---|---|---|---|---|---|---|---|---|
| Greece | -4.8* | -5.7 | -7.4 | -5.6 | -6.0 | -6.8 | -9.9 | -15.6 | -10.8 | -8.1 |
| Ireland | -0.3 | -0.4 | -1.4 | -1.7 | -2.9 | -0.1 | -7.4 | -13.5 | -30.9 | -6.5 |
| Portugal | -3.4 | -3.7 | -4.0 | -6.5 | -4.6 | -3.2 | -3.7 | -10.2 | 9.8 | -5.5 |
| France | -3.3 | -4.1 | -3.6 | -3.0 | -2.4 | -2.7 | -3.3 | -7.6 | -7.1 | -4.1 |
| Italy | -3.2 | -3.6 | -3.6 | -4.5 | -3.4 | -1.6 | -2.7 | -5.4 | -4.3 | -3.6 |
| Cyprus | -4.4 | -6.6 | -4.1 | -2.4 | -1.2 | +3.5 | +0.9* | -6.1 | -5.3 | -2.9 |
| Germany | -3.8 | -4.1 | -3.8 | -3.3 | -1.7 | +0.2 | -0.1 | -3.1 | -4.2 | -2.7 |
| Slovenia | -2.4 | -2.7 | -2.3 | -1.5 | -1.4 | 0,0* | -1.9 | -6.0 | -5.7 | -2.7 |
| Spain | -0.2 | -0.4 | -0.1 | +1.3 | +2.4 | +1.9 | -4.5 | -11.2 | -9.7 | -2.3 |

Sources: OECD Economic Outlook, Nov. 2012

Cyprus: countryeconomy.com

* = year of joining the euro

## The second wave of adjustments (2010-today)

*May 2010*:

- ECB buys Greek government bonds. Breach of Art. 123 (no monetary financing of government deficits).
- The euro-group sets up a European Financial Stability Facility for two years. Breach of Art. 125 (no bail-out).

Driving force: President Sarkozy: „J′ ai sauvé l' euro“,

cooperating: Trichet, Barroso, Schäuble, Juncker etc.

Sarkozy‘s motives:

1. Nobody is permitted to leave the euro.
2. Long-standing French demand for a European Monetary Fund (since Raymond Barre).
3. 61 % of French against 34 % of Germans believe that they might get into the same situation as the Greeks.
4. French banks hold proportionately more Greek government bonds than the banks of the other EU countries do (except Greece and Cyprus).
5. Sarkozy is founder of the „Mediterranean Union“.

## The role of Trichet

- On 7 May 2010, Trichet attended the Euro-Council as a guest and gave a prepared speech warning against another financial panic.
- On Sunday, 9 May, he called a telephone conference of the ECB Council and obtained a majority vote in favour of buying Greek government bonds.
- Opposed in the final vote: Axel Weber, Jürgen Stark, George Provopoulos
- Trichet's majority coalition (14/22): Trichet (France), Noyer (France), Bini-Smaghi (Italy), Constancio (Portugal), Gonzales-Páramo (Spain), Bonello (Malta), Costa (Portugal), Draghi (Italy), Ordonez (Spain), Honohan (Ireland), Orphanides (Cyprus), Mersch (Luxembourg), Quaden (Belgium). Eleven would have been enough in 2010, twelve after the entry of Estonia and Latvia and 13 since the accession of Lithuania in 2015.

## Why did Trichet cooperate with Sarkozy?

– Trichet was independent but he knew that he would retire and return to France in October 2011 when Sarkozy would still be president.

– Sarkozy could help him to obtain some interesting post-retirement posts.

– Trichet has been appointed

  - chairman of the Group of Thirty
  - member of the administrative board of EADS (Airbus)
  - chairman of the French-financed think tank Brueghel in Brussels.

- Why did Schäuble co-operate?
  „We can only achieve a political union if we have a crisis“ Mr. Schäuble said (New York Times, 18.11.11).
- Why did the FDP cooperate?
  - The Genscher-Westerwelle tradition
  - Brüderle as a servant of interest groups (German banks and big business) financing the FDP.
  - The banks want to be bailed out.
  - German industry opposes any appreciation of the currency (as in 1969-73).
  - Did the SPD and the Greens, by supporting the bail-outs, want to destroy the FDP?

*Jan. 2011*: Sarkozy rejects Axel Weber as successor to Trichet. France and Italy command blocking minority in Euro Council. Weber declares resignation in February.

*June 2011*: When the ECB Governing Board decides to buy also Italian and Spanish government bonds, Stark tells Trichet that he will resign by the end of the year (Financial Times, 16.05.14).

*Nov. 2012*: Draghi succeeds Trichet.

*Jan. 2012*: Stark‘s successor (Asmussen) loses the Economic Department at the ECB.

*June 2012*:

- At the Euro-area Summit, the Italian Prime Minister Monti obtains the German government‘s assent to the ECB‘s purchases of Italian government bonds: „I used all my negotiating power – including a threat of veto – to gain support for an apparently unimportant addition to the final protocol. At four o‘clock in the morning all heads of government had signed … The added section says that all euro-countries which – like Italy – have done their homework can count on the support of the European Central Bank … This was a decisive change in the rules of the eurozone“ (translated from Volkskrant, 13.04.14).
- The Summit Statement reads: „We welcome that the ECB has agreed to serve as an agent to EFSF/ESM in conducting market operations in an effective and efficient manner“. Thus, Schäuble and Merkel agreed to the ECB purchases of government bonds.
- Mario Draghi attended this Euro-area Summit.

- My research shows that Mario Draghi has attended the ministerial meetings of the euro-group at least 15 times. He often takes part in the press conferences afterwards as well. He also participated in at least seven meetings of the European Council. At the Euro-area Summit in March 2013, he even contributed a presentation.

    This practice is very different from what used to be the case in the member states before 1999. In Germany, the chancellor was entitled to attend meetings of the Bundesbank Council but apparently there were only two such visits (Konrad Adenauer in 1956 and Helmut Schmidt in 1979).

- The Euro-area Summit Statement of 29 June 2012 contains another change in the rules: „When an effective single supervisory mechanism is established, involving the ECB, for banks in the euro-area the ESM could, following a regular decision, have the possibility to recapitalize banks directly".

*Aug. 2012*: Draghi visits Schäuble on the island of Sylt to discuss future ECB policy.

*6 Sept. 2012*: One week before the ESM decision of the German Constitutional Court, Draghi announces that the ECB is prepared to buy unlimited amounts of government bonds of over-indebted euro states.

- The German judges were to know that if they outlawed the ESM, the ECB alone would do the bail-out.
- If the ECB had wanted to engage in quantitative easing, it would have bought a more or less representative portfolio of government and/or private bonds.
- By making its bond purchases conditional on an arrangement between the over-indebted governments and the ESM, the ECB would be *accepting instructions* from the Governors of the ESM, i.e., the Ministers of Finance. This would be a breach of Art. 130 TFEU.

*27 Sept. 2012*: The European Stability Mechanism starts.

Other aspects of the politicization of the ECB

- The ECB appoints one member of the so-called „Troika“ which negotiates the policy conditions to be attached to ESM loans. Thus, central bank officials are imposing budgetary policy measures on democratically elected governments.
- As a supervisor of banks, the ECB has been made dependent on the European Parliament which has to confirm the appointment of the president of the ECB supervisory board (Danièle Nouy) and her deputy (Sabine Lautenschläger).
- The ECB essentially delegated its „Asset Quality Review“ to the national supervisors in all countries except Germany, Spain and Cyprus where private consultants were in charge. Have the national supervisors identified the poor „legacy assets“ for which the other countries do not want to be liable?
- As the institution in charge of closing insolvent banks the ECB will be exposed to strong political pressure.
- On 28 April 2014, Draghi provided insider information to a group of German parliamentarians at a private meeting on Petersberg (Königswinter) telling them that quantitative easing was not imminent (Bloomberg, 28.04.14).

Why has the ECB become more politicized than the Bundesbank ever was?

- The policy independence of the Bundesbank was less secure than the policy independence of the ECB is. The Bundesbank Law can be amended by parliament by simple majority, the Statute of the ECB may be altered only by unanimity among all member states. This has led the Bundesbank to pay more attention to public opinion as the main support of its policy independence. For the ECB Board public opinion is much less important.
- The members of the Bundesbank Council enjoyed more personal independence than the ECB Board members do. As a matter of tradition, every member of the Bundesbank Council knew that he would be reappointed if he wished. The national governors in the ECB Board have to be appointed for only five years, and they may not be reappointed. The members of the executive board may need „career assistance“ from their government when returning home (Trichet).
- The ECB fears that one or several of its member states may wish to leave the monetary union. For the Bundesbank, exit was never a threat.

- The ECB blackmails governments (Financial Times, 07.11.14):
  - „The ECB released letters showing that its then-president Jean Claude Trichet threatened to cut off emergency funding for Irish banks at the hight of the country‘s financial collapse unless Ireland agreed in writing for a bailout … The letter [of November 19, 2010 ] states:

    ‚It is the position of the governing council [of the ECB] that it is only if we receive in writing a commitment from the Irish government […] on the following four points that we can authorise further provisions of [emergency liquidity assistance] to Irish financial institutions‘.

    Alongside the demand that Dublin apply for a bail-out, the ECB wanted the government to start fiscal consolidation and structural reform, recapitalise and restructure the banks, and guarantee the repayment of ELA“.

„Although the letter was unprecedented at the time, such demands from the ECB became almost commonplace … :

– In August 2011, Mr. Trichet sent letters to Silvio Berlusconi … and José Zapatero … demanding similar economic reforms as a condition for the ECB to rescue both countries by purchasing their sovereign bonds in the open market.

– In March 2013, ECB board member Jörg Asmussen made a similar demand to Nicos Anastasiades, Cyprus' president. At a Brussels meeting, Mr. Asmussen said the ECB would cut off funding for Cypriot banks unless Mr. Anastasiades accepted tough conditions.

Within the board, a handful of members were opposed to the letters, arguing it was improper for central bankers to be dictating economic and fiscal policy to sovereign governments."

# The third wave of adjustment: high inflation?

- Up to now, the euro has been fairly stable but less stable than most other Western European currencies issued by independent central banks:

  CPI inflation, compound average rate in 2001-13 (OECD)

| | |
|---|---|
| Switzerland | 0.57 |
| Sweden | 1.38 |
| Norway | 1.91 |
| Denmark | 2.01 |
| Eurozone | 2.06 |
| UK | 2.46 |

- The ECB expects that its balance sheet may be expanded again by up to 50 percent.
- Technically, it will be possible to re-absorb the monetary overhang and raise interest rates in time but politically that is very unlikely:
  - The banks would warn against another financial crisis.
  - Rising interest rates would increase the governments’ cost of servicing their debt.
  - Rising interest rates would aggravate the recession in the over-indebted countries.
  - Since a large part of the bank reserves has been made available for several years, the ECB would have to offer attractive interest rates on time deposits to re-absorb the reserves.
  - By raising interest rates, the ECB (eurosystem) would incur losses on the government bonds it has purchased.
- Draghi has announced that he will keep interest rates very low at least until the end of 2016.
- Benoit Coeuré: „We are going to keep rates close to zero for an extremely long period while the US and the UK will at some point return to a cycle of rate rises“ (Reuters 09.06.14).
- I expect high inflation in the euro-area by the end of this decade.

## Outlook: A new game?

Optimum currency areas in the eurozone (real exchange rate criterion): Inflation measured in euro, 2001-2013 (rate of increase of the harmonised consumer price index in percent)

| | per annum | overall |
|---|---|---|
| Estonia | 4.18 | 77.5 |
| Lithuania | 3.95 | 72.1 |
| Latvia | 3.90 | 70.9 |
| (Poland) | 3.33 | 58.2 |
| Slovakia | 3.04 | 52.1 |
| | | |
| Slovenia | 2.77 | 46.5 |
| Spain | 2.77 | 46.5 |
| Luxembourg | 2.75 | 46.3 |
| Greece | 2.64 | 44.0 |
| Cyprus | 2.48 | 41.1 |
| Portugal | 2.43 | 40.0 |
| Italy | 2.31 | 37.7 |
| | | |
| Netherlands | 2.25 | 36.6 |
| Ireland | 2.22 | 36.0 |
| Belgium | 2.19 | 35.5 |
| Malta | 2.17 | 35.1 |
| Austria | 2.05 | 32.9 |
| Finland | 2.04 | 32.7 |
| France | 1.89 | 29.6 |
| Germany | 1.70 | 26.6 |
| | | |
| UK measured in euro | 0.13 | 1.9 |

# Conclusion

If the need for real exchange rate adjustment is used as the criterion for optimum currency areas (Vaubel, JIE 1978) and if Belgium and Luxembourg as well as Italy and Malta are treated as common economic units, a „Northern Euro“ could comprise Germany, France, Finland, Austria, Belgium/Luxem-bourg, Ireland and the Netherlands (in this order).