Progress through crisis?

Proceedings of the Conference for the 20th Anniversary of the Establishment of the European Monetary Institute

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The European Monetary Institute (EMI) started its activities with the beginning of Stage Two of EMU on 1 January 1994. The EMI was a somewhat special Community body in between the Committee of Governors of the central banks of the Member States and a full-fledged European Central Bank. The EMI had no responsibilities in terms of monetary policy as such but had as a mandate to make all necessary preparations for the establishment and operational capacity of the Eurosystem at the start of Stage Three of the EMU i.e. 1 January 1999. As the predecessor of the ECB, the EMI fulfilled a crucial role in the orderly and successful transition towards a monetary union. The environment in which the EMI had to start its activities was not an easy one however as during the first years of the 1990s the EMS seemed to be dragging itself from crisis to crisis.

In January 2014, the European Central Bank and the National Bank of Belgium co-hosted a conference to commemorate the 20th anniversary of the key milestone on the way to EMU. At the same time the Conference was the opportunity to honor the first president of the EMI, Alexandre Lamfalussy who successfully steered the EMI through its first three and a half years of its existence. The book brings together the contributions made at this Conference. The organizers of the Conference explicitly asked contributors to draw parallels between how the lessons from the crisis of the 1990s had influenced the progress towards EMU with how the recent euro crisis could give some pointers for the future functioning of the EMU. In this way the book is more than a mere remembrance of the past but tries to shed some light on the path ahead. The fact however that most of the contributors were or still are holding official positions is of course likely to guide the views expressed.

The contributions to the conference are divided into three parts with some concluding remarks made by Alexandre Lamfalussy. The first part looks back at the turbulent 1990s in terms of monetary cooperation in Europe and tries to identify the lessons that this period might hold. What are these lessons? The book lacks a proper synthesis by the editors, but such synthesis could possibly run along the following lines. The convergence criteria for entry into the EMU were mainly nominal criteria with effective policy coordination too soft and economic governance too weak as there was too much confidence in the corrective power of market discipline. It took the recent crisis to develop new instruments and procedures to correct for this (see the contribution of Wieser and Haine). The sustainability of public finances came to the forefront of the discussions on monetary union after 1993. The view was that free ride attitudes of irresponsible governments with undisciplined fiscal policies risked undermining the stability of the monetary union. As D. Gros points out however, countries with high levels of debt might be forced to pay high risk premia irrespective of the fact whether they are in a monetary union or have monetary policy autonomy. In the former case the risk premium will reflect the risk of default, in the latter the inflation risk. In any case, high interest rates will impose a cost to the country. The EMS of the 1990s had to avoid two types of mistake: to defend exchange rate parities that were perceived by markets to
be misaligned given the economic fundamentals and to give in to speculative pressures when the exchange rates were in fact in line with the fundamentals. In analogy, Gros continues, the EMU should avoid providing financing to countries with public debt levels that are considered by the markets to be unsustainable and to give in to speculative pressures when public finances are fundamentally sound. Dwelling further on this, A. Sapir argues in his contribution that in order to solve the crisis in an efficient way, the nature of the crisis should be clearly identified. While the EMS crisis of the 1990s was perceived as a liquidity crisis while in fact being a crisis of fundamentals, the opposite was to a large extent the case with the EMU crisis. An incorrect diagnosis leads to a waste of time and ineffective policies. Furthermore, Sapir points to a number of failures in the set-up of the monetary union such as the failure to fully recognize the heterogeneity of the member countries and its implications for coordination policies and adjustment paths.

The second part focuses on the role the EMI has played in preparing the ground for the ECB. In many ways, the EMI had to boldly go into uncharted territory. The Treaty of Maastricht laid down the global framework of principles, guidelines and objectives for the EMU. The EMI had to translate all this into practicable, manageable and commonly accepted rules, procedures and instruments to conduct monetary policy in a completely new environment. It had to federate member countries while at the same time guarding the relationship with those staying out. Preparing the single monetary policy and strengthen policy coordination was top of mind, but also reporting on the progress that countries made on letting their economies converge and adapting their institutional framework was key in the preparation. Not less important was the need to design a painstakingly detailed changeover scenario taking into account the numerous interdependencies between steps towards the union.

The contribution of F. Moss provides an in-depth insight into the EMI’s assessment of sustainable convergence based on the broad principles laid down in the Treaty and the difficulties inherent in this task. H. Scheller focuses on the design of the ECB’s monetary policy strategy and its toolbox of instruments.

The third part is of a more forward looking nature. In his contribution Jean-Claude Trichet points to the incompleteness of the EMU and the ways in which it has already been tried to remedy this through a strengthening of the governance. Further steps are necessary however. Progress should be made by giving Commission and Council the possibility to take over decision-making from countries that are behaving badly and are unwilling to adapt. At the same time a stronger democratic anchoring is called for through a more decisive role of the European Parliament. I am curious to learn how Athens would react to such line of thinking. Several contributors pointed to the elephant in the room when designing the EMU i.e. the role of increasing private debt levels and inherent instability of the financial sector. In his contribution, M. Draghi elaborates on the role of the banking union in making financial integration sustainable.

In his concluding remarks, A. Lamfalussy reflects on the reasons for the good track record of the EMI. He finds these in the political support of the EMU project and the fact that the institution-building process was governed by the Maastricht Treaty. A Treaty that not only provided a strict time constraint for the start of the single monetary policy but also assigned specific roles to all institutions involved.

A. Lamfalussy ends with one final word of caution though. He points to the fact that - as a result of the crisis - the ECB has received on top of its traditional mandate of monetary policy also a macro-prudential mandate. He warns that central banking independence could in this way be put at risk and that this will in any way add to the complexity of the task of central banking. If so, this could spell trouble ahead. We may have to wait another 20 years to fully assess whether or not this remark was indeed a well-aimed prophecy of that wise old man A. Lamfalussy.