

1. GLOBAL AND EUROPEAN MONETARY ARRANGEMENTS: FROM BRETTON WOODS TO EMU

Niels Thygesen

Abstract

Very significant changes have occurred in both global and European monetary arrangements – and in their interactions – since SUERF was founded in 1963. Then the European countries were on the whole comfortable participants in the Bretton Woods system, though keen to make the role of the United States less dominant. On three occasions over the last half century, European efforts to build their own monetary arrangements were triggered by global currency instability, but on the two occasions when Europe tried to form an Economic and Monetary Union – 1970 and 1991 – the response went far beyond what a quest for more stable exchange rates could explain; the set-up of the European Monetary System in 1978 was a more defensive reaction. The European experience has analogies to the global one, particularly in the inadequacy of surveillance of national policies, while conditional lending in Europe has become aligned to that of the IMF. At the end of the half-century Europe has, of necessity, become more narrowly focused on regional than on global monetary arrangements which have proved very difficult to modify.

1.1. INTRODUCTION

The overall headline for monetary and financial events in Europe over the half-century since 1963 is well captured in the title of the present introductory chapter to the anniversary volume of SUERF. In 1963 the attention of policy-makers in the six member states of the then European Economic Community (EEC) was to a large extent focused on improving the functioning of the global monetary order established at Bretton Woods that had, until then, served well also their interests. They had by 1959 successfully overcome the regional arrangement of the European Payments Union, designed to economize on scarce dollar balances in the early post-war period, and liberalized their current account transactions. Further moderate reform efforts in the global monetary system, notably to diminish reliance on the dollar, might have postponed subsequent European ambitions to create distinct and tight regional monetary arrangements well beyond the 1960s.

However, the global order soon began to erode; a decade later it had virtually disappeared, inspiring several European countries to grope for more stability at

the regional level. By 1970 they had produced a very ambitious outline for an Economic and Monetary Union (EMU) which was too far ahead of its time when dollar instability and energy prices combined to produce an unprecedented shock to the European economies from 1973. After nearly two more decades, marked by some overall progress, but also significant reversals, the now 12 Member States in the European Union signed a Treaty in Maastricht to establish a second version of EMU, with a single currency to come into existence at the latest by 1999. Another two decades later, attention has had to be focused on assuring the survival of EMU in the face of a deep crisis, lasting so far for more than five years.

Crucial to the outcome of those efforts throughout the half-century is the triple challenge, faced by any multilateral monetary system: to design adequate mutual surveillance of national policies with international ramifications, to provide international liquidity, and to be ready to extend conditional lending to countries with limited access to international financial markets. Now as in 1963, the interaction of global and regional dimensions of international monetary arrangements is important, even though the European focus has of necessity shifted nearly completely from the global to the regional dimension.

This chapter will follow a largely chronological pattern. Section 1.2. looks at the first decade from 1963, marked by the gradual demise of Bretton Woods and the early ambitions for EMU. Section 1.3. chronicles the difficult experience that followed, as a fragmented Europe developed even greater internal instability than the global, now much looser system, but also how Europe began to overcome this state, as priorities were gradually clarified and finally embodied into the Maastricht Treaty. Unfortunately this framework proved inadequate after an initial relatively smooth decade: first increasingly divergent performance and policies in a number of member state economies built up major tensions between the member states; then the absence of instruments for crisis management delayed recognition and reactions. But the deficiencies have been under intensive repair since early 2010, drawing in part on the experience with global monetary arrangements; this is the topic of Section 1.4. Tentative conclusions are presented in Section 1.5.

1.2. THE DEMISE OF BRETTON WOODS AND EARLY AMBITIONS FOR EMU

By 1963 the Bretton Woods system was near peak status, though its future was not entirely unquestioned. The system no longer looked quite like the design from 1944, or at least the vision of the main international power, the United States, see Steil (2013); the United States was no longer as dominant in the global economy where Europe and Japan were catching up rapidly, and a US current-account

deficit had emerged. One US concern from Bretton Woods remained: to defend the United States against becoming uncompetitive in a system where the US could not herself devalue her currency. The system's custodian, the International Monetary Fund, was not as firmly in charge of surveillance, including of exchange-rate changes, as planned.

But the initial European disaffection with the global system was motivated more by concern about international liquidity than by the exchange-rate system. Some far-sighted economists, notably Robert Triffin, then at Yale University, had taken up the argument, unsuccessfully advanced by Keynes at Bretton Woods, that an international monetary system based on one national currency would tend to become not just politically contentious, but outright unsustainable. In his 1960 book, *Gold and the dollar crisis*, Triffin had convincingly argued that it would be a rare coincidence for the rate of expansion of international reserves, desirable from a global perspective, to match the supply of assets from the main reserve provider through a deficit on current account; if the supply were to rise more slowly than demand international growth would be adversely affected, but if it were to outpace demand, a confidence crisis would arise sooner or later. More specifically, could the US reserve provider assure convertibility into the ultimate reserve asset of gold at the fixed price of USD 35/ounce – the core of the gold-exchange standard – in the latter circumstances? This “Triffin Dilemma” was about to reach the official agenda in 1963, largely at the instigation of France; President de Gaulle and his advisers, most prominently Jacques Rueff (1971), advocated a revaluation of gold which could have provided at least a temporary relief to the dilemma. But from 1965 global officials and the IMF began to design an alternative response to the dilemma in line with Triffin's analysis, viz. to influence the pace of international reserve creation by issuing a supplementary international asset – initially labelled Composite Reserve Units, later Special Drawing Rights (SDR) – not based on a national currency, but on a basket of internationally usable currencies. Even the US authorities had by 1965 become convinced of the need for reform.

In the course of the 1960s the United States, over a decade-long upswing which started in 1961, moved into a sizeable current-account deficit, not matched by longer-term inflows. Indeed, there were also large US outflows of longer-term funds in several forms: Foreign Direct Investment, portfolio capital or borrowing by European enterprises and public authorities in the large and liquid US securities markets. Hence, the inflow of short-term private funds into US markets, supplemented by the willingness of foreign central banks to accumulate dollars, had to finance both the US current-account deficit and long-term capital exports, the “basic balance”. While US policy-makers did not show willingness to modify the widening current-account deficit through domestic policy adjustments – “benign neglect” has been an apt term for characterizing the US attitude to the

current account almost without exception since 1945 – various measures were adopted to dampen US longer-term capital outflows, notably an Interest Equalization Tax of 1963 which made borrowing in US markets more expensive (and boosted an embryonic dollar market in London).

The US authorities encouraged their European counterparts to improve the functioning of European capital markets, hence reducing Europe's reliance on US as a source of funds. Major studies were produced, notably by the OECD (1967). But any prospective improvements in the capacity of European capital markets to channel excess savings into productive investment could at best become observable in the long run; Despres, Kindleberger and Salant (1966) convinced many that the United States had – and was bound to retain for some time – a comparative advantage relative to Europe in transforming short-term flows into longer-term (and more profitable) lending. Adjusting current-account imbalances did not get far, when the OECD's Working Party 3 addressed the underlying problems explicitly for the first time, see OECD (1966); there was no agreement on who should adjust to whom. The issue of symmetry between surplus and deficit countries in the adjustment process was as controversial then as it is today at the global level and within Europe; the only difference is that the Europeans in the 1960s were largely in agreement that rebalancing was primarily a US responsibility as the deficit country, a view currently held by Germany and other surplus countries in Europe.

There were, however, important nuances in the way the Europeans expressed this view. In particular, France adopted a more aggressive stance on the US role than did Germany (and most other European countries). France saw the role of issuer of the dominant international reserve asset as “an exorbitant privilege” for the United States. This perspective is invoked occasionally also in current debates on international monetary reform, but is this suggestive label justified and, if so, in what sense? It is a privilege for a country to be able to borrow substantially in the domestic currency to finance a current-account deficit; it may be an even greater privilege to host internationally very efficient financial intermediaries, able to turn short-term inflows of funds into longer-term more profitable foreign investments, as the experience first of the United Kingdom in the age of sterling dominance and then, in the postwar period, of the United States illustrated. It was arguably the second privilege that especially irked Rueff and others in France, a recipient of major FDI inflow from the US, vividly described in Servan-Schreiber (1967).

Both elements of privilege permit a longer period of domestic demand expansion than would otherwise be possible; gaining time for longer-run adjustment is valuable, but opens up temptations to misuse. But there are also more outright costs to being the main issuer of reserves; Triffin's dilemma focuses attention on the modern theme of a “sudden stop” – the risk of rapid reversals of financial

flows, as the build-up of short-term liabilities outstrips reserve assets, in the US case gold. Easy financing can also imply the accumulation of imbalances and external debt of a size which becomes difficult to correct even at a moderate pace. Some recent authors have gone as far as to talk about an “exorbitant burden” of being issuer of a reserve currency, see Pettis (2013). However, benefits seem to have outweighed costs for the United States; US economists have had a difficult time finding clear examples of US policies over the past several decades significantly modified by external considerations.

France tried hard to bring forward such considerations, first by drawing explicit attention to them – President de Gaulle’s press conference in early 1965 was a highlight in these efforts – subsequently by requesting conversion into gold of parts of France’s dollar reserves, as they began to accumulate in the mid-1960s; France aimed to hold 90% of international reserves in gold, only the remaining 10% in dollars. Although France was not isolated in taking this action – the Netherlands also converted dollars into gold – it triggered assurances from the German Bundesbank that Germany would not demand such conversions. This difference in attitude reflected general foreign policy considerations, and the bank drew criticism inside the country. Anyway, pressure on the US reserve currency status was mounting, also because the residual European reserve currency, sterling, was approaching the end of its role, following several payments crises and a large devaluation in 1967.

The agenda of European policy-makers focused in this period to a surprisingly large extent – at least from today’s perspective – on efforts to coordinate European views on how to deal with major and growing Atlantic imbalances and the associated cracks in the global monetary system. That was the case in the EEC Monetary Committee of Treasury and central bank officials and, from 1964, in the new Committee of Central Bank Governors (CoG) which also began to meet on a monthly basis. The CoG met at the time of the monthly meeting of the Group of Ten (G10) countries at the Bank for International Settlements in Basel, and it seemed quite natural to continue the discussions on the global agenda from the G10. James (2012) documents how the agenda of this new significant body from 1965 was dominated by the systemic issues of the creation of a new reserve asset. Officials from Treasuries and central banks discussed current-account imbalances with their North American and Japanese counterparts at the OECD; the IMF had not yet become a forum for debates on the global monetary system, but confined itself largely to looking at their major members one by one. So the Europeans and their central bankers had – and liked to have – a special role in discussing global systemic issues.

Regional issues, particularly surveillance and conditional lending facilities, first caught the attention of European officials during Italy’s balance-of-payments

crisis in 1963-4. In the absence of regional borrowing facilities, the Italian authorities asked for an IMF programme, without prior consultations with their EEC partners. The US authorities were helpful in facilitating swift negotiations between the IMF and Italy, and the current-account crisis was soon overcome, as overheating was corrected by a modest tightening of policy.

The IMF was not better prepared than the Europeans, but seemed more capable of reacting firmly, but generously, to a balance-of-payments crisis, a challenge it has taken Europe nearly half a century to rise to. Europe's capacity to react seemed to have diminished since the early 1950s, when, at the time of the European Payments Union, an adjustment programme for an overheating German economy had been rapidly and successfully implemented as proposed by her partners, but with the United States still looking over their shoulders. The experience of 1963-4 – to be repeated in the mid-1970s – left the impression that the European club of nations was too small, and had too much mutual dependence, to exercise firm surveillance of each other and to extend conditional loans; to perform these tasks it would be more useful to call on the global institution, the IMF, more distant from any borrowing government, and hence capable of greater objectivity.

A few years later, growing tensions between France and Germany forced an adoption of a fuller regional agenda. The weakening of political authority in France and the costly wage negotiations – “les Accords de Grenelle” – through which the government bought off the labour unions to end months of unrest had undermined the residual confidence in a continuation of a decade-long currency stability in the EEC. France resisted a devaluation until August 1969; shortly thereafter Germany revalued, producing a change of nearly 20% in the central rate between the two major currencies. This called for a political response to contain future divergence. The European Commission, through its Vice President Raymond Barre, and new political leaders in Germany and France – Chancellor Brandt and President Pompidou – were ready at the first meeting of Heads of State and Governments – later to be labelled the European Council – in the Hague in late 1969. That meeting accepted a package of two momentous steps: to enlarge membership, notably with the United Kingdom, and to deeper integration by authorizing a study on moving by stages to a full-scale version of EMU in the course of the decade of the 1970s.

Was the main motive for the latter surprising initiative the emerging intra-area disequilibria, or the recognition that exchange-rate and monetary stability could no longer be imported from a benevolent international system, but had to be underpinned by a special regional effort? The answer is not obvious; both inspirations are evident in the Werner Report (1970) which followed up on the Hague Summit guidelines on EMU. The trend towards more flexibility in the

global exchange-rate system, as fluctuation margins for each EEC currency against the dollar were to widen, hence allowing twice the width of the swings between two EEC currencies, did not suit the purposes of a Common Market and a Common Agricultural Policy, based on uniform prices.

In retrospect, the main contribution of the Werner Report may have been to make it very clear that the Europeans did not share the view that they needed within their Continent anything like the exchange-rate flexibility sought, or accepted as a necessity, in the global system. The Bretton Woods system did wait very long to recognize the need for a weaker dollar, which could only come about by the appreciation of non-US currencies. But, once that imbalance had been corrected, the European preference would have been to continue with fixed, though adjustable, rates. And there was no readiness to accept that wider fluctuation margins against the dollar would spill over in margins twice as wide between any two non-dollar currencies. Constraints on exchange rates to at least preserve the past degree of intra-area stability achieved was the least that should be assured. This first EMU initiative, however, went far beyond such modest defensive aims by outlining over three stages towards a federal central banking system, explicitly inspired by the US Federal Reserve System, permanently fixed intra-area exchange rates, removal of controls of capital flows, and a European centre of decision-making for non-monetary policies, all to be achieved within a decade. If fully implemented, the Werner Report would have shifted policy-making in Europe to a distinctly federal framework from that of trying to coordinate national policies.

The Werner Report was a very remarkable document, the ambition of which suggested that internal objectives dominated, though the crumbling of the global monetary system did provide a convenient enabling environment. In one respect, the Report with its comprehensive centralization of economic policies appears, in the light of recent experience with more lopsided integration, logical and appealing, but it was (even) further from the politically feasible than similar proposals would have been two or four decades later; its confidence in the ability of a European political body to improve the stabilizing features of national budgetary policies was overoptimistic in view of subsequent experience and analysis. EMU was nevertheless solemnly confirmed at a meeting of the European Council in 1972, but movement towards it barely started over the next couple of years. The only elements that survived were the more modest ones linked directly to regional substitutes for the fast eroding international monetary order: an exchange-rate system among some of the EEC member states along the lines of the fading Bretton Woods system – the parity grid of the currencies participating in the exchange-rate arrangement called the “snake” – and a shadowy European Monetary Cooperation Fund (EMCF) to manage, i.e. keep the accounts of, the very short-term credits among the participating central banks, very far short of

enabling the conditional lending possible through IMF facilities. Only the set-up in 2012 of the European Stability Mechanism (ESM) marks a permanent development in Europe in this direction.

The reasons why this first attempt at EMU ended up as a modest and totally inadequate response to the implosion of the global monetary system are not difficult to see. Underlying disagreements within Europe – papered over in the Werner Report – between countries that saw monetary unification as a strategic step in political integration and others who wanted the latter to proceed much further before considering a common central bank and a single currency might have stopped the project even under propitious global circumstances – as they nearly did two decades later. But the main reason for leaving the ambitions behind was the unexpectedly dramatic nature of the collapse of the global order, once again confirming the interaction of global and regional processes.

President Nixon on 15 August 1971 broke the link of the dollar to gold and imposed temporary US “import surcharges” (duties). Initially, the effort – also of the United States – was to save the basic elements of Bretton Woods, viz. the system of fixed exchange rates; IMF and OECD economists did the technical work underlying a package of exchange-rate adjustments, calculated to achieve sustainable current-account positions for the major economies – on the assumption of no major further divergence in macroeconomic policies. This hastily prepared package was endorsed in the Smithsonian Agreement of the Group of Ten in December 1971. Early in the following year, governments pushed ahead by asking the Committee of Twenty (C20), representing all of the then constituencies in the IMF Board, for an outline of a reformed international monetary system. But two global events in 1973 made the effort unrealistic: by March fixed exchange rates for the dollar had to be abandoned, mainly due to more expansionary US policies in the election year of 1972 than foreseen at the Smithsonian, and in October, as the C20 was nearly ready with a carefully drafted document for the IMF meetings in Nairobi, war broke out in the Middle East, followed by the first energy price hike. These events made it impossible to even try to retain the main elements of a reformed Bretton Woods system, and also for the European countries to preserve similar reactions to events.

The United Kingdom and Italy had already left the nascent monetary arrangements before the crisis hit; France followed in January 1974, shortly after the energy shock, leaving only smaller countries around Germany in a rump exchange-rate system. It was not so much that the shocks hitting Europe – a sharp fall in the dollar and higher energy prices – were “asymmetric” between countries; the latter just reacted very differently to these shocks, making exchange-rate stability impossible. Some, notably Germany, interpreted the shocks primarily as a threat to moderate inflation and hence adopted a non-

accommodating monetary stance; others were trying to build a bridge across the temporary shortfall in demand that they saw as the main result of the shocks. The implications of both the massive changes in the global environment and the visible differences in policy preferences had to be acknowledged by the C20 – in which European officials played a prominent part – but also within Europe. When the C20 finally produced its *Outline* for a reform of the international monetary system, Committee of Twenty (1974) it had to be a permissive one, instituting, or permitting, floating exchange rates and with accordingly limited prospects for effective international surveillance of national policies. Not only had the exchange-rate system and prospects for surveillance faded, but the context for monitoring of reserve creation had also been profoundly modified.

The desirability of phasing out sole reliance on a national currency as reserve asset had in principle been agreed when the first allocation of SDRs was made in 1970, but with the arrival of floating further steps in this area seemed less urgent. There was no longer any shortage of international liquidity, if the new energy exporters were to recycle their massive surpluses, as they appeared ready to do. Formally, however, the commitment to the SDR as the “principal reserve asset” and a correspondingly reduced role for currencies and gold remained. Valuable discussions of these issues were left in the Annexes to the *Outline*; some of them were dusted off by European officials for regional use in the course of the 1970s. A global reform – or rather an “Interim Agreement” – was finally agreed in Jamaica in January 1976, but it provided no path for accommodating a still dominant European ambition for more exchange-rate stability. To find such a framework, the Europeans would from now on definitely have to look inwards to restart their ambitions – towards more solid regional monetary arrangements. They could no longer have any illusions that global monetary reform would advance in a direction which made regionalism superfluous, as had arguably been the case, as long as the Bretton Woods system was functioning well.

1.3. FRUSTRATIONS 1973-93 THE EMS AND THE SECOND PLAN FOR EMU

In the aftermath of the energy price shock and the massive depreciation of the dollar that followed the break-up of fixed exchange rates, the EEC economies were in deep disarray. At no earlier times in post-war history had they been so divergent with respect to the major economic indicators. Average inflation rose to 10% by 1975, and the following year the United Kingdom and Italy both moved into the 20-25% range, and their currencies collapsed. Both countries called in the IMF, again without prior consultations with their European partners.

While changes in exchange rates had become unavoidable in the face of underlying divergences between national performances and policies also within Europe, currency movements had themselves become a trigger for disequilibrium processes no longer just a buffer to accommodate national divergences. It was no coincidence that the model of overshooting exchange rates, presented by Dornbusch (1976), received much attention at this time as an important analytical tool. With a serious worsening in the outlook for an economy and/or an easing of monetary policy, the exchange rate as the only fully flexible price in the system would tend to jump temporarily well beyond what could have been a sustainable new equilibrium level, before beginning to appreciate back towards such a level. But, if wages and prices were becoming faster to adjust upwards to a weakening exchange rate, as seemed to be the case in Italy (which had full indexation of wages) and in the United Kingdom, an inflation-depreciation spiral would be set into motion.

Could one limit currency movements to compensate at most for historically observed differences in national inflation rates? Such defensive thinking had penetrated even the European Commission that had a few years earlier promoted ambitious visions of EMU. If the large countries that had left the “snake” – France, Italy and the United Kingdom – could not realistically reenter a parity grid similar to the one they had been pushed out of, were softer approaches to dampening exchange-rate instability also ruled out, e.g. based on so-called “target zones” for their effective (average) exchange rates? Or, could the intervention rules in a parity grid system be made more symmetric, i.e. more accommodating to weaker currencies? Proposals of the latter type were made on several occasions over 1974-76 by France, and of the former type in 1976 by then Dutch Finance Minister Wim Duisenberg, (Gros and Thygesen (1998)), but they all foundered on the objection that more stability in exchange markets could only come with more serious threats to price stability in the better performing countries than was acceptable to them. If a trade-off between price stability and exchange-rate stability existed, the former would have to be given priority. That had, indeed, been the main German argument against continuing with a fixed exchange rate for the dollar which by the late 1960s had allowed US inflation to be imported into Germany.

Opposition from both the weaker and the stronger economies to taking up another challenge from the Werner Report – to liberalize capital flows and hence subject the EEC economies to competition between national monetary policies – was strong; as the experience with the currency crises in the early 1990s was to demonstrate, this remained a radical approach. Germany, which had liberalized early, did not yet push for others to follow; the difficulties of managing massive capital inflows into Germany in the final stage of the Bretton Woods era were fresh in mind.

Prior to 1977 instability and divergence were more visible in Europe than in the global economy. But that began to change in 1977-78, as inflation decelerated in Italy and in the United Kingdom, France turned to more cautious policies, and dollar depreciation picked up once more. President Carter's Administration was not, despite proclamations to the contrary, averse to a weaker dollar, at least as long as the threat of such weakness actively promoted international policy coordination and, in particular, more expansionary domestic demand policies in Germany and Japan – or, failing that, sharper appreciation of the Deutsche Mark (and of the yen). The terminology of exhorting the two major countries in external surplus to become “locomotives” for the international economy gave way to the more diplomatic notion of “leading a convoy”, but the reality remains that Germany at the Bonn Summit in 1978 agreed, in return for US measures to curb energy demand and prices, to embark on a stimulus of German domestic demand, subsequently seen as excessive from a domestic viewpoint. The experience of what global efforts to coordinate implied for Germany helped to make the German political leadership more ready to join France in the concurrent effort to launch the European Monetary System (EMS), comprising eight EEC member states (all but the United Kingdom).

Arguably, the EMS initiative of 1978-9 was the occasion when the global monetary environment most directly inspired both the timing and the nature of European integration. The looming break-up of the Bretton Woods system some years earlier had required a European response, but as argued above the Werner Plan for full-scale EMU went so far beyond a direct reaction that it revealed much deeper regional objectives, however unrealistic they subsequently turned out to have been. The EMS was a more focused and modest approach to preserving and consolidating emerging exchange-rate stability in Europe in the face of a renewed challenge from major swings of the dollar and US pressure on Germany to expand domestic demand or appreciate. The German political leadership, though not the Bundesbank or the financial sector more generally, did accept the case for linking the Deutsche Mark more firmly to those of large, but weaker, European partners, hence sharing the management of external monetary relations at the European level. However, in two important respects, the EMS did not live up to the intentions of its founders.

First, exchange-rate management was to be “as strict as the snake”; that was not a very demanding standard, since there had been regular realignments of central rates since 1973. However, over the initial years between 1979 and 1983 realignments became even more frequent – and cumulatively larger than they had been over any comparable period in the snake. The EMS appeared to succeed relative to the original Bretton Woods system, in the sense that realignments were, indeed, decided in common, not just implemented unilaterally. But the success was mostly apparent, since the decisions taken over a series of realignment weekend meetings

mainly ratified past differentials in national inflation, and much less clearly an ambition to bring about domestic policy adjustments that would reduce future divergence and hence the need for realignments over a longer horizon.

One virtue of a fixed-but-adjustable exchange-rate system is that it provides opportunities for influencing adjustments in the country asking for a devaluation. There was not much evidence of effective surveillance of this type in the early EMS. A relatively permissive approach became necessary when economic policies in Germany and France once more began to diverge strongly during the first two years of the Mitterrand Presidency in France (1981-83). A tightening of procedures became observable from 1982 for some smaller EMS countries in the shape of smaller devaluations than they had asked for, and, with a third large French devaluation of 1983, for France herself. But the lack of firmness of the EMS in its early years meant both that convergence was slow and that it took longer to bring about any sharing of the European role in the global system, still performed by Germany.

Second, the idea to develop the EMS into a European Monetary Fund (EMF) after a two-year period was quietly shelved already in the course of 1980. This second stage was to have added some of the functions of a regional IMF, by extending the management of short-term support among the central banks to longer-term credits of the conditional nature given by the IMF to countries in balance-of-payments difficulties. But there were strong internal and external objections to the EMF. As had been the case with the EMCF from which it started, the EMS founders had disregarded the need to have a separate political institution to handle conditional lending to governments; the central bank officials who were to oversee the implementation of the EMS and its evolution into an EMF insisted that they should not be involved in the essentially political task of passing judgement on national economic policies. They succeeded throughout the first decade of the EMS in keeping the automatic mutual credits arising out of interventions so short – about three months – that countries would not be tempted to delay the more basic policy adjustments that could stop the need for intervening. The automatic very short-term credits were designed to ease liquidity problems for the participating national central banks, just like mutual swap facilities in the global system, not to facilitate more basic adjustments.

There was also opposition from the IMF and from its main shareholder, the United States, to the EMF; international conditional lending should, they argued, be extended according to global principles, rather than within a regional club which could be suspected of softening standards, see Polak (1980), (1997) and Thygesen (1997). A similar reaction from the IMF and the US was observed 20 years later when Japan, in the aftermath of the Asian crisis, proposed an Asian Monetary Fund to assume important responsibilities in intraregional lending in

Asia. There is a strong and understandable interest in the global community to preserve global standards in conditional lending, an attitude to which both Europe and Asia have since accommodated by linking the terms of their respective regional lending programmes to those of the IMF, though there is as yet no experience in Asia as to how this type of linkage would work in practice.

To summarize, the two weaknesses of the EMS relative to intentions – an initially permissive exchange-rate mechanism and an inability to develop instruments for longer-term adjustment of imbalances – implied that Europe did not quite rise to the challenges posed by renewed global instability in the late 1970s. Germany was not as firmly embedded into the regional system as to be relieved of the burden of being in the front line in international policy coordination, nor did Europe succeed in designing conditional lending of a type that would make reliance on the IMF superfluous. But in the course of the 1980s two additional powerful impulses came from across the Atlantic to encourage Europe to take bolder regional policy initiatives and to remedy the observed weaknesses of the EMS.

The first was the familiar one of continuing, but by the mid-1980s unprecedented, dollar instability. For more than four years from early 1981 the dollar appreciated strongly against the European currencies, primarily as a result of expansionary US fiscal policies and, at least initially, tight monetary policies as inflation was reduced. This faced the EMS countries with an acute dilemma: should they accept higher inflation by allowing their currencies to depreciate, or should they raise interest rates to defend the external value of their currencies, hence dampening growth below already modest levels? The tensions also affected the EMS national currencies differently, illustrated when a correction of the major overvaluation of the dollar gained additional momentum from September 1985 through the so-called Plaza Agreement. This was a belated recognition by the Reagan Administration, 12 years after the break-down of Bretton Woods, that exchange markets would not stabilize simply as a result of each major country “putting its own house in order”, as had been the US hope over the first half of the 1980s; more focused and coordinated policies had to be put in place. These policies worked well for a year and a half as the dollar dropped to a sustainable level, and they were then replaced by the stabilization of the main currency relationships, embodied in the Louvre Accord of February 1987.

Both the rise and the fall of the dollar, but particularly the efforts of the Accord to stabilize the dollar against the EMS currencies, revealed the continuing weaknesses of the system, as long as the Deutsche Mark was effectively the pivot; this was illustrated in the fall of 1987 when Germany angered the US authorities and, to a lesser extent, the other EMS participants by raising interest rates. Even when national economic performances in Europe had converged substantially, residual policy differences would attract the attention of currency markets and make the

EMS unstable, particularly as long as the global system showed instability; this provided an incentive to take the EMS further.

The second impulse to further European integration came from the observation that the US economy had been growing much faster than the aggregate of the European ones since coming out of the recession of 1981-82. There was a need for Europe to create a more competitive and deeply integrated Single Internal Market for goods and services in Europe. Detailed plans were agreed in 1985, including use of Qualified Majority Voting in their implementation – a reform supported by all Member States, even the United Kingdom. There would have been no firm determination to take this programme seriously without reducing the risk that competitive positions in the integrated market could be undermined by sizeable shifts in relative prices due to the currency realignments which remained possible in the EMS. Monetary integration had to catch up with the real integration underway, particularly as the latter implied also a timetable for removing controls with capital movements which was bound to make the EMS more unstable. Policy officials were well aware of Mundell's trilemma, viz. that a country cannot aspire at the same time to achieve the three objectives of a stable exchange rate, free capital flows and autonomy for national monetary policy; one would have to go – and with EMU it would be the third objective in what Padoa-Schioppa (1994) labeled “the inconsistent trinity” (or quartet, if one also takes into account the objective of sustaining free trade and avoiding protectionism).

The perception that a single market, extending also to financial services, would work far better with a single currency than without one was the main economic inspiration for launching EMU. As in 1970 internal objectives were more important than defending Europe against global currency instability, though the latter was even more readily observable in the late 1980s than a decade earlier when the EMS was set up. As also discussed in Chapter 6, with the Maastricht Treaty, Europe by 1992 went much further than any defense against global instability required. A single currency broke with the perception, still guiding the global system, that the issue of money is a distinctive prerogative of a national state; and this time the break was clearer than in the Werner Report where “irrevocably fixed” exchange rates were still discussed as an option for the final stage.

The vision for EMU was, however, less ambitious in its design for implementation than two decades earlier: there was to be centralization of monetary policy, but other economic policies would remain in national hands, though subject to upper limits on public sector budget deficits and longer-term norms for public debt. In contrast, the Werner Report had advocated central decision-making at the European level, also for the budgets of Member States. Many have been very critical of the narrower version of EMU, claiming it was dictated by political convenience rather than economic analysis. Such criticism overlooks that the

emphasis in the Maastricht Treaty was not on improving national stabilization policies through joint European decisions, but on upgrading longer-run sustainability of public finances as a policy objective in the Member States. In 1970 the average ratio of public debt to national income was about 30%; two decades later it was close to 70% and rising. Higher priority had to be given to the long-term perspective for national budgets; that could be achieved better by clear rules than by joint and discretionary management of the budgetary stance, provided there is both a sense of national responsibility towards the rules on ceilings and a willingness on the part of partners to monitor compliance. A contributing factor to the major change of emphasis since 1970 was that there was less confidence around 1990 that budgetary policies could – or would in practice – be designed so as to contribute to short-term stabilization; both the difficulty of getting the timing right and political considerations would often prevent that. As the Treaty was being negotiated, pro-cyclical national budget policies were observable in several European countries; governments found irresistible the temptation to stimulate domestic demand when they felt able to afford it rather than to react countercyclically.

Political initiatives try to respond to recently experienced challenges. At Maastricht the main challenge was to make the European economies more robust to the spill-overs of national monetary developments and policies across borders which could threaten the Single Market. Spill-overs from other national economic policies, macroeconomic or structural, are likely to be largely contained within national borders; hence authority to decide on them could remain in national hands in accordance with the principle of subsidiarity. This was, in retrospect, too optimistic a view – as was the omission of macroeconomic imbalances other than those observable in public budgets. In the EMS participating central banks and government regularly monitored developments in indicators of external imbalance – current account positions and relative price trends – as the guidance from these indicators to the size of and follow-up to realignments depended on them. In EMU, this monitoring stopped.

In my Marjolin Lecture to the SUEF Frankfurt Colloquium in 1998, a few months before the formal starting date of EMU, I argued that it was possible to trace five major ambitions of European monetary integration that had evolved over the long history since the 1960s. They were (Thygesen (2000)):

- reducing, then eliminating nominal exchange-rate fluctuations;
- reducing, then eliminating inflation;
- developing rules for non-monetary national policies, then scope for coordinating them without undermining the rules;
- developing a potential role in the international monetary system, then adjusting it to the realities of today; and
- developing a European profile in financial regulation.

This is still a useful summary list, but my assessment of 15 years ago that three, may be only two and a half, of these ambitions had been met in the Maastricht design was too positive. In addition, one ambition – effective crisis management – was missing, because it was regarded as superfluous. By 1998 the need for it had not yet emerged.

By definition, the introduction of a single currency eliminates all fluctuations between the national currencies that have merged into the new supranational unit. Hence, this first ambition can be dealt with briefly; but the arguments why it is important need to be kept in mind also today. They go back to what most Europeans regarded as costly and excessive fluctuations in exchange rates, not so much in the short term as over longer disruptive cycles, since the breakdown of the global fixed-rate system in the early 1970s. EMU is at its core an expression of the continuing stronger preference of European policy-makers for fixed exchange rates inside their region than is found in other regions of the world economy.

The challenge for the founders of EMU was to assure that eliminating national currencies in Europe would not lead to a downgrade of the objective of price stability. The Bretton Woods system – which did have a formal anchor through the link of the dollar to gold – had left the perception that fixed exchange rates were likely to be incompatible with low and stable inflation over longer periods. The lengthy preparations in the EMS for Maastricht did persuade the countries that had been skeptical, notably Germany, that there was not necessarily a trade-off between internal and external stability. The starting point looked auspicious: France, in particular, had seen her inflation rate converge substantially towards German levels, before EMU was negotiated; Italy was making good, though slower progress. Optimism that this process was likely to be reinforced was based on expectations that intensified competition in the Single Market would keep national cost and price trends broadly parallel, and that economic policies based on the fiscal rules would support such tendencies. The participants in EMU would by sharing a single currency come closer to meeting the criteria for being an Optimum Currency Area. Such optimism, not totally unwarranted at the time, formed the premise for the Franco-German compromise on EMU: for a well-behaved France (and others) a deserved share in the leadership of Europe's monetary affairs, so far solely in German hands, in return for Germany's prospect of exporting the "stability culture" on which past German EMS leadership had been based. This compromise extended to reliance on both objective criteria of economic performance for admission to EMU and a firm timetable for starting the final stage with whatever number of countries proved to be ready by 1999, at the latest.

These two main achievements still stand, but the third – achieving coordination of national economic policies outside the monetary area through a simple rule

book for national policies, particularly in the fiscal area – can not be said to have been even half-implemented. The ceilings on national budget deficits and the norms for public debt ratios of the Stability and Growth Pact (SGP) fell into disuse and have had to be subjected to intensive repair work in the recent period, see Section 1.4. below, and the balance between a rules-based system and more discretionary decisions which continues to be tilted towards the former in line with the original ideas behind the Maastricht Treaty is being questioned anew.

As regards an exchange-rate strategy for the euro, few at the time of Maastricht believed that much ambition needed to be put into this area. Disagreements within EMU on the tolerable range of fluctuations for the euro against other main currencies have persisted until today, but the provisions of the Treaty, quite deliberately, make it very complex for the two Euro area authorities concerned – the Eurogroup and the ECB – to agree on interventions in exchange markets; despite large swings in the external value of the euro, the Eurogroup has never been able to agree within its own ranks and, *a fortiori* with the ECB, on even the vague “general orientations” for exchange-rate policy foreseen in the Treaty.

The role of the exchange rate vis-à-vis the dollar and other global currencies is an illustration that most Euro area policy-makers tend to view the problems of the euro primarily as an internal matter, much less as part of a global agenda. But some have disagreed all along; at the stage of planning for EMU, a minority of national officials believed that some pooling of international reserves and interventions in third currencies according to a jointly formulated strategy would provide an important starting point for an internationally responsive EMU, as well as a useful training experience during the transition to the final stage, see de Larosière (1989). But such emphasis on the exchange rate was not acceptable to Germany and to other national officials who saw no need for sharing any form of monetary sovereignty until the third and final stage of EMU and who anyway placed less emphasis on the role of the exchange rate in policy decisions than France did. As the competitive positions of the participants have diverged in EMU, disagreements on what is an appropriate level for the external value of the euro have widened, making a reversal of the hands-off attitude to the exchange rate ever less likely. The Eurogroup has yet to agree on the formulation of some “general orientations” for the external value of the euro, and remains likely to be unable to do so.

As regards financial regulation and supervision, a European dimension is now finally developing, with a major role for the ECB first in macroprudential supervision and, more recently, even as a supervisor of banks. Neither officials, nor most academic economists had foreseen any need for such developments 20-25 years ago, when financial crises had not been observed on any systemic scale for decades, and banking remained a largely national industry in Europe.

Governments would not have been ready to contemplate any transfer of national sovereignty over their financial institutions and markets, a more sensitive area from a political point of view than monetary policy. National regulators who at the time saw their authority being widened and merged within national borders into powerful unified Financial Services Authorities resisted incursions onto their turf. Central banks were not anxious to ask for supervisory functions which they regarded as tedious, unnecessary for their monetary mandate, and potentially dangerous to their autonomy in monetary policy vis-à-vis both the political authorities and the financial institutions. Almost by accident, the Maastricht Treaty left in a vaguely formulated sentence that has recently provided the tenuous legal basis for giving the ECB “specific tasks related to prudential supervision” beyond an advisory role (now Art. 127.6 of the Lisbon Treaty).

Leaving the general macroeconomic underpinnings of a single currency relatively weak, avoiding any collective or joint responsibility in EMU for national government finances and particularly a lender-of-last resort function to governments for the ECB, making ECB intervention in the exchange market complicated and unlikely, and limiting the bank’s role in financial rescues can all be seen as illustrations of the core ambition at Maastricht: to enable a particularly purist version of a central bank to emerge. The coming ECB was not to be distracted from its central mandate – to assure price stability in the medium term – by the tasks of lending to public authorities, buying other currencies or providing liquidity on a major scale during periods of financial instability. On this strategy there was wide agreement among the signatories at Maastricht. Nor was there much criticism from academic economists – though Folkerts-Landau and Garber (1992), pointedly asked whether Europe was setting up a central bank or just instituting a monetary rule.

From today’s perspective there should have been a sixth ambition – to design a crisis mechanism for the situations when, despite all good intentions and rules, a country falls into severe difficulties and loses access to international financial markets. The global system has long had such mechanisms in the form of IMF conditional lending to members in balance-of-payments difficulties, and these mechanisms have since about 2000 been extended and refined on several occasions, and more recently supplemented by short-term lending, targeted at countries in liquidity difficulties, but not requiring major adjustment (the Flexible Credit Line and the Precautionary Credit Line). EMU was not seen at Maastricht to need such facilities. There were elaborate and, hopefully, binding constraints on national behavior, both in the form of the rules for budgetary policies and, ultimately, of the so-called “no-bail-out” rule, preventing other EMU countries from assuming the debt obligations of a country in financial difficulties. The whole framework was seen as providing strong incentives for each participant, positive as well as negative, to maintain access to international financial markets.

Anyway, external imbalances should be financeable more automatically for countries in a single currency area than globally. New mechanisms were only put in place when the financial and economic crisis had demonstrated a definitive need by 2010.

As the EMU preparations ended at Maastricht, many observers doubted whether the transition to the final stage of EMU could be made; to make the prospect less uncertain, a firm target date of 1999 was put in, regardless of the number of countries ready at the time to adopt the single currency. The final stage had been outlined in sufficient and reassuring detail, but the provisions for the transition through the initial two stages were vague. The first stage looked very much like the past; while the second stage did establish a new institution, the European Monetary Institute, that was only to prepare for full EMU, not to rehearse the exercise of common powers. However, doubts proved unfounded; the final stage looked sufficiently attractive for a surprisingly large number of countries to make an important effort to be in the first group. By advancing the convergence in interest rates that would take place from the start of a credible EMU, the budgetary efforts required to meet the Maastricht admissions criteria became less onerous. Despite the set-back of first the loss of some participants in 1992, then the relaxation of the EMS as a result of the crises in 1993, it proved possible for no less than 11 Member States to meet the criteria on the basis of their economic performance in 1997, only four years after the EMS stepping stone to EMU wobbled.

There were two major reasons for the speed with which a wide EMU could start: (1) Some of the supposedly weaker EMS participants, notably France, retained their central rates, resisting the calls from the IMF and other outside observers to use their greater room for maneuver within the wider fluctuation margins in the EMS, and (2) the German economy remained weak during this period (and in the initial years of EMU). At Maastricht other countries were fearful of the added strength of the German economy after unification which would raise its population by nearly one third. This proved to be unjustified; for nearly 15 years after the fall of the Berlin Wall the performance of Germany was impeded by the heavy budgetary burdens of unification with massive fiscal transfers to the East and by weaker competitiveness imposed by too much construction activity at home and by devaluations by some future EMU partners. These two factors too gave the process of the build-up to EMU an image of greater cohesion and success in the transition than expected.

In retrospect, the period 1994-98 was promising both for the European efforts to prepare entry into EMU and for the global monetary system. The US economy was growing faster and the apparently intractable budget deficit was fading fast. There were early warnings of international financial instability in Mexico and

East Asia, both facing “sudden stops” of capital inflows, requiring sharp macroeconomic adjustments through IMF conditional lending. But the lesson that financial market discipline could be brutal was regarded as irrelevant in EMU where the main past transmission channel of tensions through exchange markets had been effectively removed. Criticism of an “incomplete” union abated within Europe as well as globally, allowing EMU to start as planned – on a note of self-congratulation. The Asian crisis of 1997-98 did not cause much soul-searching in Europe; the perception was that some of the countries had conducted policies that were more unsustainable than could occur in Europe. Furthermore, Europe did not have the currency mismatch problems of the Asian countries who relied on borrowing in foreign currencies. The European complacency turned out to have been misplaced on both counts; external imbalances would build up to far higher levels than in Asia, and no single EMU participant could safely regard the euro as their national currency at times of crisis, raising questions about solvency similar to those in Asia.

At the time when EMU started, the prevailing view on the choice of exchange-rate regime among both officials and academics was that it was basically a binary choice between fully flexible rates or a common currency. Intermediate forms, ranging from regular management through interventions, through target zones to more closely administered systems such as the EMS or even currency boards were likely to be inferior to either extreme regime. This conclusion seemed to be borne out by both the EMS crises in 1992-93 and the subsequent events in Asia and Latin America. Yet, some experiences with a system of tightly managed, but still in principle adjustable exchange rates, have been successful, even with high capital mobility, as long as the participants were able to maintain a high degree of credibility for their policies. Some countries had a positive experience in the EMS, and a similar regime, labeled Exchange Rate Mechanism II, was retained for countries preparing to enter the euro. The only country to retain participation in ERM II over a long period is Denmark, though not a candidate to join the euro in the nearer future. Euro candidates have typically regarded ERM II as a waiting room where it was unsafe, for the reasons mentioned above, to remain for more than the minimum two-year period prescribed. But the capacity of good domestic policies by themselves to make a fixed exchange rate sustainable should not be overlooked to the degree experienced in the run-up to EMU.

1.4. REPAIRING SURVEILLANCE TO SAVE EMU – BUT NO GLOBAL ROLE FOR EUROPE

There were two challenges in the early years after the start of EMU: the single currency weakened surprisingly vis-à-vis the dollar and other major currencies

over the first two years, and the fiscal rules came under strain. The first was also a global issue, the second purely a regional one.

The “challenge” of a weaker euro was temporary, largely explicable in terms of fundamentals, and not unwelcome in several EMU countries, including Germany, which still had competitiveness problems and a current-account deficit. The challenge led to the single occasion in 2000 when the ECB intervened in exchange markets, in part together with other central banks. When the Fed lowered its policy rate to 1% and kept it there for an extended period in 2003-4, the euro appreciated; by 2004 it had risen above its initial level which was widely considered to be close to a longer-term equilibrium.

The strain on the fiscal rules had more serious consequences by revealing weakness in the surveillance process. Ireland and Portugal had received recommendations in 2001 to conduct more prudent, in the Irish case, less pro-cyclical budgetary policies. When the Commission addressed similar recommendations to Germany and France in 2003, the Eurogroup – Finance Ministers of EMU participants – did not support this step; for a year and a half the SGP was suspended. France and Germany supported each other and were backed by the two countries with the highest debt ratios, Belgium and Italy. The two largest countries did not even bother to argue in detail for an extension of the adjustment period, as Germany could have done with reference to the longer-term structural reforms on which the Schröder government had embarked and which would contribute to the sustainability of public finances.

By May 2005 a revised SGP was agreed. The Pact was now more a framework for negotiation than a firm ceiling (or norm) from which Member States could be expected to keep a respectful distance. This was a relaxation of the central element in EMU surveillance which had initially attracted positive attention globally. Yet the revised Pact might have worked, if participants had been less inclined to be polite to each other. Still the next 2-3 years did not reveal additional budgetary imbalances; an economic upturn made it gradually easier to keep the deficit under 3% of GDP. But the analytical methods for evaluating the underlying or structural deficits were only being developed in this phase, and monitoring efforts remained inadequate and sometimes undermined by national misreporting.

A particularly gross example of the latter was brought to light after the Greek elections of October 2009. Until then financial markets also had failed to do their homework, since spreads between 10-year sovereign bond rates, even in the case of Greece, had stayed in the 20-30 basis points range, representing a surprising underpricing of risk, due to a belief that the no-bail-out provision would not in the end prevent rescue by a country’s EMU partners, or to an underestimation of the imbalances. Governments and the ECB tended to take the remarkable

convergence of interest rates as a compliment to the cohesiveness and success of EMU, rather than as a conundrum. Other international institutions performing regular surveillance such as the IMF and the OECD did not identify the severity of the Greek crisis either.

Greece was a unique case both because of the size of her budgetary and external imbalances and the suddenness of the revelations, but not the only country where EMU surveillance should have raised the alarm. Portugal also had serious imbalances in both dimensions. Spain and Ireland had apparently sound public finances, but in both cases largely due to an exceptional credit-financed boom in their construction sectors and to consumption. The overheating of these economies caused additional inflation, loss of competitiveness and growing external deficits. Constructive surveillance would have identified these two countries as pursuing unsustainable policies, where the large capital inflows financing the current account deficits were not used to build productive capacity to redress the imbalance. But the EMU institutions were focusing excessively on public finances, rather than on the overall macroeconomic balance. This perspective has now been built into the revised procedures in EMU surveillance by restoring indicators of external imbalance – developments in the current account and in competitiveness.

Major repair work on the policy rules and on the effectiveness of surveillance has been performed by the Commission and the Council of Ministers, often under the prodding of the European Parliament and the ECB¹. In late 2010 a major legislative package - the “six pack” in EMU jargon – tightened the SGP procedures while shifting the focus from actual to the economically more meaningful underlying (or structural) deficits, expanding the perspective from purely public sector to broader macroeconomic imbalances, and making it almost impossible to vote down the Commission’s recommendations for adjustments and ultimately sanctions, as had happened in 2003. In 2012 agreement was reached on the introduction of the revised budgetary rules into national legislation – “the fiscal compact” – and the rules will be monitored in each Member State by fiscal councils, independent of the national government, and not only by the Commission. In 2013, the final improvements in surveillance of national policies fell into place when the European Council and the Parliament reached agreement to advance the calendar for examining national budgets to a more meaningful early date and by introducing enhanced surveillance relative to SGP procedures for countries in financial difficulties, the “two pack”.

These improvements in international surveillance, in the view of most observers, have gone far enough to seem adequate for normal times; had they been operative

¹ Reviewed in greater detail in Chapter 12 of this book by Ayuso and Blanco.

from the start of EMU, most elements in the crisis might have been avoided. Participants in a monetary union have a stronger need for mutual surveillance than individual countries in the international economy, but the recent improvements have brought the EMU procedures back into the front line of global surveillance practice. In doing so, the Europeans have found it necessary to draw on the stronger analytical work on structural imbalances and public debt sustainability done by the IMF and other global institutions. If the reformed system, when fully implemented, does not work, it is difficult to see how any surveillance can work.

The tighter surveillance now being implemented is primarily designed to reinforce the instruments to make future crises more unlikely. An even more urgent effort has had to be undertaken to bring EMU to a more normal state than the deep crisis of the last few years. The agenda of the EMU institutions has been focused both on preventive measures and on crisis management, and the latter has brought the IMF as guardian of the global monetary system more directly into Europe than foreseen over the past half-century of attempts to develop regional surveillance.

The Greek crisis forced the EMU institutions to strike a balance between the regional and the global dimension in designing support to a country which had lost access to international financial markets. Greece is a member of the IMF, entitled to address herself directly to the global institution to seek financial assistance. The EMU participants, the Commission and the ECB hesitated to call on the IMF for a couple of months, weighing the usefulness of global involvement to dispel the long-standing perception that lending was more lenient in Europe than elsewhere against the loss of European pride in not being able to handle the problems within a regional framework. A formula was found, applied also in the subsequent cases of Ireland, Portugal and Cyprus: the IMF would participate in formulating the conditionality, adding analytical capacity, not least in evaluating the sustainability of public debt, and professional experience in negotiating conditional lending programmes to that of the two EMU participants in a “troika” – of the IMF, the Commission and the ECB. The IMF would contribute half of the amount provided through European institutions.

Cooperation appears to have been useful, but whether it will continue, at least with partial IMF financing, remains uncertain. A recent study, Pisani-Ferry *et al.* (2013), argues that IMF participation in the troika may now largely have outlived its usefulness. The IMF’s non-European membership finds that an excessive part of resources are being channeled to Europe which prides herself in being in approximate overall external balance or small surplus; hence the Europeans should be capable of financing intra-area imbalances on their own. Given the way that conditionality has been applied in EMU, concerns that figured prominently

at the start of the EMS with the plans for an EMF have faded both at the IMF and in Europe. It is difficult to claim that lending to EMU countries has been extended on more lenient terms than in IMF practice generally; the notion that such lending continued to be labeled “bail-outs” of debtor countries at low cost to them must have been put to rest since 2010. Continued input from the IMF on the analytical side may be welcome both for its analytical quality and its greater distance from outright political considerations, but it is hardly essential. It is interesting to note that 13 Asian countries cooperating in an extended network of swap facilities, have reached a similar conclusion on the balance between global and regional lending by agreeing to link the conditionality applied in their framework to that of the IMF, see Henning (2011), despite stronger misgivings than in Europe, dating from the Asian crisis, about involving the IMF in regional surveillance and lending, but this model has not yet been tested in Asia.

EMU also appears finally to have found a solution to the problem of defining a division of work between the monetary and the political authorities in crisis management. That problem could not be resolved in the 1970s since the established short-term credit mechanism between central banks could not just be extended in maturity without conditionality and the setting up of a new political institution. On a more permanent basis that has only happened in 2012 with the European Stability Mechanism (ESM), the present version of the EMF of 1978; the ESM is separate from the ECB and managed by a board of political decision-makers.

The delay in setting up the ESM, and its limited size relative to the potentially massive demands on its resources, explains why increasing doubts in 2011-12 as to the capacity of Spain and Italy to preserve access to financial markets created great pressure on the ECB, still the only fully operational EMU institution, to step in to buy sovereign bonds issued by these two countries, to improve the sustainability of their debt. The ECB could hardly do that in view of the firm wording of the Treaty on buying public debt, but a compromise was found, when the ECB announced in September 2012 a programme of Outright Monetary Transactions (OMT), contingent on the issuing country having obtained a conditional loan from the ESM. At the time of writing this innovative initiative has not been tested, but the impact of announcing it did lower the spreads of Spanish and Italian bonds over the German benchmark by approximately 200 basis points.

The sustainability of a country’s debt depends on three factors: the initial level of debt, the average interest rate paid on the debt, and the growth rate of the economy. In view of the risk of fostering additional financial instability and contagion through rescheduling of “excessive” debt to private and public creditors, the first of these possibilities, often used in traditional IMF programmes, has been approached with great hesitation in EMU and so far only for the private creditors of Greece. The growth rate of the economy is low, or even negative, in countries

in adjustment programmes – and particularly so in EMU where the initial imbalances were extremely serious. On this background it is an acute problem in making the debt manageable to avoid interest rates that are much higher than justified by fundamentals; if markets push them higher in a mood of pessimism about not only the country's own performance, but also the survival of its participation in EMU – “dissolution risk” – lending programmes with subsidized interest rates – relative to excessively negative views in markets – and supplemented by ECB purchases of sovereign short-term debt under the OMT programme become justified.

The intensive repairs of the surveillance framework, the set up of the ESM and the OMT option have all been implemented without more than a very minimal addition to the Treaty (for the ESM) which did not require ratification by referendum in any Member State, and hence relatively speedily. But these steps, radical and unanticipated as they are, have not exhausted the agenda. Over 2012-13 a banking union with elements of joint fiscal responsibility for bank resolution and deposit insurance were added, and joint issues of parts of national sovereign debt in return for stronger EMU authority over national budgetary policies have moved closer to the agenda. At least the latter package is likely to involve changes in the Treaty and hence a relatively long time horizon; whether they can be implemented at all, is uncertain. If they are, steps will have been taken which make the future EMU more like a national federation than a regional cooperative agreement relying primarily on national responsibility in most policy areas.

The Maastricht Treaty assumed that a single currency would not require centralization of authority for economic policies outside the monetary area, and, as argued above, with the more elaborate preventive surveillance now in place for sustainable national economic policies, this assumption may well be correct in normal times. The dividing line in the European debate is whether it will be possible to get back to “normal times” without putting in place permanently a stronger, more federalist framework, or whether ad hoc measures to end the crisis, notably involving steps of solidarity beyond any Treaty for the transition to normality, could be sufficient – and more acceptable in electoral terms. Those who continue to doubt whether even reinforced surveillance can work will advocate the former.

There are analogies to the experience in the global monetary system. There, too, there is a sharp distinction between surveillance of a country in the preventive, advisory sense and lending on conditions to a country. The former has often been either neglected by the addressee, particularly by larger countries, or watered down in its final version. Despite being more precise and prescriptive than surveillance by global institutions, the SGP was not taken very seriously prior to the crisis from 2008-9. On the other hand, when an IMF programme is sealed by a Letter of Intent from a country, or when the troika settles a programme with an

EMU participant, the additional clout that comes with making external funding available assures that a major effort is made to live up to the agreements. Both types of programmes have fostered resentment in the borrowing country, as decisions taken by international bodies begin to impinge directly on the details of national economic policy with respect to taxation, public expenditures and structural reforms, rather than just on more aggregate indicators, such as the budget deficit. This was the legacy of IMF lending in Latin America and Asia in the 1980s and 1990s which has not quite been overcome; it is currently an outcome of conditional lending to EMU countries. Several “peripheral” EMU countries experience public anger over policy adjustments requested by the European institutions (and the IMF), and ultimately by the creditor countries.

At the global level the IMF may find it easier to overcome this legacy than will be possible at the regional level; policy prescriptions have less of an air of technocratic objectivity in EMU, where national politicians regularly comment on the policies in partner countries. After the Asian crisis several countries in the region decided to follow sufficiently prudent policies that they would not again risk to have to seek IMF programmes. That is not a very efficient solution, but less disharmonious than simple rejection of the interference by partners in a more tightly knit regional grouping. It is particularly important in EMU to get back to a more normal state of affairs where conditionality is less detailed, leaving more room for national responsibility.

During the recent internal crisis and the associated intra-area conflicts the EMU countries have not been particularly active in contributing to the debate on reforming the global monetary arrangements. There was one exception: France, during her simultaneous chairmanship of the European Union and of the G20 in 2011, did try hard to find allies beyond EMU – in China and elsewhere – for a push towards a reformed, multipolar monetary system, as described in Angeloni *et al.* (2011). Not without bitter irony, the Cannes G20 meeting in November 2011 which should have marked a major advance towards this objective was overshadowed by political crises in Greece and Italy. The focus inwards on Europe may have been the best use of time, since the prospects for making any progress in international policy coordination, currency instability and management of international reserve creation have not been propitious. The EMU countries have still taken no steps towards a unified representation in global fora – another indication that external ambitions are not so strong in Europe.

The experiences with the euro as an international reserve currency have also been sobering. The share of the euro in official reserves is only marginally higher than the 22 % recorded for the German mark just prior to the formation of monetary union, and that of the US dollar is nearly unchanged. This fact and the still fragmented nature of representation of the Euro area do not provide the

underpinnings for advancing the long-standing European view that the international monetary system should be based on more than one national currency. There remains intellectual support for such reforms in Europe, see notably the cogent arguments advanced by Padoa-Schioppa (2010) in favour of an updated version of the Keynes plan at Bretton Woods for a non-national reserve asset and a symmetrical adjustment process. There is some recognition by US international economists of the weakness of the dollar standard, as in McKinnon (2013). But there is no prospect of these themes moving on to the official agenda over the next decade or so in the way they did towards the end of the Bretton Woods era, even if European views may find sympathy among potential new issuers of international reserve currencies such as China. Europe will be under little pressure not to focus on the internal agenda.

1.5. CONCLUSIONS

Early postwar global monetary arrangements were in broad conformity with the preferences in Europe for a high degree of exchange-rate stability and rapid growth in international liquidity. The European governments and central banks were to a large degree engaged in efforts to improve the global system, in particular by putting reserve creation on a more diversified basis than through the US balance of payments. While the central role of the United States had been readily accepted in the early post-war period as constructive and necessary, Europeans began to question both the stability and the equity of an international monetary system based only on the dollar. But from the late 1960s they turned their attention increasingly to internal matters with the first plan for EMU and, when that foundered, to differentiated responses to global disorder. The plans for EMS are particularly interesting as the main example of inspiration from the global system; this initiative extended exchange-rate stability in Europe, but also moved towards a European Monetary Fund (EMF) – a regional IMF.

As convergence among the European economies improved in the 1980s, while global currency markets saw wider swings than ever before, the ambition to launch a single currency as a complement to the Single Market grew into the Maastricht Treaty. Given the increasing instability of the EMS in 1992-93, opinion firmed that the only safe way to exchange-rate stability was to forge a common currency. To the surprise of most observers EMU actually started in 1999 with no less than 11 participants. Though successful in meeting its narrower monetary objectives, weaknesses of surveillance of non-monetary policies – a lack of political backing and inadequate analytical foundations – made EMU highly vulnerable when the international financial crisis struck from 2007 onwards.

Intensive repair work since early 2010 has greatly improved the capacity of EMU surveillance to prevent future crises, while crisis management has been bolstered by the set up of a safety net, the ESM, filling the gap that was left by the failure to build an EMF earlier; conditional lending has become possible at the regional level, and has been coordinated with the IMF global experience in managing programmes with borrowing countries. There are also efforts under way to set up facilities for countries not (yet) in programmes, but facing punishing interest rates in financial markets. But the experience in Europe with conditional lending, as with surveillance, has shown similarities with the global experience that are a source of great concern: the national reactions to programmes have become even more adversarial in Europe than for the IMF in Latin America and Asia during earlier crises. Can this conflict be dampened sufficiently over the next few years until reinforced normal surveillance becomes applicable, or will additional measures well beyond the current Treaty framework have to be adopted?

During its turmoil in recent years Europe has become less active as a player in the global system – and has continued not to find a way of unifying its representation in global institutions such as the IMF and the Financial Stability Board. This is one more illustration that the primary inspiration for Europe's monetary arrangements has been internal rather than global. Progress in solving Europe's regional problems remains a prerequisite for a more active and constructive global role.

The European countries in the 1960s wanted to reform the international monetary system by making it less reliant on a single national currency. They wanted the system to make it possible to combine very stable exchange rates in their own region with low inflation, to take on more responsibility for surveillance of each other and to be assured of steady non-inflationary growth of international liquidity. In a sense their wishes have been fulfilled to excess: there is a common currency for currently 17 EU countries, they have been obliged to set up an unprecedented system of mutual surveillance, and international liquidity is more than ample. But the apparent fulfillment of their main wishes has posed massive new challenges which have to be met by their own regional efforts.

References

- ANGELONI, I. *et al.*, 2011, *Global Currencies for Tomorrow: A European Perspective*, *Bruegel Blueprint 13*, Brussels.
- COMMITTEE OF TWENTY, 1974, *International Monetary Reform, An Outline*, IMF, Washington DC.
- DESPRES, E., KINDLEBERGER, Ch. and SALANT, W., 1966, "The Dollar and World Liquidity: A Minority View", *The Economist*, London 5 February, pp. 526-9.

- DORNBUSCH, R., 1976, "Expectations and Exchange Rate Dynamics", *Journal of Political Economy* 84, pp. 1161-74.
- FOLKERTS-LANDAU, D., and GARBER, P., 1992, "The ECB: A Bank or a Monetary Policy Rule?" in CANZONERI M.B., V. GRILLI, AND P.R. MASSON (eds.), *Establishing a Central bank: Issues in Europe and Lessons from the US*. Cambridge: Cambridge University Press, pp. 86-110.
- GROS, D. and THYGESEN, N., 1998, *European Monetary Integration*, Pearson Education, Harlow.
- HENNING, C.R., 2010, "Coordinating Regional and Multilateral Financial Institutions", *Working Paper Series WP 11-9*, Peterson Institute for International Economics, Washington DC.
- JAMES, H., 2012, *Making the European Monetary Union*, Harvard University Press, Cambridge and London.
- DE LAROSIÈRE, J., 1989, "First Stages towards the Creation of a European Reserve Fund", *Report on Economic and Monetary Union in the European Community* ("the Delors Report"), Collection of Papers, Office for Official Publications of the European Communities, Luxembourg, pp. 177-84.
- MCKINNON, R.I., 2013, *The Unloved Dollar Standard*, Oxford University Press, Oxford and New York.
- OECD, 1966, "The Balance of Payments Adjustment Process", *A Report by Working Party No. 3*, OECD, Paris.
- OECD, 1967, *Capital Markets Study*, General Report, OECD, Paris.
- PADOA-SCHIOPPA, T., 1994, *The Road to Monetary Unit in Europe*, Clarendon Press, Oxford.
- PADOA-SCHIOPPA, T., 2010, "The Ghost of Bancor: The Economic Crisis and Global Monetary Disorder" *Unpublished*, Lecture at Université Louvain-la-Neuve, 25 February.
- PETTIS, M., 2013, *The Great Rebalancing*, Princeton University Press, Princeton.
- PISANI-FERRY, J., SAPIR, A. and WOLFF, G., 2013, "EU-IMF Assistance to Euro-area Countries: An Early Assessment", *Bruegel Blueprint 19*, Brussels.
- POLAK, J., 1980, "The European Monetary Fund: External Relations", *Banca Nazionale del Lavoro Quarterly Review* 134, Rome, pp. 359-81 (with comments by Pierre Languetin and Robert Mundell).
- POLAK, J., 1997, "The IMF and its EMU Members" in MASSON, P.R., T.H. KRUEGER and B.G. TURTELBOOM (Eds.), *EMU and the International Monetary System IMF*, Washington DC, pp. 491-511.
- RUEFF, J., 1971, *Le péché monétaire de l'Occident*, Plon, Paris.
- SERVAN-SCHREIBER, J.-J., 1967, *Le Défi Américain*, Denoël, Paris.

- STEIL, B., 2013, *The Battle of Bretton Woods*, Princeton University Press, Princeton.
- THYGESEN, N., 1997, "Relations among the IMF, the ECB and Fund/EMU Members" in MASSON, P.R.L., T.H. KRUEGER and B.G. TURTELBOOM (Eds.), *EMU and the International Monetary System*, IMF. Washington DC, pp. 512-30.
- THYGESEN, N., 2000, "Evolving Ambitions in Europe's Monetary Unification" in ARTIS, M., A. WEBER and E. HENNESSY (Eds.), *The Euro: A Challenge and Opportunity for Financial Markets*, Routledge, London for SUERF, pp. 29-56.
- TRIFFIN, R., 1960, *Gold and the Dollar Crisis: The Future of Convertibility*, Yale University Press, New Haven.
- WERNER, P. *et al.*, 1970, *Report to the Council and the Commission on the Realization by Stages of Economic and Monetary Union in the Community* ("The Werner Report"), supplement to Bulletin II – 1970 of the European Communities, Brussels.