Otmar Issing: The euro – a currency without a state

Speech by Mr Otmar Issing, Member of the Executive Board of the European Central Bank, at an event organised by the Bank of Finland, Helsinki, 24 March 2006.

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After more than seven years, the euro is firmly established as the currency of over 300 million people. Its internal stability is evidenced by the fact that inflation has been steadily low from the very start, despite a sequence of negative price shocks (in particular a continuous surge in oil prices). As an international currency, the euro is second only to the US dollar.

At the same time, the euro represents a unique experience in history. On the one hand, it is based on a clear supranational monetary order, whereby the European Central Bank has full sovereignty in conducting a single monetary policy for the euro area. On the other hand, political union is still limited and sovereignty remains predominantly national in many policy areas. This asymmetry has raised questions about the sustainability of such an institutional arrangement since well before European Monetary Union started on 1 January 1999.

The "no" from the French and Dutch people on the Treaty establishing a Constitution for Europe triggered new interest in the prospects for Monetary Union and the future course of political union. This happened despite the fact that the text of the European Constitution does not imply any changes to the role of the ECB, nor does it significantly affect the allocation of responsibilities in most other policy areas.

The continuous challenge for Europe has been to find the right balance between *political*, *economic* and *monetary* integration. This has been called the "triangle" between the *state (or States!)*, the market and the *currency.*

Economic integration took the lead

In September 1946, Winston Churchill, in his memorable Zurich speech, called for the re-creation of the "European family". This included the setting-up of a structure permitting Europe to live in peace, safety and freedom.

Although political integration proved to be over-ambitious, some visionary political leaders decided, nevertheless, to pursue the path of economic integration. This led to the founding of the European Coal and Steel Community in 1952 and the establishment of the European *Economic* Community with the Treaty of Rome in 1957.

The first step was a customs union among the six founding countries. At the time, probably nobody could have guessed that economic integration would advance through various phases and over such a long period. But the Single European Act followed in 1986 and the "Single Market Programme" in 1992.

In short, the Single Market is now becoming a reality. Work on the remaining imperfections of the Single Market is also advancing. We must not forget that this process has required many decades and continuous political support.

Why, in the last 50 years, did economic integration face fewer obstacles and actually keep in motion the process of European integration? The main reason is that, from the outset, economic integration removed barriers and thereby secured material and economic benefits. In fact, it has brought widespread benefits by promoting reciprocal trade. Trade in fact has grown by several multiples. Economic integration has also helped to establish a more competitive environment.

We must also not forget that economic integration has rendered all EU countries more interdependent than in the past. Under these circumstances, spillovers from national policies could be significant. Each country has a stake in the well-being and, let me say, "good behaviour" of its partners.

Given such circumstances, the conviction underlying the Maastricht Treaty was that nominal exchange rates should be irrevocably fixed to achieve and maintain a truly unified single European market. Without a single currency, it was felt that the achievements and deepening of the Single Market could be endangered.

It was a political decision to launch European Economic and Monetary Union among a group of countries, which did not form a fully-fledged political union. Taking stock, we may ask: *was this move appropriate and well founded from an economic standpoint?*

For a moment, I want to go back to research on the economic arguments for – and against creating a monetary union. In the 1960s, a group of researchers – following the pioneering contributions of Mundell, Kenen and McKinnon started posing a crucial question: from a purely economic point of view, what is the optimal area for a single currency? The Optimum Currency Area (OCA) theory that ensued is well-known to you all and I don't have to say much about it.

It is not easy to summarise the many views on the euro area as an OCA, or to sum up the vast volume of empirical studies of all OCA criteria for European countries. The euro area may not yet be an optimum currency area in all respects to the extent that, for example, the United States is. On the other hand, it scores quite highly under several OCA criteria – such as economic openness, diversification in production and consumption, degree of price stability, and several elements of financial integration. In the areas where it scores less well – such as price and wage flexibility, and some facets of financial integration – remedies are being sought.

How could EMU affect the optimality of the euro currency area over time? Andrew Rose and Jeffrey Frankel offered an important new forward-looking perspective strengthening the OCA argument in the euro area. By studying the effects of several currency unions that occurred in the past, they showed that monetary integration leads to a significant deepening of reciprocal trade. The implication for EMU is that the euro area may turn into an optimum currency area after the launch of monetary integration, even if it was not an OCA before.

In other words, to quote Rose and Frankel: "*countries which join EMU, no matter what their motivation may be, may satisfy OCA properties ex-post even if they do not ex-ante!"* This has been termed the "endogeneity of optimum currency area" effect.

Several authors have brought forward concepts similar to the above hypothesis of the "endogeneity of OCA", but in areas other than trade. Artis and Zhang have discussed the endogeneity of symmetry of shocks. Blanchard and Wolfers, and Saint Paul and Bentolila, have discussed the endogeneity of labour market institutions. Kalemli-Ozcan, Sørensen and Yosha discuss the effects of sharing a single currency on financial markets and insurance schemes. Therefore, there may be diverse sources of "endogeneities of OCA."

Such endogeneities can be seen as a set of processes triggered by the start of a monetary union. Hence, monetary union may help to set in motion forces bringing countries closer together, forces that were not present (or strong enough) before.

To be fair, various other issues may arise in the years ahead that could render the verdict more complex. Some authors, such as Krugman in his "Lessons from Massachusetts", postulate a "concentration" hypothesis: the euro, together with stronger trade and financial ties, will result in greater specialisation of euro area countries. This may gradually intensify inter-industry trade, and cause each country to become more sensitive to industry-specific shocks. In turn, more idiosyncratic business cycles would result.

Hence, if the forces of concentration prevail, euro area countries may witness more pronounced growth, employment and inflation differentials than in the past. This could be a concern in view of the generally limited price and wage flexibility, low labour mobility and the lack of a risk-sharing mechanism due to the still incipient financial integration. Time will judge the severity of this potential effect.

Montary Union

With the completion of the Single Market and European Monetary Union the *economic* and the monetary side of the "triangle" have been completed. This raises the fundamental question: Can monetary union work and survive without the third side of the triangle, which is without a fully-fledged political union?

The answer is clear: yes, it can. It is possible that, over the very long term, strong elements of a political union may (need to) emerge, but for the time being Economic and Monetary Union (EMU) can proceed perfectly well without a political union in the form that we understand today. Here are the main arguments:

First, Monetary Union in itself has a clear political dimension. It entails the transfer of national monetary policy decision-making powers to a supranational entity, the European Central Bank. Relinquishing national sovereignty in such an important field is a substantive contribution to political integration. A central bank is, after all, an element of statehood. The Maastricht Treaty has made the ECB independent of any political influence so that it is able to fulfil its clear mandate of preserving price stability. Monetary policy-making is hence not only centralised but also depoliticised. This step was only possible because euro area members had achieved a high degree of convergence in monetary policy attitudes and preferences in the run-up to Monetary Union.

Moreover, the way participating countries see themselves and their role as nation states has changed profoundly. In this respect, the launch of the euro marks the most recent and far-reaching step. National sovereignty has not only been transferred in the area of monetary and exchange rate policies but also in other key policy areas, such as competition and trade. Finally, a single market has been established. As a result, the euro area countries already share important elements of state formation which are also key to the functioning of Monetary Union.

Flexibility

Second, from a purely economic perspective, what else is needed to make the single monetary policy work? Most importantly, flexible markets are needed to enhance the ability of individual countries to respond to specific circumstances and economic shocks. Wages and prices in particular may need to adapt more quickly and strongly. The mobility of capital will become an increasingly important adjustment mechanism. In order for markets to be flexible and send the proper signals, policy-makers must ensure an institutional framework that sets the right incentives.

Substantial progress has been made but a lot still needs to be done. In particular, labour market reforms are still lagging in many countries. As a result, the ability of economies to adapt quickly and generate employment is still limited. The Lisbon agenda, the “pro-employment and growth blueprint” for Europe, sets the right priorities. However, it needs to be implemented more forcefully. This would go a long way towards creating the dynamic and flexible environment that Europe needs, not only for the proper functioning of Monetary Union but also for the attainment of the growth and employment objectives of the Lisbon agenda.

The Stability and Growth Pact

Sound fiscal policies are another prerequisite for Monetary Union to work. As sovereignty over fiscal policies remains at the national level, the EU member countries decided to introduce fiscal rules to help to prevent imprudent fiscal policies and their adverse effects on inflation and expectations. These rules are enshrined in the Maastricht Treaty and operationalised in the Stability and Growth Pact. In setting deficit and debt targets (most notably the 3% deficit limit) and establishing procedures for budgetary surveillance and control, they are not fundamentally different from appropriate rules at the national level. Compliance with the rules in Member States will keep deficits low enough to ensure government solvency while providing governments with the necessary room to smoothen economic fluctuations through the operation of automatic fiscal stabilisers. This will also generate an appropriate fiscal environment for monetary policy-making at the euro area level.

The Growth and Stability Pact is a fundamental pillar of European Monetary Union. Past problems with its implementation cannot be denied, but the recent reform of the Pact aims to remedy this. In order to foster fiscal discipline, the governments of the Member States, together with the Commission, now need to implement the revised rules in a rigorous and consistent manner. The current excessive deficit procedures, and above all the case of Germany as not only the largest economy but also the “source” of the Pact are the real test. In this way, confidence in the credibility of the rules and in prudent fiscal policies can be reinforced. This will not be an easy task, admittedly, and serious concerns have been expressed. Sound fiscal policies will remain a priority for many years to come.

The final stage

What does all this imply for the future of Europe? Given the achievements of economic and political integration in Europe over the past 50 years, we should remain confident that we will also find answers to our current problems. Many problems have emerged and been mastered, although solutions typically take time and rarely come overnight. Does that mean that we can trust only in our past record of achievement? Obviously not. Current and future challenges will need to be addressed by the actions of current and future political leaders. We will no doubt see new challenges and ongoing discussion and debate about the most appropriate policies and approaches to consolidate and extend the success of EMU. However, to expect that such challenges and debates will threaten EMU is to underestimate the strength of European institutions, our willingness to make this project work and our ability to knock heads together when tough solutions are required.

On the final stage of the integration process, the steady state of political union in Europe, one can only speculate. None of the examples of history, be they a federation of states or a union of nations, can serve as a blueprint for shaping political union. The EU has always been, and will remain, a unique undertaking for which there are no models that can easily be adopted. It is important to allow an evolutionary process, which is open to further steps of integration, yet safeguards what is already in place and working well, and which assigns competencies to nation states or even regions as appropriate. In fact, we have been in the midst of such a process for quite some time, and Monetary Union is and will remain one of its major success stories.