Fourth BIS Annual Conference

Basel, Switzerland, 28-29 June 2005

Central banks, governments and the European monetary unification process

by

Alexandre Lamfalussy

Preliminary remarks

It is not without hesitation that I have accepted the challenge of sharing some thoughts with you on the evolving relationship between central banks and governments in the European monetary unification process. For one thing, I am not a historian — and the formal, narrowly defined beginning of this process goes back to the Hague Summit in 1969 when the heads of state or of government "agreed that on the basis of the memorandum presented by the Commission on 12 February 1969 and in close collaboration with the Commission a plan by stages should be drawn up by the Council during 1970 with a view to the creation of an Economic and Monetary Union". Anything that was conceived more than 30 years ago deserves careful scholarly treatment calling on all the virtues of a reliable historian — even if the scholar is not a professional historian. This is the more so since European monetary cooperation in a broader sense began with the establishment of the European Payments Union in 1950, well before the emergence of the Common Market and of the European Community. It is arguable that neither the decision taken in The Hague, nor the subsequent Werner Report, nor indeed the long history of the monetary unification process which has led us to where we are today, can be fully comprehended without referring back to the early 1950s. Much of this scholarly work has already been accomplished, and accomplished well. Let me just refer to the collection of papers edited by Alfred Steinherr (*Thirty Years of European Monetary Integration: From the Werner Plan to EMU*, London: Longman, 1994), to Daniel Gros and Niels Thygesen (*European Monetary Integration*, New York: St Martin's, 1992) and to André Szàsz (*The Road to European Monetary Union*, London, Macmillan, 1999). I have neither the intention nor the ability to compete with them. But I could try to rely on my personal experience and attempt to draw some lessons from my participation in the

monetary unification process — if only to stimulate an exchange of views on our current problems in EMU.

But what are my credentials for doing this? Here I have encountered some other reasons for being modest: my direct participation in the European monetary unification process was neither continuous nor of the same "quality" all the time. Sure, I was a member of the Delors Committee, where I could and did play a role, but this took up less than one year; sure, first as Economic Adviser of the BIS and later as General Manager of the Bank, I was in a good position to observe what was going on within the Committee of the Governors of the Central Banks of the Member States of the EEC which was meeting in Basel, and whose secretariat was provided by the BIS — but this was observation rather than action; sure, the fact that the BIS is a bank allowed me to gain a privileged insight into the crisis mechanics of the critical years of 1992-93, but I did not participate in crisis management meetings. More important, I did not take part in the negotiations leading to the Maastricht Treaty, although of course the Treaty took over a very substantial part of the recommendations of the Delors Report. As opposed to all these "buts", I do not have to be unduly modest about my role as the first President of the European Monetary Institute. Whatever was achieved by the EMI was of course the result of the teamwork of the Council and of the staff of the member central banks and of the Institute; but as President I had ample opportunities to wreck, or at least substantially slow down, the realisation of the institution-building project. Which I chose not to do. Moreover, during these three and a half years I was directly exposed to a rich variety of political influences and gained a first-hand experience of dealing with high-level civil servants as well as with their political masters — which entitles me to hold some views on the relationship between governments and central banks. This is the reason why most of the remarks which follow are strongly influenced by the experience gained during my EMI years.

I propose to group my remarks on the relationship between central banks and governments under two headings: institution-building and policy mix.

Institution-building

A major part of the European monetary unification process has had to do with institution-building. This observation is valid for the whole process, but it applies especially to periods of accelerating change; and there is little doubt that the quantum jump implied by the introduction of the single currency and the establishment of the European Central Bank was such a period.

One would think a priori (and so I had thought myself) that a period of this kind would provide a propitious environment for bitter conflicts. For conflicts between the central banks operating

within the EMI structure (which had been put in charge of setting up the ECB, defining the operational infrastructure of the single monetary policy and preparing the future monetary policy strategy), on the one hand, and the member governments of the EU, on the other. But also for conflicts within the central banking community as well as among governments, and for conflicts with the Commission, guardian of the treaties. So many vested interests were at stake. Countries had to give up their monetary sovereignty (even though most of them had already lost it in practice). The national central banks were invited to cooperate in a sort of merger process as a result of which they swapped their ability to carry out "their" monetary policy for their Governors having one vote in the future ECB's decision-making body. They might have considered this a net loss, even though most of them had already tied their currency to the DM, without having any say in the Bundesbank's decisions. Even the Commission was about to lose a bit of its power: there would no longer be a Commissioner in charge of monetary affairs. Last but not least, you could not expect generalised popular support for losing the national currency (even though the citizens of a great number of European countries could hardly derive great pride from the past performance of their national currencies).

These forebodings proved unfounded. The road leading to 1 January 1999 — the beginning of Stage III — was on occasion somewhat bumpy, but there were no major conflicts of the kind that could have fatally jeopardised the implementation of the single currency: neither between the EMI Council and the governments, nor among governments, nor inside the EMI, nor indeed between any of these and the Commission. I myself was not excessively optimistic about the outcome when I was appointed President of the EMI, but I became gradually more and more confident, and by the winter of 1995-96 I had acquired the conviction that we were on the right track. Market sentiment was also beginning to change at that time: witness the downward convergence of long-term interest rates. This was not the case for the majority of our American friends, who argued, first, that it had been foolish to conceive the single currency project; at a second stage, when they could no longer ignore the determination of our politicians to go ahead, they predicted that implementation would fail; and when implementation was about to be achieved, they were beginning to foretell that the system would shortly be blown apart by market forces.

There can be little doubt that the institution-building phase of the single currency project has been successful — this much, I would guess, has by now been accepted even by those who dislike(d) the project or those who (not without reason) harbour some misgivings about current developments. And by institution-building phase I do not refer only to the period ending on 1 January 1999, but also to the one which ended, during the early weeks of 2002, with the exchange of banknotes. The absence of disruptive conflicts, however important it

was, does not fully explain this success story. First, because the absence of these conflicts itself requires an explanation. Second, because the enterprise was a unique event, for which there had been no genuine historical precedent: it amounted to the merging of the monetary policy functions of 11 central banks, all of which had a long history behind them and were operating in highly complex monetary and financial systems. A lot of things could have gone wrong in this process, even without the disruptive influence of vested interests. How is it that they did not go wrong?

My explanation is that we have been well served by the exceptional convergence of several facts and influences. In what follows, I will try to list them, but not in their order of importance, because I have no clue what this order is.

First, the initiators of the project were the governments themselves — and at the highest level: the heads of state or of government (as it should be). This was the case when, in The Hague, they started the process; this was again the case when, in Hanover in June 1988, they recalled that "in adopting the Single Act, the Member States of the Community confirmed the objective of progressive realisation of economic and monetary union" and therefore decided to set up the Delors Committee, which was given the "task of studying and proposing concrete stages leading towards this union". Finally, at the Maastricht Summit (December 1991) they adopted the Treaty on European Union, which, among many other provisions, decided the creation of the European System of Central Banks, of its central institution, the European Central Bank, and of a new currency, the ECU, to replace the national currencies of the member countries. The ratification process took almost two years but, after granting an opt-out clause to the United Kingdom and an opt-in clause to Denmark, the Treaty entered into force in November 1993. So the initiative was clearly a political one. Not simply because the initiators were heads of government, but also because, at decisive moments, the political motivation played a major role. This had already been the case in the earlier years, but the political motivation became quite decisive at the time of the negotiations preceding the Maastricht Treaty, as we all know. With such a political commitment, our highest political authorities acquired a vested interest in a successful implementation process.

Second, it is worth noting that the political leaders entrusted the central bankers right from the beginning with a major role in the preparation of the Maastricht Treaty. First, when they decided to set up the Delors Committee, the membership of which was overwhelmingly of central banking extraction. Jacques Delors was not only a good chairman, but he also possessed the political wisdom of accepting that the majority of the meetings, and practically all the preparatory work for the meetings, would take place at the BIS, with both rapporteurs being central bankers. Second, the Dublin Summit (June 1990) mandated the Committee of

EC Central Bank Governors to draft a statute for the ESCB to be submitted to the Intergovernmental Conference on EMU.

Third, the institution-building process was governed by the Maastricht Treaty, which set out a roadmap in great detail, described reasonably clearly what should be the division of labour between the Council, the Commission and the central bankers of the EMI and of the ECB, and, most important, set 1 January 1999 as the latest date on which the single monetary policy should start operating. Time constraint, as I and Wim Duisenberg had the privilege to learn, turned out to be a barbarian but most effective instrument for finding compromises in matters which were not regulated by the Treaty (I propose to give a major example). Finally, while the Treaty left open a number of issues, it was (almost) clear on two subjects which could have created serious conflicts between governments and the central bankers. The independence of the ECB — and before that of the EMI — was well defined; and so were the convergence criteria for accession to EMU. Among these criteria the fiscal ones, and naturally the inflation criterion, were of crucial importance for sparing us major conflicts between governments and the central banks.

Fourth, let me make a few remarks on how it was possible to avoid major disruptive conflicts <u>among</u> the central banks. There was of course the time constraint just mentioned. At the EMI we devised in 1994 a somewhat pompously called "master plan", which set out for each of the monthly Council meetings the topics on which decisions <u>had</u> to be taken in order to ensure that the single monetary policy became operationally feasible on 1 January 1999. Given the long, but variable, lead times necessary for implementing measures, and the interactions between them, this was a highly complex procedure, which, moreover, required appropriate deadlines for the various subcommittees which prepared the Council decisions. We included, of course, precautionary safety margins and made appropriate adjustments, but this technique served as a useful monthly reminder of the Treaty obligations imposed on the EMI. Second, the discussions, and the search for constructive compromises, received increasingly powerful support from the EMI staff, which grew from about two dozen members taken over from the secretariat of the Committee of EC Governors to more than 400 by the time I relinquished my position as President in mid-1997. Most of the staff, and all those in key positions, came from the member central banks, but within months they had acquired the "multilateral" frame of mind so indispensable for making realistic proposals to reconcile conflicting views held by member central banks — and do not forget: most of the Council decisions had to be unanimous. Achieving progress would have been impossible if, instead of a solid institutional structure, the work had had to be carried out within a cooperative framework. Finally, I have to pay tribute to all Council members. They were given an

institution-building mandate, and they fulfilled their obligation, even when some of them had misgivings about the feasibility, or even the desirability, of the project.

At the same time, the absence of major conflicts and the relatively smooth development of the institution-building process owe quite a lot both to the facts and figures relating to the economic situation prevailing at that time in Europe, and to the changing perception of how macroeconomic policy should operate. As regards the first of these factors, these facts and figures concern mainly the deterioration of the fiscal indicators. As noted in the first annual report of the EMI (April 1995): "The early 1990s marked a sharp reversal of trends in general government deficits in the Union. Following a prolonged period of decreasing deficits, fiscal balances deteriorated significantly from 1989 onwards. After standing at 5% of GDP in 1992, deficits in the Union reached 6% of GDP in 1993, the highest level on record since the foundation of the European Community." The deficits began to decline in 1994, but in 1996 still stood at 4.4% of GDP. As a result, general government gross debt, which had stood at 56% of GDP in 1991, reached 73.5% in 1996. This was such an obviously unsustainable development that in all likelihood it would have triggered policy reactions, though perhaps not with sufficient vigour. The constraint of the convergence criteria emerged at the right time.

As for macroeconomic policy, Keynesian demand management went out of fashion after the stagflation experience of the 1970s — and not only in Europe — many years before the revival of the EMU initiative. This resulted in a dramatic decline in the rate of inflation in Europe, which started after the observation of very high inflation rates, which peaked in 1974 at slightly above 14%. As observed in the second annual report of the EMI (April 1996): "Average EU inflation has declined successively from 10.5% in 1980-84, to 4.4% in 1985-89, to 4.1% in 1990-95, and to 3% in the past two years." Even more significant, the (unweighted) standard deviation of national CPI inflation, which had been 6.5% on average during 1972-82, fell to 2% by 1995. This goes a long way towards explaining the relatively serene atmosphere prevailing in the ECOFIN Council meetings which I attended. To which one has to add the fact that the regained respect for both inflation-fighting, and the inflation-fighting capability of monetary policy, has been accompanied by a gradual, but general, move towards granting policymaking independence to central banks — and this, too, began well before Maastricht. It is of course true that the Federal Republic played a major role in shaping the definition of the ECB's independence (which in fact was defined more strictly than that of the Bundesbank, although not more strictly than what had become over time the German practice), but these requests fell on receptive ears in the case of the majority of member countries. The time was ripe for moving collectively in this direction.

Let me conclude these remarks by recalling the story of the scenario of the changeover to the single currency. This is a good illustration of how it was possible to achieve decisive

progress in an area which the Treaty left undecided, without unnecessarily spectacular conflicts between the Council, the Commission and the EMI, which all had their part to play. Indeed, while it was quite clear that the irrevocable pegging of exchange rates vis-à-vis each other and vis-à-vis the ECU and the implementation of a single monetary policy had to start at the latest on 1 January 1999, as regards the introduction of the single currency the Treaty simply said that the "Council shall, acting according to the same procedure [which meant "on a proposal from the Commission and after consulting the ECB"], also take the other measures necessary for the rapid introduction of the ECU as the single currency of those Member States" (the "those" refers to the member states which passed the hurdle of the convergence criteria).

By early 1995 it became gradually clear that unless agreement was reached on a precise changeover scenario, the credibility of the whole undertaking would suffer. How could market participants prepare themselves for the changeover in a timely manner, unless they knew what was going to happen and when? Or perhaps nothing would happen anyhow? (A question I heard so often from quite a few market participants, and not only Americans.)

The Commission took up the challenge first, by publishing on 31 May 1995 a Green Paper on "The practical arrangements for the introduction of the single currency". The EMI, which was supposed to be consulted instead of the not yet existent ECB, was somewhat behind. During the spring it undertook an extensive EU-wide survey of the banking community, covering nearly 400 credit institutions, on the detailed technical implications of the changeover. This was indispensable for drawing operational conclusions, of which we prepared a preliminary version for the informal autumn meeting of ECOFIN, scheduled to take place in Valencia, under Spanish presidency. (The final, formal EMI report, entitled "The changeover to the single currency", was published on 14 November.)

The Valencia meeting was a crucial one. A number of informal decisions were reached, possible compromises were outlined — to be submitted for formal decisions to the November ECOFIN meeting and to the December Madrid Summit. The main objection to the Commission's Green Paper, coming principally from Germany but supported also by other countries, was that it wanted to achieve at a very early stage a volume of transactions denominated in the single currency which would reach a "critical mass" (thereby ensuring "no return"), and, if necessary, through regulation. At a time when public opinion was barely familiar with the whole process, it was deemed dangerously counterproductive to signal four to five years ahead the list of transactions which would have to be denominated in the single currency, announcing only too clearly the ultimate disappearance of the national currency units. The alternative therefore seemed to be an early announcement of a number of mandatory changeovers, which would have enhanced credibility at the risk of creating a

political backlash, versus leaving to the very end of a three-year period practically all the changeovers, which would have appeased those who feared this backlash but at the same time could have undermined the credibility of the whole process. In other words, the choice appeared to be between an early "big bang" and one that would have occurred more or less simultaneously with the exchange of banknotes. I tried to extricate ourselves from this unappealing alternative.

In discussions within the EMI I began to argue that all monetary policy operations by the future ESCB should be carried out from the very first day in ECU — which meant that all accounts held by counterparties with the ESCB would have to be denominated in ECU, yet the banks and all private market participants would retain their right to undertake their changeover at the time of their liking, but naturally at the latest at the beginning of the banknote exchange. I thought (and after some discussion it turned out that I was right) that even the most hesitant members of my Council would realise that not doing this would have made monetary policy operations remarkably cumbersome (although not impossible technically) and would have exposed the central bankers to the criticism that they themselves had some doubt about the final outcome of the process. I also thought that any such decision implied that the entire interbank market would start operating instantaneously in ECU — not by decree, but for obvious practical reasons.

The second initial change which I considered essential was that, right at the beginning, governments should denominate in ECU new tradable debt issues by the public sector, for the same credibility reason which applied to monetary policy decisions — knowing of course full well that any such decision would have to be accompanied by the conversion of the outstanding stock of public debt into ECU. Once we had agreed among ourselves on the decision to be taken by the Governing Council of the future ECB, all of us saw that this was a practical necessity for conducting a smooth monetary policy (it would not have been impossible, just ridiculously unpractical, to operate with repos otherwise). At the same time, it was obvious that we should keep a low profile on an issue which had to be decided by the governments. But this did not prevent me from outlining the argument to a number of ministers.

Interestingly, the final decision in favour of denominating all new tradable government debt issues in the single currency was triggered, as so often happens in intergovernmental negotiations, by a deal which would seem strange to any distant, outside observer. The Germans did not like the idea (even though they acknowledged the logic of the argument), but accepted it in the end in exchange for the French agreeing to swap the name ECU for euro.

The changeover scenario contained a large number of less controversial but quite important decisions: the formal acceptance of dates, the carefully worded legal definition of the euro (as a result of which the national currency units would on 1 January 1999 become the non-decimal components of the euro), the commitment by the national central banks to provide conversion facilities during the three-year period to those financial institutions which had not been able to equip themselves with such facilities, a timetable for the changeover of the public administrations, and so on. Combined with the two key decisions, they formed a coherent whole, which radically enhanced the credibility of implementing the single currency project, without, however, imposing on private market participants by decree an early changeover. In the spring of 1996, I concluded one of my presentations to a group of European banking CEOs thus: "You may still have some doubts, but you would be well advised to insure yourself against the risk that the single monetary policy will effectively start operating on 1 January 1999." A year before, they would have taken this remark as a joke; this time they did not smile, but looked genuinely interested.

The package which was finally adopted by the Madrid Summit, on the recommendation of the (formal) 27 November ECOFIN meeting, was fully compatible with the detailed report issued by the EMI on 14 November. Little mention was made of the earlier Green Paper drafted by the Commission. This, in a sense, was unfair. It was the Commission which had got the ball rolling, and for this initiative it deserved praise. Moreover, the "critical mass" concept was far from being a silly one. But the EMI played a decisive role by formally proposing one key measure, suggesting a second and putting in place a number of practical ones, which crucially contributed to the fact that, for the financial markets, the euro became an early reality — without having to resort to administrative regulations.

The policy mix

The absence of major, disruptive conflicts, during my EMI years, between the central banks and the governments characterised not only institution-building, but also macropolicy decisions. This applied certainly to the relationship between the EMI Council and ECOFIN, but also to the relationship between most of the NCBs and their respective governments, although in the latter case there were instances or periods of conflict (one significant example was provided by France). For the central banks there were two main reasons for not being unduly worried by actual, or prospective, policy misbehaviour by governments. One was the declining trend of inflation. The other was the existence of the fiscal convergence criteria, which governments did try to respect. Yet even in a period which by today's standards could be regarded as having been relatively peaceful, we were beginning to

perceive causes for concern. Both in the 1996 Convergence Report published by the EMI (in November 1996) and in the Institute's 1996 Annual Report (published in April 1997) you may find numerous examples of concern expressed regarding several developments: the slowness of the pace of reduction of fiscal deficits; the recourse to one-off measures; the temptation to raise taxes rather than reducing expenditure; and, most important, the little attention paid to the sustainability of the deficit reduction measures. (The Convergence Report contains a detailed analysis of a development which received far less attention at that time than it does today: the growing fiscal burden of old-age pensions.)

As regards governments, their traditional inclination to blame central banks for poor economic performance was also tempered by two factors: on the one hand, by the declining trend of long-term interest rates (which had started at the beginning of the 1990s and was interrupted only in I994 for a short period); and, on the other, by their formal commitment, as a result of the ratification of the Maastricht Treaty, to respect central bank independence. It would have been strange if they had chosen to so quickly ignore this commitment — especially since this was in fact the "sixth" convergence criterion, compliance with which conditioned access to EMU, and could therefore not be taken lightly.

More than six years have now elapsed since the beginning of the end of the institution-building process on 1 January 1999 and more than three years since its unquestionable end. These are short periods when compared to the more than 35 years which have elapsed since the Hague Summit, and even shorter if you trace back the origins of European monetary cooperation to the establishment of the EPU in 1950. Yet we have been watching significant changes in the relationship between central banks and governments; and these changes have not been for the better. Hardly a week passes without one or the other head of state or of government publicly questioning the appropriateness of the monetary policy stance decided by the Governing Council of the ECB, and suggesting that the ECB should take as its model the Federal Reserve of the United States — thereby flatly disregarding Article 107 of the Treaty, which unequivocally states that: "The Community institutions and bodies and the governments of the Member States undertake not to seek to influence the members of the decision-making bodies of the ECB or of the national central banks in the performance of their tasks." Similarly, the cavalier way in which an increasing number of member states have dealt with the constraints of the Stability and Growth Pact suggests that they have conveniently forgotten that this Pact was explicitly designed (not in prehistoric times, but in 1997) to preserve the constraining elements of the fiscal convergence criteria after accession to EMU, precisely because uncontrolled fiscal laxity could severely undermine the ECB's ability to fulfil its prime responsibility of maintaining price stability. No wonder that this triggered reactions not only from the President of the ECB, but also from

practically all NCBs — reactions that were not to the liking of the governments concerned. No wonder either that when the head of government of one of the large countries attributes all the hardships of his country simultaneously to the introduction of the euro and the high level of the ECB's interest rates, central bankers feel it appropriate to argue that his country's problems have nothing to do with monetary policy. This hardly amounts to an environment which would favour a balanced and constructive exchange of views on optimal policy mixes (note the plural).

What has gone wrong since the second half of the 1990s?

It is easy to see with hindsight that, after the completion of the "heroic" institution-building phase, some deterioration in the political environment should not have come as a surprise. Managing the successful implementation of the single currency required considerable efforts on the part of politicians — efforts that could not be expected to be sustained. The success may have given the impression that the difficult part of the process was behind us, whilst it simply implied that the nature of the challenges had changed: you now had to "live" with EMU. On top of this, within a few years there has been a generational change in the political elite in the majority of countries and, most important, in three of the largest countries (but not only there). This stands in stark contrast both with what had been happening in the political world during the decade following the signing of the Maastricht Treaty and with the continuity still prevailing in the world of central banking. A personal note: when today I meet members of the ESCB (at various levels), I expect to know at least two thirds of them, whilst when I meet politicians, or even high-ranking civil servants, the proportion is below one quarter — and even this is to be attributed to my recent activity relating to the reform of the regulatory process in the European securities markets rather than to my more distant EMI experience.

A much heavier responsibility for the deteriorating relationship between European governments and European central bankers lies with the worsening performance of the economy in the euro area, especially in comparison with the United States. The single most important fact in this respect has been the decline in Europe of the rate of growth of labour productivity (as measured by output per hour). For the EU 15 the deterioration has been dramatic, in comparison both with the European past and with the performance of the United States. Between 1985 and 1995 the average annual rate of growth was 2.2%, which allowed a sizeable catching-up with the United States, where productivity rose at that time at an average rate barely exceeding 1%. Since the middle of the 1990s, this relationship has been radically reversed; and during the years 2000-2004 the US figure came close to 3%, while the European declined to 1% (and this figure would be even lower if the UK was excluded from the total). As estimated by the BIS (74th Annual Report, p 20), more sophisticated calculations of total factor productivity developments confirm this dismal story. I find

convincing the arguments put forward in this Report that this discrepancy cannot be solely attributed to greater use of IT equipment in the US: "much of the acceleration in the trend TPF in the United States could well have come from the previous deregulation of markets for goods and services" (p 21). Central bankers, looking at these figures, come to the conclusion (which I share) that there is precious little that monetary policy could do to alleviate these supply side inefficiencies. Supply side reforms are the responsibility of governments.

But this is arguably not the full story. That in the medium to long run these productivity developments are bound to put a brake on European growth is beyond doubt. But it is true that other factors are also at work; and in a shorter perspective they seem to play a more important role. One is the relatively low rate of participation of the European population in the labour force; another is the high rate of unemployment; and the third is that Europeans tend to work fewer hours per year than their American counterparts. These three facts can be summed up in one sentence: fewer Europeans work fewer hours than the Americans, which explains to a large extent why European income per head of population is lagging behind the American equivalent. No wonder that governments, and quite a few academics, argue that even if you define potential output in a quite restrictive way, there is a negative output gap which could be reduced by an acceleration in the very modest rate of growth of European domestic demand. And, so runs the argument, since central bankers are so vocal in opposing fiscal laxity, they should engineer this acceleration by pursuing a more aggressive monetary policy. By doing this, they would also help alleviate the danger that the so strongly anticipated US policy adjustment measures — cutting the US fiscal deficit and raising the propensity to save of US households — would end up creating a slump in the world economy (which, incidentally, is about the last thing that Europe needs).

This is a serious debate which has to be pursued, but how can this be done within the framework of our current institutional arrangements?

It is at this point that I turn to the third group of reasons which bear a responsibility for it not being possible to pursue this debate in an environment conducive to constructive solutions. The major weakness of our current institutional arrangements can be summed up in a few words: that while the M-leg of EMU is solidly established, its E-leg is not. Let me remind you that I had misgivings about (what one might summarily call) the "missing federal finance minister issue" from the very beginning of my active participation in the monetary unification process. You may find the expression of my misgivings in a paper (for the preparation of which I received Claudio Borio's active assistance) submitted to the Delors Committee and published in an annex to the Report itself ("Macro-coordination of fiscal policies in an economic and monetary union in Europe", January 1989).

Let me briefly elaborate on how I see this problem today.

One problem would not necessarily be solved by having a large federal budget and a powerful federal finance minister: the destabilising emergence of a "globally" excessive fiscal deficit. No doubt, there is a powerful Secretary of the Treasury and a large federal budget in the United States, yet few of us would argue that the current and prospective American public sector deficit is an optimal one. Nor would I argue that such a situation would by itself prevent the emergence of differences, even of major differences, between national (or "state") fiscal balances. To avoid this happening, you need additional arrangements: you cannot dispense with something akin to our poorly managed Stability and Growth Pact. A large federal budget would, however, represent one major advantage. It would provide a framework for more or less automatic transfer mechanisms which could help alleviate the politically and socially disruptive impact of differences between the growth performances of the member countries. Whether this would be a good or a bad thing would, however, depend on the origin of these differences: probably a good thing if we had to deal with country-specific external shocks — but a rather bad thing if the differences are of the countries' own making. And since my suspicion is that the emerging differences between the growth performances within Euroland can to a large extent be attributed to policy decisions (or the lack of them) by individual countries, I come to the conclusion that we should not expect much help from any move towards macroeconomic fiscal federalism — which in any case is highly unlikely to happen.

I would therefore today put less exclusive stress on the need for macropolicy coordination than I did 16 years ago, but would rather emphasise the desperate need to accelerate — and collectively accelerate — the micro- or supply side reforms, of which we have so far seen only timid, and very uneven, beginnings. It is in this particular area that the E-leg should be strengthened.

Concluding remarks

It would be disingenuous on my part not to briefly outline, by way of conclusion, where I stand in my "stylised" summary of the current debate between European central bankers and their governments.

Let me start by saying that I share the concern of those who would like to see a pickup in the lacklustre rate of growth of domestic demand in Euroland. But what are the policy means of achieving this?

Forget about monetary policy — however tempting it might be to ask for "more responsive" policy reactions by the ECB. Anyone who cares to take a glance at the monetary statistics published by the ECB is bound to notice the currently relatively high rate of growth of broad money. You also have to bear in mind that this is not a new development: between mid-2001 and late 2003, M3 had been growing at a yearly rate of around 8%. As a result, Euroland now enjoys a comfortable "money gap" — even if allowance is made for the earlier portfolio shifts from equity into money. By calling attention to these figures, I do not want to imply that I see a danger of such "excess" liquidity putting upward pressure on consumer prices in the foreseeable future — although I would not rule out that it could have an undesirable impact on asset prices, at least in some countries. All I am trying to say is that, with such a high degree of liquidity and with the currently prevailing very low nominal and real interest rates throughout the whole yield curve, it would require a generous dose of imagination to believe that a relaxation of monetary policy could significantly stimulate domestic investment and consumption. I do not possess such imagination. Moreover, in a world flooded by dollar liquidity, a liquidity-generating European monetary policy would surely not contribute to global financial stability.

What about fiscal policy? It would seem difficult to argue that a relaxation of the fiscal policy stance could provide no stimulus whatsoever to domestic demand in Euroland. Initially, and for a short period, it possibly could — but at a price. Public opinion is no longer ignorant to the point of not realising that any such relaxation would come on top of the irresponsible handling, by the largest member countries, of their commitment to the Stability and Growth Pact. This has seriously undermined the credibility of future fiscal policy commitments. It is easy to lose credibility, but very hard to regain it. And this has happened at a time when the same public opinion has become acutely aware of the need to reform our health care and social security systems and to draw the appropriate conclusions, for our pension systems, from the ageing prospects of our populations. With the level of taxation well exceeding any reasonable level, it would seem difficult not to expect an increase in the burden of public debt. No wonder that the citizens of Euroland are not very keen to abandon their high propensity to save.

The upshot of all this is that the use of the two traditional macropolicy tools for stimulating domestic demand is unlikely to yield sizeable and lasting results, but would surely pile up trouble for the future. So what to do? The short answer is: try to exert an influence on investment and consumption by other means.

As for investment, two objectives should be simultaneously pursued. First, to nurture an "investment-friendly" climate across the full range of the enterprise sector, but with special attention to small and medium-sized firms, which as a group are the only ones likely to create

jobs. The core concern in this field (in addition to the obvious need to reduce the administrative, fiscal and regulatory impediments which hinder entrepreneurial initiatives) is to encourage risk-taking, which in plain language means increasing the rewards in case of success in comparison with the penalties in case of failure. The second objective is to raise not only the level of, but also the return on, investment, ie the reverse incremental capital/output ratio. This is what I regard as one of the major lessons to be drawn from the US experience.

As regards consumption, the key word is "confidence", or rather the lack of it. Many of our citizens are worried about their future because, on the one hand, they are fully aware that our "European model" (the solidarity features of which they are deeply attached to) badly needs repair, but, on the other hand, they either do not see the beginning of a credible reform process, or they fear its outcome. Our politicians face the historical challenge of having to relieve these often conflicting anxieties. They will not succeed in their endeavours unless the reform programmes enjoy wide popular support, which, in turn, requires broadly based consultation of all stakeholders. The bulk of the reforms will have to be conceived, agreed upon and carried out within national borders — but, Euroland being a politically motivated collective endeavour, confidence-building would gain much through agreement on broad principles at the European level. Quite a challenge for the policymakers of EMU's E-leg.