Jürgen Stark: Ten years of Maastricht - currency union leading to political union?

Lecture by Dr Jürgen Stark, Vice President of the Deutsche Bundesbank, at the 17th European Finance Convention, London, 2 December 2003.

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I

The Treaty on European Union - better known as the Maastricht Treaty - entered into force ten years ago on 1 November 1993. The then 12 EC member states launched at that time an innovative and unique approach to creating in Europe an Economic and Monetary Union (EMU).

This was only the latest step in a far-reaching process of economic integration initiated 50 years ago. Back then, it soon became clear that the time was not ripe for political integration. The pragmatic path which was being followed went from economic to monetary integration. The wider political purpose of establishing in Europe an area of peace and prosperity has been served well by this approach, despite all major and minor setbacks.

EMU brought about a profound transformation within the international monetary system. Sovereign countries showed their determination to hand over one of the major instruments of macroeconomic policy making to a supranational institution.

The historical dimension of this political project is undisputed. Europe - at least continental Europe - has fundamentally changed with the creation of EMU and the consequential introduction of the euro.

The project has weathered many storms in the past ten years. However, thundery clouds are still lingering. It is obvious that not everybody has fully grasped all the ramifications of this project. The damage done by the legally dubious abeyance of the Stability and Growth Pact (SGP) constitutes a real institutional crisis.

This politically short-sighted decision is a regrettable step backwards in the European integration process and shows the talent of some politicians to increase the already impressive number of challenges ahead. But no one should forget where we came from and what has been achieved already.

Right now, we are actually in the process of establishing a Constitution for Europe. Something we already have in the monetary field. Maastricht has in fact established a stability-oriented monetary constitution. On the other hand, the purpose of the Convention’s draft Constitutional Treaty, which is being discussed by the Intergovernmental Conference, is to replace and modify the content of the existing treaties.

The Constitutional Treaty seeks to establish more efficient structures. The whole decision-making process is intended to become more transparent and comprehensible. This will strengthen the democratic legitimacy of the EU, a step which is also necessary in view of the upcoming enlargement with its increase in diversity and complexity within the Union. It is therefore not a further integrative step but rather a consolidation of the existing institutional framework. Changes to the institutional framework of EMU were not originally intended, but these now seem to be on the agenda. The ECB and the euro area central banks have voiced their opinion. It is now up to the Intergovernmental Conference to decide if a change in the European stability consensus is in the interest of Europe’s citizens.

I do not intend to comment on whether the UK should join the euro area or not. When the UK requests that it be allowed to move to the third stage, the Council of the EU will have to decide if the necessary conditions - that is to say, the convergence criteria - have been fulfilled.

II

Europe has changed. It should not be confused with the Europe of ten or twenty years ago. The process leading up to the final stage of EMU has especially helped the countries with an unstable track record to reduce inflation rates, interest rates and fiscal deficits. The appeal of being part of EMU has certainly been helpful and has released an impressive amount of energy.

What have been the key characteristics, the main achievements of Maastricht?

A medium-term-oriented macroeconomic policy framework based on sustainable economic convergence with two distinct features:

1. an independent system of European central banks with the supranational European Central Bank and the primary objective of maintaining price stability

2. a fiscal institutional framework which - if properly applied - is meant to ensure fiscal discipline and which has the goal of preserving the sustainability of public finance.

Is that enough? Have we achieved these worthy and courageous objectives? Where would we like to go? And in which direction should we go?

The expectations of EMU were manifold. There were many sceptical voices which did not believe that a "one-size-fits-all" monetary policy was appropriate for such a heterogeneous area.

Convergence was seen to be insufficient, and the criteria of an optimal currency area not fulfilled. The proponents of this view saw monetary union only as the last crowning step of economic integration. Furthermore, experience has shown that all attempts in the past to establish a currency without a state have failed.

The optimistic view focused more on the advantages of greater price transparency, the removal of exchange-rate-induced planning uncertainties and the lower transaction costs in intra-euro-area trade. The euro was seen as the next logical step to complete the single market. EMU was expected to serve as a catalyst for further economic reforms and political integration.

Who was right?

After almost five years of EMU one has to acknowledge that neither the positive nor the negative extremes have become true. However, the institutional framework currently faces a crucial stress test.

The Eurosystem's monetary policy has managed to gain credibility and to build up confidence despite quite a number of challenges. This could not be taken for granted given the fact that there were no blueprints to fall back on. The centralised monetary policy and the decentralised but closely co-ordinated economic and budgetary policies constitute a rather demanding regime.

The Eurosystem at least has proved that it is up to the task. The ECB is endowed with an unambiguous mandate and has developed a strategy in accordance with the latest insights into monetary theory and practical experience. Even the severe criticism of Anglo-Saxon economists and media has become less ardent recently. The monetary policy strategy is increasingly understood or at least better respected by market participants. Long-term inflation expectations have been close to and mostly below the ECB definition of price stability of 2%.

The economic rationale behind the mandate and strategy is the generally accepted principle that price stability is the best contribution monetary policy can make to improving economic prospects and raising living standards. How this translates into a monetary policy strategy depends, of course, on the structural preconditions. It concerns the manner in which the complex transmission mechanism works its way through from monetary policy decisions to the economy in general and the price level in particular. A very important influencing factor in this respect is whether investment decisions are influenced more strongly by developments in long-term or in short-term interest rates.

The two-pillar approach has proved to be the appropriate strategy for the euro area. It avoids creating unnecessary volatility in financial and real markets through its medium-term orientation, thus recognising that monetary policy does not have the instruments to fine-tune the economy. The prominent role of monetary growth acknowledges that money matters. This is by no means an outdated concept and is a lesson which I would like to stress considering the recent experiences of stock and housing market bubbles.

And the track record?

The ECB, together with the national central banks in the Eurosystem, has delivered. It is fair to say that the credibility test has been passed so far. Average inflation over the past five years has been close to 2%. The implementation of the single monetary policy has been conducted quite smoothly from the outset. The logistical endeavours linked to the cash changeover from the national currencies to the euro were a success, and the euro banknotes and coins were readily accepted by market participants.

However, EMU did not create the expected impetus for further political integration. The intergovernmental nature of the police and judicial co-operation and the so-called common foreign and security policy have not been decisively strengthened since the inception of EMU. On the contrary, this year has shown that we are quite some way from a “common” European foreign policy.

Owing to the asymmetrical nature of Maastricht, other economic policy areas still remain largely decentralised. There is, however, economic policy coordination through the Broad Economic Policy Guidelines and the Stability and Growth Pact.

Nobody seriously challenges the need for budgetary rules in a currency union with supranational monetary policy and national budgetary policies. Both policies are linked in the medium to long term. Lasting monetary stability needs sound and reliable public finances. The pact was designed to sustain the confidence of the public and financial markets in the euro.

The pact was, in fact, the answer to monetary union without a political union, just like a virtual European finance minister.

III

What has to be done?

The economic rationale clearly and unambiguously calls for retaining medium-term-oriented fiscal policy rules. It is not about applying a mechanistic procedure. Stability and growth go hand in hand. There is no trade-off between these goals; instead, they are mutually reinforcing.

The structural growth obstacles of euro-area countries cannot be solved with monetary policy nor with expansionary fiscal policy measures. Further damaging the pact would expose the policy regime of EMU to a very severe endurance test with tensions between the member states owing to the free-rider problematic. Furthermore, the open budgetary flank increases the likelihood of tensions between politicians and the central bank.

I am not surprised that the financial markets have so far reacted rather moderately to the ECOFIN decision. What weighs most are the medium to long-term effects on credibility and on the functioning of the institutional setting of economic and monetary union.

The decision of the ECOFIN Council threatens to break the political consensus of the Maastricht Treaty. Signing the Maastricht Treaty has limited the national sovereignty of fiscal policy. The Treaty is primary international law and contains *inter alia*:

- the commitment of member states to avoid excessive deficits
- the 3% threshold
- an early warning procedure
- the provision to give notice to a member state to take measures to reduce the deficit within a specified time limit
- the right to impose fines if a member state fails to comply.

The Stability and Growth Pact fleshed out these provisions and streamlined the procedures at the same time. Contrary to appearance, the Stability and Growth Pact is not a non-committal statement of political purpose but secondary EU law. Permanently fumbling with the pact is a clear sign that political authorities in many member countries were only vaguely aware of the implication of EMU on fiscal policy leeway.

The pact is a decisive element of the institutional framework of the monetary union. Treaty and pact already resemble a partial political union.

The technical preconditions for the functioning of EMU are in place. If properly applied, this will suffice for the time being. In the medium to long term, however, additional political back-up will be indispensable.

EMU has tied the participating countries permanently together. National policy choices have become a matter of concern for all. For the lasting success of the politically decentralised monetary union

1. it is crucial to implement structural reforms, thus lifting member countries on to a higher growth path
2. it is crucial to overcome integration and adjustment fatigue

3. it is crucial to embrace reality and accept the fact that national sovereignty in fiscal policy is limited in a monetary union

4. it is crucial to accept the constituting principle of all democracies, the rule of law, which lays down the primacy of law over policy

5. it is crucial to adhere to the stability consensus of Maastricht which is additionally put in question by disregarding the suggestions of the ECB and the central banks of the euro area to refine the Convention's proposal.

It will be necessary to reconcile the "ever closer union" with the "ever wider union". Today we are further away from a political union than we were when the euro was introduced five years ago. Regarding the co-ordination of budgetary policies, we are even thrown back to intergovernmental co-operation.

It will be necessary to reconcile the negotiations on the Constitution for Europe with the damage done to the political stability consensus of Maastricht.

It is in the European and in the national interest to solve the institutional crises.

We must put a stop to incurring excessive debt because we are living at the expense of future generations. Sustainable growth can be achieved only on the basis of stability and sound public finance.

We must put a stop to the process of aggravating the credibility crises which strangles a sustainable European recovery.

We must put a stop to the disintegrating forces which allege victories by organised majorities over reason. I cannot comprehend how such behaviour - I am not willing to call it a system - can be expected to work in an enlarged union with 25 member states.

I do hope that the suspension of the rules and procedures of the Stability and Growth Pact is only temporary.

I do hope that Europe develops the political will and leadership to return to a rule-based system.