Guy Quaden: Regional economic integration and monetary cooperation (in Europe and Africa)

Exposé by Mr Guy Quaden, Governor of the National Bank of Belgium, at the Eurosystem seminar with the central banks of West and Central Africa, jointly organised by the Bank of France and the European Central Bank, Paris, 1 February 2007.

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Dear colleagues,

Chairman Trichet and Governor Noyer have asked me to introduce the session of our seminar devoted to "Regional economic integration and monetary cooperation". It is both an honour and a pleasure for me. In my presentation, I would like to talk to you about the subject that I know best, one in which I obviously have a comparative advantage, and that is Economic and Monetary Union in Europe (EMU). So, I will recap on why and how the euro was introduced and what are the main problems with European monetary union in practice. Drawing on this European experience, I will then broaden the perspective to Africa, under the supervision of our friends and colleagues from over there.

I. EMU: a single and stable currency

EMU comprises two separate, but complementary, elements: a single currency and a stable currency. These correspond to the two, interrelated, objectives of EMU: efficiency and stability.

EMU is, in the first instance, a culmination of the Single Market. Monetary union implies that some exchange rates no longer exist, as for instance the rate of the Belgian franc against the German mark or the Italian lira. In the past, the volatility of these exchange rates has been most harmful to our economies and the functioning of a Single Market. With the introduction of the euro, this form of intra-European monetary instability has been entirely wiped out once and for all.

The single currency is a major step forward in terms of efficiency, resulting in lower transaction costs, more price transparency and a financial market operating in a more integrated way. All those elements favour a more efficient allocation of resources, thereby allowing a better functioning and a deepening of the European Single Market and more dynamic economic growth.

The introduction of the euro and the new monetary policy have had important consequences for the financial markets in particular. A thorough integration process has taken place in the whole euro area. This integration is most evident on the money markets, especially on the interbank market. On that level, one may really refer to a single European market, the direct outcome of the common monetary policy. The integration of the money market and the disappearance of exchange rate risks have also provided a great boost to integration of the other financial markets.

The Maastricht Treaty also ushered in a new framework for macroeconomic policy in Europe, aiming at stability through both a single monetary policy and coordination of other economic policies. Significantly, the Maastricht Treaty also laid down guiding principles for the conduct of economic policies, thereby elevating the goals of “stable prices and sound public finances”, as well as the “principle of an open market economy with free competition” to constitutional status.

Monetary policy plays a crucial role. The institutional foundations on which the ECB has been built are very sound. The Maastricht Treaty has made it one of the most independent central banks in the world. In this way, political pressures can be avoided and European citizens can be assured the central bank's mandate of price stability will be pursued from a long-term euro-area-wide perspective.

The Maastricht Treaty leaves, in principle, the other elements of economic policy in the hands of the Member States as a matter of national responsibility. This has led to an "asymmetric" economic policy framework. This asymmetry reflects the limits of the Member States’ willingness to hand over their national sovereignty in the area of economic policy-making. However, it is also a reflection of the subsidiarity principle, a fundamental constitutional principle of the European Union. But the subsidiarity principle also has an economic rationale, namely that the delegation of policy responsibilities to a higher level is only justified if the Community is better placed to carry them out. Applied to economic policy-making in the euro area, the subsidiarity principle therefore implies that monetary policy, by its very nature an indivisible whole, is not suitable to be left decentralised. The same logic of centralisation also holds true for the Single Market's regulatory framework. By contrast, fiscal, structural and employment policies have remained largely national prerogatives.

II. Why was Europe's attempt at EMU successful?

European integration is to a large degree a political process, which has its roots in the two world wars and the devastation they caused. The Second World War proved to be a real trauma for Europe's political leaders. The Schuman Declaration of May 1950, which laid the foundations for the European Coal and Steel Community, stated clearly that "solidarity in production will make it plain that any war between France and Germany becomes not merely unthinkable, but materially impossible". So, the memory of the two wars made for a very strong political will to further European integration. At its heart was a process of Franco-German reconciliation and cooperation.

So, although the start of the European integration process dates back to the years after World War II, the first official attempt to set up an economic and monetary union was not made until 1970, when the so-called Werner Report (commissioned by the European Council) outlined the main features of EMU and the road to its achievement. However, due to strong turmoil in the international economy (the collapse of the Bretton Woods system and the oil crisis) and the absence of both policy coordination and political will, this first attempt at monetary union proved unsuccessful. It was not until the end of the 1970s that the monetary integration process resumed, more specifically with the establishment of the European Monetary System.

Despite considerable difficulties, especially during the first years, the EMS contributed to a broadening of the "*acquis communautaire*", on the basis of which a genuine project for monetary union could be set in motion. This new initiative was based on the "Delors Report", again commissioned by the European Council, which came up with a blueprint for an economic and monetary union in Europe and specified the successive stages through which it would have to go. Further negotiations resulted in the Treaty of Maastricht, which, despite the serious problems in the EMS during the years 1992-93, finally led to the launch of EMU in 1999. The EMS crises in 1992 and 1993 could have been fatal for the EMU project and served to show that EMU was not inevitable. However, the crises also underlined the political will of Europe's leaders and showed that they were ready to adopt difficult measures in order to move on to Economic and Monetary Union.

Apart from an ever-stronger underlying political will, two long-term structural factors which prepared the way for the key decisions on EMU can be singled out, namely, an increasing degree of economic integration and a growing consensus on macroeconomic policy objectives.

Economic integration in Europe has advanced enormously over the last few decades. Trade interdependence has increased. With growing financial integration in Europe and more foreign direct investment flows, income from wealth has also become more internationally diversified. Economic linkages between the European countries have therefore grown much stronger. This interdependence has pushed up the costs linked to the use of national currencies in a Single Market in terms of conversion costs as well as costs of hedging against risks of appreciation or depreciation.

Economic thinking also developed profoundly between the 1970s and the 1990s. At the beginning of the 1970s, what we called Keynesianism was still very influential among economic policy-makers in the European Community. The "Monetarist counter-revolution" shook it up completely. The Phillips curve and the economic policy trade-offs it appeared to allow were called into question. Above all, it was the stagflation of the 1970s that further indicated the limits of activist policies. The monetary and fiscal expansionary policy adopted in several countries led to an upsurge in inflation and in public debt with no sizeable effect on the level of employment.

Gradually, a new consensus developed which moved away from active demand-management policies towards a more medium-term orientation, emphasising structural, supply-side-oriented policies. A core ingredient of the new strategy was that monetary policy should be conducted by an independent central bank and geared towards price stability.

III. Does EMU need a political union?

I would now like to turn to two questions which, for some outside observers, constitute just as many objections to European monetary union:

- is a monetary union conceivable and can it be stable without a political union between the countries concerned?
- can a single monetary policy be appropriate for a group of countries whose individual economic performance, especially on the growth front, remains heterogeneous.

Today, there are still some States in the world that don't have their own currency (because they use a currency – like the US dollar or the euro for instance – issued by other countries), but there is only one currency (and by no means an insignificant one because it is the world's second most important) that is not linked to any specific state structure – and that is the euro.

In Europe, it all started with economic integration. Monetary integration followed later, at least for 13 countries. Political integration is still lagging behind. Neither the European Commission nor the Council of Ministers constitute a genuine government for the EU or the euro area.

Back in the 1980s, the most widely-held view was that monetary union should go hand in hand with political union. But, at the beginning of the 1990s, a number of European leaders cashed in on the exceptional momentum triggered by the fall of the Berlin Wall to push ahead with this monetary unification plan without waiting for similar progress to be made on the political unification front.

Nevertheless, launching monetary union was in itself a political decision of the utmost importance since it meant transferring an essential part of national sovereignty – the monetary policy – to a supranational authority.

After that, and despite the lack of a European State, the euro rapidly gained recognition as a credible currency for what I think are two basic reasons. On the one hand, the ECB and the Eurosystem, in charge of euro-zone monetary policy, have a clear mandate: price stability. On the other hand, their leaders are totally independent. They can neither receive nor ask for instructions from any outside interests, especially national governments. They must protect the sole collective interest of the zone as a whole. The monetary policy decision-making process has not only been centralised but also depoliticised.

That said, there is no denying a certain lack of symmetry in the current structure of EMU, the relative weakness of the politico-economic pillar vis-à-vis the monetary pillar. Unlike monetary policy, fiscal policy remains in the hands of national States. Up to a certain point – which I have already mentioned – this situation corresponds to the principle of subsidiarity. However, we have to prevent inadequate national policies from causing any damage for the other partners and, in particular, for the common good that the euro enshrines. This is why the budgetary rules or constraints that make up the Stability and Growth Pact were defined.

As we all know, the provisions of the Pact have not been fully respected. But they have constantly exerted a certain amount of pressure on States that have flouted the rules and it is to be hoped that the revised version of the Pact will be applied more rigorously.

We also know that the Finance Ministers of the euro-area member countries meet regularly within the Eurogroup. Some politicians talk about wanting to transform this group into Europe's economic government. From a personal point of view, I don't see any objection to this, quite the contrary. But, if the objective – stated or not – of such a rise in power were to reduce the independence of the central bank, then it would be a really bad thing. However, the risk is very slight as this principle of independence is set in stone in the Treaty. I would add that the lack of visibility and substance of the political axis and the European Central Bank's "institutional loneliness" all too often, and quite unfairly, make the ECB an escape goat for everything that is going wrong in Europe. After all, the examples of Germany yesterday or the United States today just go to show that you can have a strong political power and a strong central bank at one and the same time.

IV. Is heterogeneity a cause for concern?

In reality, the question of heterogeneity comes up in the case of any monetary policy, even national policy, applying to a more or less disparate set of regions, and all the more so, of course, in big monetary unions. "Can one size fit all?"

According to theory, an optimal currency area needs free movement of the factors of production as well as flexible markets and a limited impact of asymmetric shocks on the various partners of the monetary union. The euro area is not an optimal currency area. But does that really exist? In Europe, however, factor mobility, financial integration and fiscal transfers between Member States are less than in the United States. In this case, can monetary union function properly?

There is only one single monetary policy and the ECB can only focus it on price stability at the level of the euro area as a whole. In this kind of framework, the burden of adjustment, to asymmetric shocks for instance, rests on other mechanisms such as wages and relative prices or fiscal policy.

What are the hard facts? As far as inflation is concerned, as I said before, both inflation rates and the divergences between them dropped sharply before the move over to monetary union. Since then, inflation differentials have not been any higher than the gaps that can be observed between the main American regions. As for the dispersion of growth rates within the euro area, this has not got any wider since exchange rates were irrevocably fixed and is also comparable to the American situation. In both cases – inflation and growth – the difference with the United States lies in the persistence of the differentials: it is nearly always the same countries that have the highest or the lowest inflation or growth rates.

Growth differentials may be linked to catching-up processes (and here they are to be welcomed), to specific shocks or to inappropriate national policies. They may be the result of differences in trends or cyclical situations, too.

Business cycles have become more closely aligned over the years under the impact of deeper product and financial market integration and convergence of macroeconomic policies. Differences in trend growth are now the main reason for most differentials, something which also explains why the dispersion of growth rates shows a considerable degree of persistence.

What conclusions can be drawn from these observations?

Firstly, that, since it turns out that there is more heterogeneity across countries in trend output developments than in cyclical movements, monetary policy is confronted with a relatively symmetric environment in those fields where it has an impact.

Secondly, for the competitiveness mechanism to work properly, wage and price rigidities have to be tackled by national structural reforms.

Moreover, decentralised fiscal policies based on automatic stabilisers are also an important instrument in reducing growth differentials. But sound public finances are a necessary condition for automatic stabilisers to work fully. Member States should draw lessons from their maladjusted fiscal policy in the previous upswing and get their budgets into surplus during good times.

V. Lessons from EU integration and challenges for Africa

As previously mentioned, the road to EU economic and monetary integration has been paved by three long-term structural factors. First and foremost, there has been a strong underlying political will which has its roots in the reconciliation and cooperation process initiated in Europe after the Second World War. Secondly, economic integration advanced considerably over the following decades, fostered not only by trade interdependence, but also by the web of social linkages created through business, tourism or educational exchanges. And, thirdly, there is a growing economic consensus moving away from active demand management policies towards a more medium-term orientation, based on structural, supply-side-oriented policies with a monetary policy strongly geared towards price stability.

Those three factors have reinforced each other in a long process of gradual building on prior achievements. Although that process was repeatedly interrupted owing to a diversity of economic and political difficulties, it comes to the credit of Europe's political leaders that they were able to appreciate those difficulties correctly and to respond to them with a visionary and forward-looking project, sometimes in the face of strong opposition. An important ingredient in the success of EMU is also that the project was flexible enough to address specific concerns and overcome various sources of resistance while keeping a high degree of consistency as regards its aims and conditions of access.

In launching its own economic and monetary integration process, Africa is starting out from quite a different position, in all three above-mentioned fields. Countries on the African continent are mostly young states, so they do not share a long history of common experience. They are also very heterogeneous. Compared with the EU, the degree of economic integration is also much more limited, especially when it comes to trade flows. Heavy reliance on commodities and the general lack of complementarity in production and/or exports of goods and services automatically reduce the scope for intensive intra-regional trade, even within the same monetary zone. Last but not least, the building of a consensus on policy objectives is complicated by the multiplicity of different integration initiatives in Africa. Those initiatives often overlap in terms of membership.

African countries can rely on various assets to strengthen their economic integration. The important initiatives that have been set up all over the continent over the past four decades show a strong willingness to pursue regional economic and monetary integration. Notable achievements have been realised on which to build further progress. Real integration between African countries is also stronger than it may appear from official statistics due to the large size of the informal economy. Indeed, official data largely underestimate inter- and intra-regional flows, a lot of transactions being unrecorded. These informal trade flows can be expected to be substantial, if not larger in some instances than official trade flows. Bringing those informal trade flows into the formal economy would, at the same time, represent a strong and enticing objective for further integration and, in turn, cement a wide community of interest between countries on which to build a large consensus to push the integration process further ahead.

Given the various regional integration initiatives already in place, there seems to be little need for any more formal initiatives. Taking capacity and budgetary constraints into account, the main challenge is to implement the agreements that already exist in order to bridge the gap between formal agreements and *de facto* (informal) trade integration which can be observed all over the African continent on a daily basis. This requires removing existing impediments to formal trade, improving the general business climate and enhancing transparency and good governance. It also requires giving oversight institutions the necessary resources to do their surveillance job and a forceful mandate to intervene when problems arise.

Other challenges are to address supply-side constraints, by enhancing complementarities, investing in labour-force skills, fostering a supportive business climate which allows the private sector to develop and expand its activities, and by addressing infrastructure constraints in transport and power supply. Africa has 15 landlocked countries, for which transport corridors are extremely important. The lack of adequate transport infrastructure remains a problem in some parts of Africa, and without these, economic integration is bound to remain limited.

This leaves the question of the potential role to play by monetary integration, especially since the functioning of the CFA Zone has been an undeniable success in the global process of African integration. This currency union has certainly yielded positive results, in terms of stability, for instance. Yet this stability has largely been achieved by importing credibility from a supranational central bank and thanks to the backing of the French Treasury.

This is further evidenced by the respective role played by convergence criteria in the EMU and in the CFA Zone. The observance of those criteria was, from the outset, considered as a necessary condition to ensure the credibility of the single European currency and as a prerequisite for individual countries to join the EMU. On the contrary, in the CFA Zone, those criteria were introduced afterwards. This does not mean that they are superfluous, far from it. The imported credibility of the CFA Zone would be greatly fostered by meeting those criteria and this would in turn help to make further progress with economic integration.

However, monetary issues do not seem at present to be the main impediment to regional economic integration and this integration does not seem to be much more advanced in the CFA Zone than in other parts of Africa. For African countries which do not belong to a monetary union, monetary cooperation is not the most urgent issue that needs to be addressed to improve regional economic integration. Pursuing monetary integration may even deflect much-needed political energy and focus away from the main priorities with regard to regional integration. Those priorities should quite clearly be trade, infrastructure and good governance.

As I mentioned at the beginning of my exposé, I have spoken only briefly and more cautiously about Africa as I do not know the region as well as my own continent. I am counting on the other participants who will now take the floor to certainly expand upon and perhaps even correct my remarks.

Thank you for your attention.