NÁRODNÁ BANKA SLOVENSKA

EUROZONE AND WORLD ECONOMY

Part I

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The European Monetary Union that started its real functioning in late 90s of the last century had several predecessors. Monetary unions were formed throughout Europe even in 19th century, though most of the monetary systems were based on bimetallism or monometallism. Wim F. V. Vanthoor divides those monetary unions into two basic groups:

1. Supraregional monetary unions, the establishment of which accompanied the process of politic unification: Switzerland (1848), Italy (1861) and Germany (1871).

2. Inter-European monetary unions based on agreements between sovereign states adjusting their mutual exchange rates. These monetary unions included e.g. German-Austrian Monetary Union (1857 – 1867), the Latin Monetary Union (1865 – 1926) and the Scandinavian Monetary Union (1872 – 1931).[1]

Though the history of these monetary unions has brought some interesting lessons (e.g. existence of the so called parallel currency, experience from cooperation between central banks), the conditions under which the unions operated (particularly the form of monetary systems) were far different from the current conditions. Therefore, the European Monetary Union can be not deemed a successor of the aforesaid monetary unions. Perhaps, this is the main reason why answers to the complex questions regarding operation of EMU can be not found in the history of monetary unions that existed in the second half of the 19th century.

The real efforts for establishment of a broader monetary union in Europe appeared after the World War II in connection with the development of West European economic integration. Then the words uttered by the renowned French economist J. L. Rueff in 1950: "L'Europe se fera par la monnaie ou ne se fera pas.[2]" appeared to be prophetic.

A similar conclusion was indirectly reached also by the distinguished American economist Charles P. Kindleberger who compared the customs union – i.e. a lower stage of economic integration – to a house under construction standing on the way to a broader economic integration. As Kindleberger says, it is impossible to settle in a house under construction for long. The member countries must advance ahead towards higher integration stages (in our opinion as far as the economic and monetary union), otherwise the unfinished house ("customs union " according to Kindleberger) will sooner or later break down.[3] The history offers many examples of customs unions and particularly free trade areas that were established rather easily, but their termination was even easier. European Union, however, as intended by its founders, should become a completed structure with firm fundaments able to resist any shaking.

At present we witness the long story of the European Monetary Union approaching its final act. As of 1st January 2002, euro takes the form of cash – coins and banknotes. The setting of prices of goods and services, wages and salaries, profits and other revenues becomes unified in all EU member countries, thus being easily comparable, which will certainly bring not only economic but also psychological effects.

Currently, attention of economists as well as of politicians focuses on the functioning of the European Monetary Union, the results achieved (interest rates, inflation), and particularly on the development of euro/dollar exchange rate. Today, hardly anyone can remember all the matters that preceded the monetary union (Werner Report, implementation of the European Monetary System, Delors Report, Maastricht Treaty), and the theoretical controversies in 60s and 70s on the optimum currency area concept (shall the Community be an optimum currency area?) and on approach to implementation of the single (common) currency (normative aspect).

1. The Theory of Optimum Currency Area and the Parallel Currency Approach

The main theoretical tool applied in analyses of monetary unions is the theory of **optimum currency area (OCA)** promoted by the Nobel prize winner R. A. Mundell.[4]

According to R. A. Mundell, an optimum currency area comes when the disturbances, occurring within the monetary union, cause the unemployment and prices are moving from their equilibrium level only to the least possible extent. D. A. Snider understands the optimum currency area to be "an area where economic parameters are adjusted to fixed exchange rates, while floating rates must be applied in relation to the external environment so that the optimum adjustment is achieved."[5] Other authors specify OCA as a set of areas and regions which are tightly bound together by their mutual exchange of goods, services and by the mobility of productive factors.

R. A. Mundell in his renowned article A Theory of Optimum Currency Areas endeavoured to determine the criteria to be applied in forming an optimum current area upon different regions, where common (single) currency could be used. His rationale was based on the assumption

[1] Refer to Vanthoor, Wim F. V. (1998).

[2] Europe will be created by means of money or will be not created (at all). See Weber, M. (HRSG.) (1991). Jacques Léon Rueff (1896 – 1978) undoubtedly belongs to the classics of neoliberalism, particularly in the field of monetary theory. Due to his sharp criticism of Keynes he was sometimes labelled as a paleoliberal.

[3] Refer to Kindleberger, Ch. P. (1978).

[4] Mundell, R. A. (1961).

[5] Snider, D. A: (1967).

that an economic system (i.e. the region where national economies are integrated) using numerous different currencies is not effective. Mundell as well as other authors of the OCA theory focused on the conditions under which different countries could be integrated in a monetary union and what costs and benefits can be expected as results of the participation in the monetary integration.[6]

In his theory of an optimum currency area R. A. Mundell considered how a particular country adjusts to a demand shock, and he based his considerations on the assumption of full employment and equilibrium. He considered high mobility of factors of production to be a stabilising factor allowing for an efficient response to exogenous shocks (the movements in demand in this particular case). In the case of the demand shift from region A to region B, under the high labour mobility circumstances, labour forces move to region B, which has stabilising effects on prices as well as on employment. Similar effects are attributable also to high capital mobility, though there is a remarkable difference between the capital mobility and the labour mobility (particularly after liberalisation of the capital movement). Therefore, according to Mundell, the optimum currency area is an area where high level of productive factors mobility exists. The reality is, of course, much more complicated – e.g. labour mobility is never perfect.

The Mundell's theory of optimum currency area is often criticised for certain bias based on excessive concentration on costs of the monetary union and a low level of consideration of its benefits. Mundell's critics as well as his followers, however, agree with the fact that it is just R. A. Mundell who can be deemed a pioneer of this theory and to which other authors directly or indirectly refer.[7]

Mundell's most reputable successors include:

Ronald I. McKinnon (1963), who suggested the criterion of openness of economy defined as the tradables to non-tradables ratio to be applied with respect to OCA. According to McKinnon, a monetary union is optimal if the countries constituting the union are opened to each other. His concept implies the conclusion that the optimum monetary areas must be relatively closed regions.

Peter B. Kennen (1969) stressed the importance of the similarity of the trading structure for making a monetary union less costly and concentrated his attention to the industry or product diversification: "The more open an economy is, the more microeconomic defects in individual sectors of economy are likely to compensate each other."

James C. Ingram (1973) considers financial integration to be the main criterion with respect to an optimum monetary area, while **Gottfried Haberler** (1971) and **Marcus J. Fleming** (1971) underline that fixed exchange rates (and the monetary union) can be maintained only by countries with almost equal inflation rates.

Even this brief and incomplete review suggests that different economic theories emphasise different criteria to be used in determining the optimum currency area. The criteria comprise particularly the level of productive factors mobility, openness and size of the economy, commodity diversification degree, flexible wages and prices, product markets integration degree, fiscal integration, stability of exchange rates.[8] Of course, an important role is played also by political factors, and some economists deem also certain level of synchronisation of business cycle an important criterion. Generally, the criteria are of a macroeconomic as well as a microeconomic nature.

How did the aforesaid theories affect the formation of the European Monetary Union? There is no easy answer to this question. The criteria set forth in Maastricht Treaty (so called Maastricht convergence criteria) basically ignored the theoretical approaches of economists such as Mundell, McKinnon or Kennen who put the main emphasis to microeconomic factors. The Maastricht criteria (stability of prices, stability of currency, budget deficit and government debt levels, interest rates) were prevalently macroeconomic criteria, and they reflected the theoretical contributions of Ingram and Haberler to a certain extent.[9] It should be noted, however, that the stress on low inflation and low budget deficit and government debt levels basically implied neutral (if not even restrictive) fiscal – monetary mix though under exchange rates regimes.

We think that the above mentioned microeconomic and macroeconomic criteria should be not strictly presented as opposite criteria since meeting one type of criteria (such as high mobility of factors of production, flexible wages and prices) creates preconditions needed for the general (macroeconomic) stability. It would be certainly ideal if the monetary union met all microeconomic as well as macroeconomic criteria. The quantitative setting of all these criteria would be, however, rather difficult, if not even impossible, which applies particularly to microeconomic criteria. If it was feasible to determine such criteria, though, "meeting" these criteria would be very complicated and the factual realisation of the monetary union would be postponed to a far future. In our opinion this is one of the main causes why the process of constructing EMU took another way. Similar arguments most likely apply also to the **parallel currency** approach that was in-

[6] Usually, the fact that a country entering the monetary union waives its exchange rate as a monetary policy tool (the stabilising effects of exchange rate adjustments) is considered to be a cost (though it is not always reasonable). On the contrary, the benefits comprise particularly saved transaction costs and limited exchange rate uncertainty.(The monetary union may become a kind of protective umbrella avoiding monetary crises.)

[7] Mundell's essential contribution to the theory of OCA was finally appraissed also by Swedish Academy of Sciences which awarded Nobel prize in economy in 1999 to R. A. Mundell.

[8] Refer to Muchová E. (1999).

[9] On the other hand, real convergence indicators (productivity, GDP per capita, unemployment rate etc.) were not accounted at all.

[10] While the theory of OCA endeavoured to answer the question of

tended to enable monetary integration by means of currency competition.[10]

The concept of parallel currency comes from H. Grote (1886) who used it to describe existence of two coin systems applying different metals, where relations of values between the two systems are not determined externally but remain upon the market pricing procedures. The theory of currency competition bears signs of Friedrich A. von Hayek's manuscript[11] who always concentrated his attention to the fight against inflation. Hayek's approach was based on the fact that government institutions are not able to ensure stable value of money and therefore he fought for absolute elimination of the issuing of banknotes being a state (or government) monopoly that enables government to manipulate the circulation of money in many ways. Instead of the government monopoly he preferred currency competition which he deemed to be a tool for suppression of inflation. On the other hand, though Hayek himself opposed the introduction of " utopistic European currency " that in his opinion would just reinforce the government monopoly over the issuing of banknotes. Generally, it can be stated that Hayek's conception of denationalisation of money together with the associated theory of currency competition had no significant effect to the monetary integration within EU.

Not all of supporters of parallel currency entirely accorded with Hayek's concept, though. Their views were, however, similar as they did not see any need of establishing new government institutions to ensure benefits arising from the monetary integration. In their opinion, the only measure needed was the elimination of all legal restrictions hindering in introduction of the new single currency. According to that conception it is not necessary to fix exchange rates and to coordinate national economic policies. The underlying economic rationale is obvious: generally, competition leads to a better market structure thus it should be applied also in the monetary sector.

Though Delors Report absolutely rejected the conception of parallel currency without giving any particular reason, on the other hand it brought a close definition of the parallel currency: "Pursuant to this concept (i.e. the concept contained in Delors Report – J. I.) ECU would cease a currency basket to be at the initial stage, and a new ordinary currency called ECU would be autonomously created and additionally issued alongside of existing the Community currencies, thus competing with them.[12]" However, the process of introducing the common currency in EMU developed in a different way than assumed according to the currency competition theory.

The destiny of the parallel currency approach to a large extent resembled that of the theory of optimum currency area. Again, the determining role was played by unfeasibility of the proposed concept and by absolutely uncertain time horizon within which the new currency should be put through. It is our opinion that if Maastricht Treaty had assumed the recommendations implied by the theory of OCA and the parallel currency approach, the European Monetary Union would still be waiting for its factual realisation and euro would only be competing with mark and other European currencies for the position of common currency.

Though the strategy of Maastricht Treaty was based on the principle of gradualism, but this gradualism had its rather precisely specified schedule and the schedule was basically followed. On 2nd May 1998 EU Council approved the following decision: " Belgium, Germany, Spain, France, Ireland, Italy, Luxembourg, the Netherlands, Austria, Portugal and Finland meet the conditions required for adopting the unified currency as of 1st January, 1999".

2. Institutional Framework of EMU

The European Monetary Union is characterised by three primary elements:

- full and irreversible convertibility of member countries' currencies,
- full liberalisation of capital transactions and full integration of financial markets,
- the elimination of fluctuations of exchange rates and their irrevocable fixation.

The European Monetary Union became an area with a single currency (before 1st January 2002 national currencies were used, too, but only as euro denominations), where responsibility for the single monetary policy was transferred to European Central Bank (ECB). Pursuant to the relevant provisions of the Treaty on European Union, European System of Central Banks (ESCB) was established, incorporating ECB and national central banks (NCBs) of all member countries. NCBs of those EU member countries that are not members of EMU (which are Denmark, Sweden and United Kingdom at present) belong to ESCB but they do not participate in creation and implementation of the single monetary policy of the Eurozone.

The factual core of EMU is constituted by ECB and NCBs of those EU countries that adopted euro (12 NCBs at present). To provide for easier understanding of the structure of European central banking system, ECB decided to adopt Eurosystem as the name denominating ECB and NCBs of those EU countries that are also EMU members. When all 15 EU countries will participate in the Eu-

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which countries could form a sound mone-tary union, the parallel currency concept was intended to solve the issue of how to introduce an ideal new common (unified) currency that would be added to the existing currencies. The new currency was expected to get its way in the competition with national currencies due to its quality and to gradually supersede the na-tional currencies.

[11] Refer to Hayek, Friedrich A. von (1977). By the way, Hayek's concept of monetary denationalisation contradicted the well-known Gresham's rule.

[12] Refer to Weber W. (1991). The only EU member country that supported the concept of monetary integration by means of parallel currency in 1990 was United Kingdom.

rosystem, the concept of Eurosystem will become a synonym of ESCB. The supreme decision-making bodies of Eurosystem are Governing Council and Executive Board. The Governing Council, which is the supreme decision-making body of ECB, comprises all members of the Executive Board and governors of NCBs of those states that have adopted euro. The Executive Board has 6 members (President, Vice-President and other 4 members), who are nominated by heads of state or by governments of the Eurozone member countries.[13] The both bodies are headed by the President of ECB.

The Governing Council's responsibility is to adopt directives and execute decisions needed for realisation of tasks set to Eurosystem, as well as formulation of the monetary policy of the Eurozone.

The Executive Board prepares sessions of the Governing Council, conducts the monetary policy in accordance with the Governing Council's directives and decisions, and gives necessary instructions to NCBs of the Eurozone and is responsible for regular agenda of ECB.

The third body, which operates within the entire ESCB, however, is General Council. The General Council is constituted by President and Vice-President of ECB and NCB governors of all EU member countries. The General Council will be existing until there are any EU member countries that have not adopted euro as their national currency. This body is not responsible for monetary policy in the Eurozone. Its duty is to gather statistical information and provide assistance in preparing the irrevocable exchange rate fixing in the EU member countries that have not adopted euro.[14]

The key element of the entire European central banking system is represented by the European Central Bank (ECB), the preparation of which was inspired by two patterns – German Bundesbank (that had represented one of the most successful central banks if not even the most successful bank of the capitalist world since 50s of the last century) and U.S. Federal Reserve System. Upon EU's incentive many researches had been conducted analysing the relationship between political independence of a central bank and performance of economy (particularly inflation). Many of the researches showed that the lowest inflation rate was reached by the countries with the highest degree of independence of their central banks. E.g. in 1973 – 1988 it was Germany, Switzerland and USA. Therefore, EU member countries decided to incorporate the important principle of central bank independence into provisions of the Treaty on European Union and ESCB Statute. Neither the ECB nor NCBs nor any member of their decision-making bodies shall seek or take instructions from Community bodies or institutions, or from any government of a Member State, or from any other body. This principle must be adhered to also by Community institutions and member states' governments. There are also other measures securing the independence of ECB (e.g. ECB has its own budget; Governing Council members retain their positions for long periods, and the central bank is not allowed to provide loans to the public sector). On the other hand, ECB must regularly inform EU bodies and the public of its activities.

The Treaty on European Union sets forth that " the primary objective of the ESCB shall be to maintain price stability ... without prejudice to the objective of the price stability, ESCB shall promote general economic policy in the Community aiming to achievement of the Community's goals specified in Article 2". This article of the Treaty determines the Community's goals to be, among others, " high level of employment ..., maintainable and non-inflationary growth, high level of competitiveness and convergence of economic performance ". Thus, the Treaty formulates an explicit hierarchy of objectives for ECB, while confirming the primary importance of price stability. On the other hand, the Treaty explicitly acknowledges the necessity of pursuing other objectives along with the price stability. Therefore, we can reasonably claim the ECB concept to be much alike the FRS, which in 90s of the last century alongside the Bundesbank was perhaps the most successful central bank within OECD.

In compliance with the Treaty (Article 105(2)) and the ESCB Statute (Article 3), the main tasks of Eurosystem are defined as follows:

- Definition and implementation of the monetary policy for the Eurozone.
- Conduct of foreign exchange operations.
- Administration and management of member states' official foreign exchange reserves.
- Ensuring smooth operation of payment systems.

ECB has the exclusive right to permit banknote issues within the Eurozone. The Treaty also includes provisions ensuring the pursue of price stability target being fully adhered to within the single exchange rate policy. The Treaty splits (though not quite clearly) the responsibility for the exchange rate policy between the ECOFIN and the ECB, while the exchange rate policy must be fully compatible with the primary objective of the single monetary policy.

The strategy of single monetary policy comprises three main elements:

[13] Members of the current ECB Executive Board are: President of ECB W. Duisenberg (the Netherlands), Vice-President of ECB who is responsible for legislation and administration C. Noyer (France), O. Issing (Germany) who is responsible for economic analyses and research, S. Hämäläinen (Finland) responsible for controlling, organisation and conduct of monetary policy, T. Padoa-Schioppa (Italy) responsible for international and European relations and for the payment system, and E. Domingo Solans (Spain) responsible for information system, statistics and banknotes. The nomination of the President of ECB was preceded by controversies between Germany and France.

[14] See, The Monetary Policy of the ECB (2001). Due to the expected EU enlargement process it can be assumed that the General Council will remain in existence for quite long.

• the primary objective of the single monetary policy of ECB is to maintain price stability within Eurosystem,[15]

• ECB comes out from the decisive role of money stock (monetary aggregates) which is quantified in a form of annual growth rates of reference value of M_3 (the Governing Council of ECB has specified the growth of the reference value at 4.5 % p.a.),

• The third element of this strategy is analysis focused on a wide range of other economic and financial indicators that have a determining importance in reviewing price development and price stability risks forecasts.

The second and the third elements, i.e. the decisive role of money stock (M_3) and the wide range of economic and financial indicators are labelled to be the two **pillars** of the single monetary policy strategy of ECB. The entire "philosophy" of this strategy is based on the learning that the mechanism transmitting impulses from the monetary policy in the relation to the price level contains certain time lags that must be accounted by ECB, therefore it must be forward-looking. Thus, ECB must regularly evaluate character and extent of economic shocks and the implied risks to the price stability .

When considering the monetary policy strategy of ECB prepared by the European Monetary Institute also strategy based on inflation targeting was discussed.[16] ECB, however, finally decided to choose the more flexible two-pillar strategy which represents the basement of credibility and transparency of entire Eurosystem.

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[15] In specification of this target the Governing Council of ESCB quantified the price stability as follows: "Price stability is defined as a year-to-year accrual in harmonised index of consumer prices within the Eurozone (HICP) of less than 2 %". Monthly Bulletin ECB (1999).

[16] For the inflation targeting strategy refer to V. Gonda (2001).