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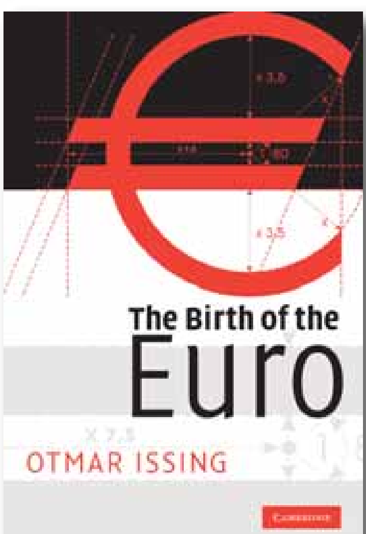
Europe at the Crossroads

BY OTMAR ISSING

Reflections from one of the euro's principal architects.



Excerpt from the forthcoming book The Birth of the Euro *by Otmar Issing (September 2008, Cambridge University Press).*

It undoubtedly required political courage to fix the beginning of monetary union definitively for January 1, 1999. To date, the euro's success has proved the confraternity of "economic doubters" wrong. The single currency has brought the member states monetary stability: internally, with a low rate of inflation; and externally, with the protection the common currency affords against the foreign exchange market repercussions of exogenous shocks that were repeatedly experienced in the past.

The political decision did not, however, remove all justification for the reservations entertained by many economists about a premature start to European monetary union. The economies of the member states still have some way to go to satisfy the conditions necessary for monetary union to function properly. The political courage at the beginning needs to be complemented by the resolve to pursue the necessary reforms.

Fiscal policy has yet to demonstrate convincingly its full compliance with the self-imposed rules of the Stability and Growth Pact. Confidence in stability is certainly not fostered if, over and over again, governments solemnly promise to follow a sound budgetary policy in the future, as they did for instance in Berlin in the spring of 2007, only to see one or the other distancing themselves from such promises a few months later. And how credible are commitments if, many years after accession to EMU, countries still have debt levels of over 100 percent of GDP—and that despite the "gift" of markedly lower interest rates associated with entry into EMU?

An especially serious long-run threat to EMU arises from the ambitions to develop the European Union in the direction of a welfare state with far-reaching social rights. Once these are given legal force, it will be virtually impossible to amend them even if glaring problems arise, since there will always be a group of countries that will benefit from the status quo.

There is no skirting the conclusion that the concept of a European social union, with wide-ranging rights that cement labor market rigidities rather than removing them, is not compatible with the principles of a stability-oriented monetary union. Under such

Otmar Issing

A *TIE* Exclusive Interview With Otmar Issing,

former member of the executive board of the European Central Bank

TIE: There is a growing interplay involving the price of oil, foreign exchange markets, and interest rates. The oil producers say we desperately need a stable dollar. Central bankers disagree on monetary policy and approaches to inflation, with the U.S. Federal Reserve focusing on core inflation, while Europe watches headline inflation. How will all of these variables play out over the next several years?

Issing: First, you are describing a scenario full of inconsistencies, and over time these will be corrected. We are all in the same boat regarding high oil prices. Our economies have to adjust. This is an impact of globalization, and those economies that are most flexible will do best. We have to accept this rise in oil prices as a reality. But this acceptance can be done in different ways. The worst reaction would be if the unions were to ask for higher wages as compensation for higher energy prices. This could trigger a game of trying to pass the buck to somebody else. For an economy as a whole the burden of the "oil tax" has to be shouldered. A sequence of increases in prices and costs would finally end in stagflation as the 1970s have demonstrated.

This time our societies have met the challenge much better. The burden of the oil tax was distributed widely. Thanks to the monetary policy of central banks, inflation expectations were well anchored. However, the continuous strong increase in energy prices puts the consensus which has prevailed so far to a hard test. Resistance to the impact of high energy prices—further strengthened by rising food prices—on real disposable income is increasing, especially in countries with stronger unions. In the context of a sequence of price shocks, central banks are confronted with a difficult challenge to preserving their credibility.

For me, one of the big questions is this: Do markets and the general public really trust that this period of low inflation which we have seen in the last twenty years constitutes a permanent regime shift, and not a temporary episode in the long history of monetary policy? The current situation will test that belief. I expect that the world's central banks will avoid the trap of trying to remedy exogenous shocks by tolerating a process of higher inflation. Otherwise we would pay a high price, first by a loss of credibility, and then through high costs to the economy to restore it. There is a big risk that we might have to go through a period of stagflation.

TIE: The subprime fiasco was exacerbated by a collapse of confidence in the financial architecture, including the sophisticated instruments used to assess and evaluate risk. Are there going to be more fundamental calls for regulatory restructuring and oversight? Where do you sense Europe moving with regard to the financial architecture?

Issing: We are at high risk of overreaction from policymakers. Politically they have a case, because financial institutions which in the past denied the need for stronger regulation asked for rescue the moment they were close to collapse. I'm concerned that the political momentum is in the direction of tight regulation and it will be very difficult to prevent that momentum from carrying us into a state of overregulation. At the same time, the ongoing crisis is evidence enough that the framework cannot just remain as it was.

One should not overlook the fact that basically the trigger for the turbulence in the financial markets was the collapse of the subprime market in the United States. As an effect of globalization, European institutions were hit not by making mistakes in mortgage origination, but by buying derivative products based on faulty mortgages. One of the ridiculous side effects is that instead of risk being distributed to those best able to bear it, risk was rather taken by those who didn't understand the products they bought. In Germany, for example, the most affected banks obviously had no understanding of the assets they had on their balance sheets.

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As for mortgage origination, the German mortgage market, which in the past my American friends sometimes ridiculed as

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being orthodox and not friendly to innovation, is equipped to be very stable. You can get any mortgage—variable rates, fixed rates, five years, ten years, etc.—but you cannot get a mortgage for 100 percent of the value of your house. This is reasonable. This kind of regulation would have also helped in other places.

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TIE: Critics of globalization think the risks are too high and that globalization is unfair, and that constraints should be put on this process. What are your thoughts?

Issing: Economists in principle are convinced that globalization, free trade, and free capital movement work best for all our societies. But this is not an answer to your question. Looking to the past, we saw several phases of what today we would call globalization which were finally stopped and even reversed. One telling example is the period of free trade before 1914. The backlash came after the First World War and the stock market crash of 1929. As we know, the United States then immediately went from free trade to strong protectionism, leading to beggar-thy-neighbor policies everywhere.World trade collapsed to less than one-third of previous levels. This example shows that history is never an extrapolation of the past or a one-way stream.

Globalization has not only winners, but losers, too. On balance societies win. But some sectors and some groups of individuals become losers, while others fear becoming losers. And this combination of losers and those who are afraid of becoming losers is very strong politically, especially in some European societies. But, as the ongoing debate reveals, the United States seems not to be immune against this trend either. It is so easy to exploit this fear politically. People are afraid to lose their jobs, their livelihoods. Workers in Germany and France are less mobile than those in the United States—they want their jobs to be close to their homes, and this is not what globalization predicts will happen. A society undergoing the process of globalization requires a lot of flexibility, and this need for flexibility, especially among older people, creates angst. There's a potential for exploitation of this angst by politicians.

I think we are in a critical moment. If the only way to save jobs and industries in Germany is to import cheap components, this is difficult to explain to the public while the mass media at the same time is showing pictures of laid-off workers because factories are transferred to low-wage countries. Despite all the reforms which have really shown remarkable success in Germany, opinion can be rather easily organized against the potential negative consequences of globalization. We economists have to do everything we can to help keep this debate rational. ◆

circumstances, the single monetary policy would be unable to yield its potential benefits, and macroeconomic tensions would inevitably arise. This risk is all the greater the more that structural unemployment—due precisely to such a lack of labor market flexibility—increases. Even leaving these consequences aside, enshrining extensive social rights at the Community level would inherently tend to be associated with transfer payments between member states, with the risk of creating deep-seated political tensions.

In reality, the opposition between social concerns and a policy of stable money that is repeatedly talked up in political debate does not exist. Inflation always affects the disadvantaged most—those who are unable to protect themselves against its arbitrary distributive effects. A free society can only endure on the basis of trust in the state and its institutions. Not least, this also includes having confidence in the stability of the currency. To take but one example: how can citizens reliably make their own private provision for old age if they cannot be confident that the currency they invest in will still retain its value after ten, twenty, or thirty years?

The fact is that European integration, starting in the west, and extending eastwards following the fall of the Iron Curtain, is built on an economic foundation, that is, on dismantling international barriers and guaranteeing free competition. This is where its great successes lie. The introduction of the single currency raises economic integration to a new level that, whether one wants it or not, has far-reaching repercussions on other, politically highly sensitive areas. Whether in fiscal policy or in the reforms needed to make markets more flexible, monetary union exacts its price. For any country interested in stability and growing prosperity, it is a price worth paying, given the return on that investment—notably also in welfare terms.

In debating the possibility of a country's exit from EMU, moreover, it quickly becomes clear that, after weighing up all the pros and cons, no country would conclude that it would be better off outside than in. Were a member state, in the context of a major crisis, actually to give serious consideration to the question of whether or not to remain in EMU, such a situation might even act as a catalyst in the implementation of long-needed reforms. There is an obvious comparison with the efforts undertaken with the aim of getting access to monetary union. The members of EMU can therefore regard any threat to leave by one of their number with equanimity. The Statute of the European Central Bank rules out solving the problem of public debt through an inflationary monetary policy, as was known from the outset. This certainty for investors in euro-denominated securities constitutes the major difference compared with national arrangements, which in principle leave this way of escaping from national debt open as a last resort.

As regards the relationship between the European Union and EMU, there remain two options for those countries that do not join the monetary union. One, which would seem to be attractive for smaller countries in particular, is to link the national currency to the euro as a stability anchor. With the exchange rate "tied down," as it were, the country becomes a "monetary policy satellite," which, as the example of Denmark shows, can certainly yield stable conditions. The other option for an EU country outside EMU is to do what is necessary to ensure macroeconomic stability on its own.

The United Kingdom has shown that this can be done, given an appropriate monetary policy regime. After a decade of growth and stability, it is not surprising that the question of a possible UK accession to EMU is currently completely off the agenda. In the light of the much-vaunted British pragmatism, one can fairly safely predict that thought will only be given to such a step if two conditions materialize: firstly, the United Kingdom experiences a sizeable and persistent macroeconomic disturbance; and secondly, a glance at "Europe" shows EMU to be thriving or at least functioning properly. At all events, for any country "going it alone"—not just for the United Kingdom and the pound sterling—the risk remains that, at some point in the future, international capital movements may have a considerable impact on the exchange rate.

Nine years after the start of EMU, Europe is at the crossroads. With the establishment of the single market, economic integration is in principle complete, even if its implementation in important areas—services, free movement—still has major obstacles to surmount. In the monetary field, the success of the euro is beyond doubt. Hence ambitions and hopes are being pinned on progress in political integration. In a sense, politics is picking up where it left off following the Second World War and the failure of the European Defence Community project.

European integration has never been a linear process. Over and over, crises had to be overcome, fresh starts were made and progress was achieved. The image of a cyclist who falls over if he comes to a stop has been used to describe the need constantly to move forward. In the meantime, monetary union has reached a stage where this "bicycle theory" carries a lot of risks. "Europe" has perhaps come closer to a "final state" (in the words of Udo di Fabio) than many would admit. Failure to acknowledge this is more and more a source of risk. Not everything that actually or purportedly serves the end of closer political integration leads us in the right direction. The difficulties that such endeavors may create for the functioning of the single monetary policy have been pointed out in several places in this book.

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The European Central Bank is well equipped to continue pursuing its policy to safeguard the stability of the euro in the future. There are two sources of vulnerabilities. Firstly, since the remarkable agreement that was reached on the stability-oriented Statute of the ECB, policymakers have so far failed to play their part in ensuring the lasting success of monetary union, a failure that is manifest in the violations of the Stability and Growth Pact and the unfulfilled promises to make markets more flexible. Secondly, the "social orientation" of many efforts towards greater political integration is at variance with the successful pursuit of the single monetary policy.

What will the future bring? It is of course easy to speculate. Based on the status quo and visible intentions, various scenarios might offer pointers to conceivable developments.

STRENGTHENING OF EMU

With the Statute of the ECB, the monetary policy for a stable euro is on a firm footing. Following the successful start and the stability demonstrated in all the years since, this scenario would see policymakers making every effort to secure the full benefits of the single currency. To this end, there would be full compliance with the rules of the Stability and Growth Pact. The internal market would be quickly completed and the reforms committed to under the Lisbon Agenda would be fully implemented. The resultant greater market flexibility, especially labor market flexibility, would vastly improve the ability to adjust to economic shocks. Under such circumstances, the single monetary policy would yield its full benefits, with the principle of "one size fits all" applying to the fullest extent possible. Over and above the active shaping of the environment in which monetary policy operates, this scenario presupposes that policymakers desist from pursuing any projects—of the "social union" sort—that would jeopardize the success of EMU.

Monetary union based on this model, thanks to stable money, sustained economic growth, and high employment, would be underpinned internally by the trust of its citizens, and would become even more attractive to those outside, in particular for the "not-yet-members" of the European Union. The euro would further strengthen its position as an international currency and, owing to its internal stability, also make a major contribution to international monetary and financial stability.

CONFLICT-FREE EXTENSION OF POLITICAL UNION

In this scenario, the European Union would progress further towards political union, without coming into conflict with the conditions necessary for a stability-oriented monetary union. In the areas that have long been at the center of efforts towards that end, the member states would agree to transfer national responsibilities to the Community. Ideas and proposals would cover areas ranging from foreign policy to defense policy and even internal security. This development towards political union could proceed more or less in parallel with scenario one, the strengthening of EMU. There remains the question of whether all twenty-seven EU member states would end up also being members of EMU.

The caveat to this scenario is how the EU institutions would be funded in order to enable them to implement the proposed measures. For such a plan to succeed, it would need the backing of EU citizens not just for the political objectives but also for their financing.

POLITICAL UNION IN CONFLICT WITH EMU

While scenario two largely leaves aside economic aspects, a third scenario would cast a cloud over future developments in Europe. This would see the European Union moving in the direction of a welfare state with codified social rights, welfare entitlements harmonized at a high level, and still tighter regulation of the labor market. Monetary union founded on the stable value of money and a European social union of this sort would be an utterly incompatible mix.

In such circumstances, monetary policy would be unable to produce its hoped-for positive effects. The "single-size" monetary policy would simply not fit all. Exogenous shocks and internal imbalances would have a marked impact on employment and growth in individual countries. Across the euro area, the economy, and hence employment and real wages, would lag behind the potential and outcomes in comparable regions. In such a situation, the ECB would still do its utmost to fulfil its mandate of monetary stability, but it would be increasingly exposed to political attack. With the economy underperforming, EMU would confirm the skeptics' predictions. Confidence in the euro would be diminished, not just among the citizens of the euro area, even if the unsatisfactory state of affairs could not be laid at the door of the ECB.

In such a scenario, the single currency would risk straining cohesion within the Community rather than fostering a sense of identification. However, it is not just that the foundations of EMU would be undermined—in itself a disastrous outcome; there would in addition be political tensions. High-level European welfare norms and social rights enshrined at EU level and therefore enforceable across "Europe" would put the Community to a critical test, not least owing to the calls for substantial intra-Community transfer payments that would unavoidably result. Even within a nation state, persistent large transfer payments between regions can create considerable tensions. Such an increase in transfer payments between EU (or EMU) member states is highly unlikely to find approval among those who would have to fund it through the taxes they pay, all the more so as transfer arrangements of this kind almost inevitably create wrong incentives. It might in the end be tempting to create or amplify a "transfer need," or in any case to do nothing that would mean becoming a "giver" rather than a "taker."

The threat that such a scenario would pose to European cohesion resides not least in the fact that, once set in stone in EU legislation, entitlements are very difficult if not impossible to revoke. In this regard, therefore, Europe would be well advised not to adopt a trial-and-error approach.

Naturally, one can conceive of any number of ways in which elements from these three scenarios might combine to shape the further integration of Europe. The respective outcomes would be determined by whichever of the elements came to dominate. Monetary union, the stability of the single currency, is at any rate an asset one should not risk losing. Of course, the currency is not everything, but without a stable currency one cannot predict a rosy future for European integration.

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European monetary union, the pre-eminent project of recent integration policy, is after all built upon the promise of stable money, a promise that, all skepticism notwithstanding, has hitherto been fulfilled.

In the end, one needs constantly to recall just how much today's Europe differs from that of the twentieth century, especially the first half of the twentieth century. The more remote the year 1945 becomes, the more the memory of war and destruction and Europe's subsequent resurgence risks being lost. It is one of the reasons why I should like to end this book with a small personal recollection.

In the European Central Bank's first year, I happened to be sitting at lunch one day with the then Vice-President Christian Noyer for company. Swapping personal experiences, we discovered that his father, a French soldier, had been interned in a German prisoner-of-war camp at the same time as my own father was in France with the German occupying forces. Over fifty years later, the sons of these two combatants were working together at the ECB to help make the euro, the common currency, a success, and not just in France and Germany. ◆