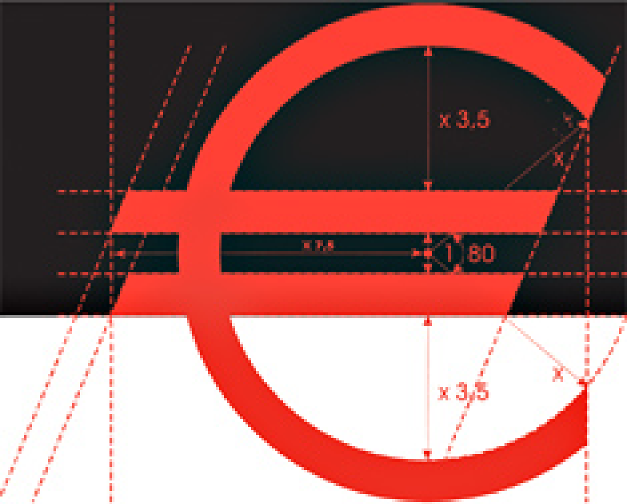

The Birth of the Euro

OTMAR ISSING

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THE BIRTH OF THE EURO

Today, 318 million people in 15 countries use the euro, which now rivals the importance of the US dollar in the world economy. This is an outcome that few would have predicted with confidence when the euro was launched. How can we explain this success and what are the prospects for the future?

There is nobody better placed to answer these questions than Otmar Issing, who, as a founding member of the Executive Board of the European Central Bank, was one of the euro's principal architects. His story is a unique insider account, combining personal memoir with reference to the academic and policy literature.

Free of jargon, this is a very human reflection on a unique historical experiment and a key reference for all academics, policy-makers and 'eurowatchers' seeking to understand how the euro has got to where it is today and what challenges lie ahead.

OTMAR ISSING is President of the Center for Financial Studies at the University of Frankfurt and Honorary Professor of the Universities of Frankfurt and Würzburg. He is a former member of the Board of the Deutsche Bundesbank (1990–8) and a founding member of the Executive Board of the European Central Bank (1998–2006).

The Birth of the Euro

Otmar Issing

Translated from the original German
by Nigel Hulbert

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Preface

The date 1 January 1999 marks a milestone in monetary history. Eleven national currencies – not least among them the D-Mark, held in such high esteem by the citizens of Germany – ceased to exist. Their place was taken by the euro, as the single currency for over 300 million people. In the meantime, the euro area has grown, and now encompasses a total of fifteen countries.

The birth of the euro is a unique event. Never before had sovereign states ceded their responsibility for monetary policy to a supranational institution. This constellation – on one side, a central bank (the European Central Bank, ECB) and a single monetary policy; on the other, nation states that largely retain their competencies in the areas of economic and fiscal policy – creates a particular kind of tension in the interrelationship. Quite a few observers, with probably the majority of economists to the fore, were more than sceptical as to the outcome of this experiment. To begin with, will the euro get off to a good start? Under the prevailing circumstances, how likely is it, if at all, that the euro can be a stable currency? And then: what about the future? Can European monetary union (EMU) survive in the absence of political union?

The subject has been comprehensively addressed both by economists and in the media. Since well before the start of EMU, and even more so afterwards, there has been a vast output of economic research. Hardly surprising, in light of the fact that the political decision presented economists with a special kind of experiment whose many different facets offer broad scope for in-depth theoretical and empirical studies. Among economists, as in the media, the pendulum has swung back from a predominantly sceptical assessment towards regarding the experiment as having been successful – initially with some surprise, but meanwhile almost as though it could have been taken for granted. After nine years, most observers pronounce the ECB and the euro to be an unqualified success. In so doing, they tend to forget just how difficult it was to prepare for the start of EMU, to build up the ECB as a new institution, and to lay the foundations for a single monetary policy.

This volume describes the road to the euro, and the setting-up of the ECB and of the single monetary policy, from the vantage point of one who was closely involved in a leading position. After leaving academia in October 1990 to join the Directorate of the Deutsche Bundesbank, I was appointed to the Executive Board of the European Central Bank on 1 June 1998, the date of its foundation, and hence placed at the centre of this unique event. Being responsible for the Directorates General for both Economics and Research, I was called upon to play a key role, in particular in the preparatory stages and the early days of the single monetary policy. To be confronted with what was in every way a special challenge, and at the same time to be granted the opportunity to help shape the response to it: what more interesting task could an economist ever hope to be given?

In this book, my aim is to let the reader share this experience of what is probably the most exciting event in modern monetary history. To that end, I analyse the gestation and birth of the euro from an economist's perspective, and at the same time describe the process of and background to the setting-up of such an important institution as the ECB. On the one hand, as a supranational institution, the ECB is a special kind of central bank; on the other, the ECB and its monetary policy can serve as the model of a modern central bank in general. The closing chapters look to the future, to the challenges that lie ahead for the ECB and European monetary union.

This mix of economic analysis and historical narrative determines the flavour of the book. Most chapters are quite approachable even for readers without any major grounding in economics. In certain sections, such as that dealing with the choice of monetary policy strategy, the need to consider the background of economic analysis and research is a determining factor.

The bibliographical references are for the most part to other works by the author. Their publication was largely contemporaneous with the processes described in the present volume and they serve to illustrate how every step, every decision taken was accompanied by intensive economic discussions within the ECB, in particular with my own staff. In turn, these publications contain extensive references to other literature. The book should therefore form a useful starting point for students and those wishing to pursue the topic further.

The present work is a reflection of the successful collaboration with my colleagues in the Directorates General for Economics and Research. I shall never forget the way in which they supported me in accomplishing my tasks through their outstanding professional competence, their commitment and their loyalty.

For their many valuable comments and criticisms, I should like to thank Marcel Bluhm, Vitor Gaspar, Hans Joachim Klöckers, Julian von Landesberger, Klaus Masuch, Wolfgang Modery, Wolfgang Schill and Volker Wieland, and also Ludger Schuknecht for individual chapters. Lars Svensson and John Taylor were kind enough to comment on passages relating to the choice of monetary policy strategy. Not least, five anonymous referees encouraged me in my project and at the same time made numerous suggestions, many of which I have followed. Wolfgang Modery took care of the figures and tables. My assistant Marcel Bluhm was an indispensable aid to me on all technical matters. Birgit Pässler untiringly transposed my manuscript into readable text. Chris Harrison guided the publication process at Cambridge University Press, and kindly offered to take charge of preparing the index.

In Nigel Hulbert I found the ideal German–English translator, and I am also grateful to him for a number of valuable suggestions concerning the text.

I dedicate this English-language version to my colleagues at the European Central Bank as an expression of my gratitude for their outstanding collaboration over the years.

Otmar Issing

ONE

The euro in 2008

Today, in 2008, the euro is the common currency of fifteen EU countries with around 320 million inhabitants, and most other member states are aiming to join the euro area in the near or not-so-distant future. With the issuance of euro-denominated banknotes and coins at the beginning of 2002, the former national currencies were taken out of circulation, their names henceforward consigned to the history books. The fact that isolated attacks by populist politicians fail to elicit much support for a return to the national currency only serves to confirm that the common currency has become an irreversible reality, and that going back is not really an option.

Globally, too, the euro has become firmly established as the second most important currency after the US dollar. By some measures, for example in terms of its share of global official reserves, the euro still lags a long way behind; but in other respects, notably in its role as currency of denomination for credit, the euro has more or less drawn level with the American currency. Investors all around the world put their faith in the euro and buy euro-denominated long-term paper. Confidence in the stability of the euro is reflected in inflation expectations that are firmly anchored at low levels, helping explain what are, historically, exceptionally low long-term nominal interest rates.

Over the nine years that have passed since its birth on 1 January 1999, the euro has been a striking success. With an average annual rate of inflation of around 2 per cent, it can deservedly be called a stable currency, both in historical terms and internationally.

This success story stands in marked contrast to many of the forecasts made before its introduction. The doomsayers either ruled out the currency union getting off the ground at all, or predicted its early demise, or at the very least thought it would lead to inflation – none of which actually materialised. So were all the concerns unfounded? Can one simply assume that the euro's success story will continue?

The fact remains that for sovereign states to cede their authority in the monetary sphere to a supranational institution, while retaining a greater or lesser degree of autonomy in other policy areas, is historically unprecedented. It is no coincidence, therefore, that observers speak of an experiment, an experiment whose outcome seems likely to remain uncertain for a considerable time to come.

The future offers excellent scope for speculation. But what are the reasons that lay behind the euro's good start and its success to date, and where do potential vulnerabilities lie? This book attempts to provide an answer to such questions.

TWO

Historical background

The rocky road to monetary union

The idea of creating a monetary union in Europe can be traced back a long way. Indeed, in the first century AD, a merchant could pay with the same money, the denarius, throughout his long journey from Rome via Colonia Claudia Ara Agrippinensium and Lutetia Parisiorum to Londinium – that is, via Cologne and Paris to London. Sixteen centuries later, however, the same journey involved an unending sequence of money changing and conversion. Trade was heavily hampered by high tariffs between countries and even broke down in the frequent times of war. In Germany alone, if one may call it that, a hundred different territories exercised the right to mint their own coinage. The number of customs borders in this region in 1790 has been estimated at some 1,800. It was only with the establishment of the customs union in 1834 that most trade barriers disappeared in Germany. And it was only following political unification within the German Reich in 1871 that the multiplicity of coinages was fully abolished and the Mark introduced as the common currency.

What lessons might we draw from comparing these epochs of European history?

There were two conditions that characterised the common currency period:

- The stability of the currency was ensured by the natural scarcity of the metal.
- A common currency went hand in hand with political union under the Pax Romana.

The loss of monetary stability due to the persistent debasement of coinage and the disintegration of the Roman Empire undermined the old system. There was no single currency in Germany again until the adoption of the gold standard and the establishment of political union under the German Reich in 1871. Elsewhere, other nation states such as France and Great Britain had brought about a single currency much earlier. The notion of a common *European* currency was aired now and again by individual authors or groups, often in conjunction with ideas for the political unification of Europe. But for a long time, there were no serious, still less promising, attempts towards such an objective.[1]

It was only after the horrors of two world wars that the project of European integration was given a new and decisive impetus. This is not the place to depict the various stages in this process, starting with the establishment of the *European Coal and Steel Community* in 1952. If at all, the goal of a common currency played only a background role.

Just a few years after the start of the *European Economic Community (EEC)* in 1958, there were occasional suggestions that work should also be undertaken towards monetary integration. A concrete first step was taken by the heads of state or government assembled at the summit conference in The Hague on 1 and 2 December 1969. They agreed that 'on the basis of the memorandum presented by the

[1] In 1712 Abbé de Saint Pierre, for example, published an essay, 'Projet de traité pour rendre la paix perpetuelle entre souverains chrétiens'.

On the history of money in Europe see F. Berger, *12 into One: One Money for Europe* (Frankfurt, 2001).

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'. In autumn 1970, the 'Werner Group', named after the then Prime Minister of Luxembourg who chaired it, presented its report, which essentially contained a plan for the establishment of economic and monetary union in three stages. A short time afterwards, it was considered that this project should be completed over a period of ten years.

This ambitious aim was basically doomed to failure from the outset. For one thing, the international environment was to be affected in the years that followed by major turbulences: the floating of the D-Mark on 19 March 1973 signalled the final collapse of the Bretton Woods system of fixed exchange rates, and the European partner countries differed markedly in their views on fundamental exchange rate issues. For another, although the Werner Plan was the first to elaborate on the need for progress on the economic and institutional front in parallel with monetary convergence, the positions taken were still relatively vague and marked by controversy. What was missing above all, however, was the political will to press forward with this parallel approach in a concrete manner.

The years that followed were dominated by exchange rate risks both at the global level and in the European context.[2] Following a Franco-German initiative to break the deadlock, the Council on 5 December 1978 concluded the agreement establishing the *European Monetary System (EMS)*, which came into effect on 13 March 1979. With hindsight, this date marks a watershed in the process of monetary integration, confirming as it did the 'monetarist position'

[2] For a detailed documentation of the process from its beginnings to Stage III of economic and monetary union, see H. Tietmeyer, *Herausforderung Euro* (Munich, 2005); A. Szasz, *The Road to European Monetary Union* (London, 1999).

For another perspective and a somewhat different assessment, see T. Padoa-Schioppa, *The Road to Monetary Union in Europe* (Oxford, 1994).

supported above all in French circles and based on the assumption that, with monetary agreements in place, consequences would follow in their wake. In a nutshell, the argument ran: once exchange rates are fixed, further monetary convergence is more or less bound to follow. The exchange rate crises that ensued, however – a seemingly never-ending series of revaluations and devaluations, generally combined with hefty political altercations – testified to the relevance of the 'economistic position', whose proponents included prominent politicians such as Karl Schiller as well as virtually all leading German economists. On this view, the (premature) fixing of exchange rates inevitably creates tensions that ultimately generate sudden, major exchange rate movements. Lasting exchange rate stability can only be achieved if at least national monetary policies are in proper accord.

For an understanding of the further development of monetary integration, it is important to note the following characteristics of the EMS:

1. The European Currency Unit (ECU), though formally at the heart of the system, played a much more limited role (as a unit of account, etc.) than originally intended by the French.
2. Exchange rates were determined between the member currencies (the 'parity grid').
3. Compulsory interventions were correspondingly tied not to the ECU, that is, to a currency basket, but to the parity grid.

It soon became apparent that the EMS was a system founded on the strongest currency; in short, it was a 'DM bloc'. In the wake of the strong price pressures exerted by the second oil shock in 1979/80, the consequences of this currency system quickly came to light. The Deutsche Bundesbank fought against the inflation risks with a clear, stability-oriented monetary policy, thereby sparing Germany a repetition of the sequence of inflation and stagflation that had marked the period after the first oil price shock in the 1970s. Those countries that were unable or unwilling to join in this disinflationary process were forced into repeated devaluations of their currencies as their attempts to defend the parities reached crisis point. Under this system, there was no other alternative than to align monetary policy with the Bundesbank or to devalue one's own currency.

The increasing tensions within the EMS then escalated in the crises of 1992 and 1993.[3] Unlike the oil price increase, German reunification caused an extremely asymmetrical individual 'German shock', to which the Bundesbank reacted in accordance with its mandate by pursuing a monetary policy that first quelled the upward price pressures and then gradually brought prices back towards stability.[4]

The prospect of future monetary union lent support to the Bundesbank in its stability-oriented policy course. I wrote at the time:

> If one takes seriously the timetable for establishing monetary union in Europe in the future with a single, stable currency, one should not delay in fighting inflation; from this perspective, the end of the decade is closer than it might appear from a glance at the calendar. In Germany in particular, the fears among the public that the future European currency might prove a less stable store of value than the D-Mark need to be allayed. Keeping the value of the currency stable is therefore more than ever not just in the national interest, but is at the same time an important and indispensable contribution towards realising monetary union in Europe.[5]

The experience of this period confirms the theory of the so-called 'uneasy triangle', according to which only two of the three goals of stable exchange rates, stable prices (or monetary policy autonomy) and free movement of capital can ever be attained at the same time. Since restrictions on capital movements are incompatible with common market principles – disregarding other major objections

[3] See Szasz, *The Road to European Monetary Union*.

[4] See O. Issing, 'Economic prospects and policy in Germany', Institute of Economic Affairs, *Economic Affairs*, 15:1 (Winter 1994).

[5] O. Issing, *Frankfurter Allgemeine Zeitung*, 16 January 1993.

such as the practicability of capital controls – the only choice remaining is between the other two objectives. The option of flexible exchange rates was never seriously entertained in the context of European integration.[6] However, the regime of fixed exchange rates that were nonetheless subject to sudden upward or downward revaluations, as embodied in the EMS, had over time proven to be so vulnerable to crises that it appeared to be only a matter of time before another crisis entailed even bigger abrupt changes in exchange rates. Both the magnitude and the flexibility of international capital flows went far beyond anything experienced in the past.

In the 1992–3 turbulences, the devaluation of the Italian lira by more than 30 per cent against the D-Mark had changed competitive positions in bilateral trade at a stroke, leading to serious discussion at national level on the need to take countermeasures. There was an increasing risk that the next exchange rate crisis might jeopardise major achievements of economic integration such as the free movement of goods, services and capital.

Thus, out of the set of three objectives, it was basically 'only' monetary policy that remained on the table.[7] The solution whereby one country's currency took the lead was obviously untenable in the long run. For one thing, there were political arguments against it. The larger EMS member countries in particular were unwilling to accept a lasting necessity to act more or less in lockstep with the monetary policy of the Bundesbank. For the Bundesbank, conversely, it was not possible to pursue a monetary policy oriented towards 'European objectives'. On the one hand, this would not have resolved the sovereignty issue for the other countries; on the other, the Bundesbank would not have been able to fulfil its national mandate under the law,

[6] On this discussion, see O. Issing, 'Integrationsprozeß, Währungspolitik und Wechselkurse in der EWG', *Kredit und Kapital* (1969).

[7] On this analysis, see O. Issing, 'Europe's hard fix: the euro area', *International Economics and Policy*, 3:3–4 (2006).

nor would there have been any reasonable political, empirical or theoretical basis for such a policy orientation.[8]

The logic of the process meant that ultimately the only possible solutions were basically the two 'cornerstones', either flexible exchange rates or the path towards a common currency. Thus the creation of the EMS in 1979 had indeed laid the foundations for a common currency. In that sense, the proponents of the system of fixed exchange rates who had this ultimate aim in mind from the outset may feel themselves vindicated. Admittedly, looking back at the crises of the 1980s and 1990s one can see what huge risks had to be overcome in the process. Nor, by any means, does entry into monetary union mean that all the reasons for past crises have been, as it were, automatically eliminated. At the outset, the setting-up of a supranational central bank and the communitisation of monetary policy only initially resolve the trilemma of the 'uneasy triangle'. For the common monetary policy to be successful and for monetary union to be safely preserved, further efforts are needed. But more on that later.

The decision in Maastricht

The final decision on the shape and starting date of Stage III of European Economic and Monetary Union (EMU) was taken at the Maastricht summit on 9 and 10 December 1991. In the run-up to the summit, there had been intensive groundwork and negotiations at all levels, with two groups in particular playing a key role.

Firstly, there was the Committee of Central Bank Governors, composed of the governors of the central banks of the EU member states. Chaired by Bundesbank President Karl Otto Pöhl, the

[8] For a time, incidentally, those opposing the idea of a single supranational central bank discussed alternative solutions whereby monetary policy would remain with the national central banks but exchange rates would nonetheless be fixed once and for all, i.e. irreversibly. Such a 'system', if it may be called such at all, would have no anchor, and its inevitable consequence would be competition in inflation policies. The idea was therefore rightly dropped.

Committee of Governors had unanimously approved a draft statute for a European Central Bank that was modelled largely on the Deutsche Bundesbank Act. Inter alia, the Governors had advocated the principle of 'one person, one vote' in monetary policy matters.

Secondly, there was the so-called 'Delors Group', set up on the occasion of the Hanover summit on 27 and 28 June 1988. In addition to European Commission President Jacques Delors and the EU central bank governors, this group also included Alexandre Lamfalussy, General Manager of the Bank for International Settlements, Professor Niels Thygesen, Miguel Boyer, President of the Banco Exterior de Espagne, and Frans Andriessen, member of the European Commission. Unlike the Committee of Governors, the Delors Group was beset by controversy, in particular as regards the transition from the status quo to monetary union.

In its report of 5 June 1989, the Council of Experts at the German Federal Ministry of Economics (of which I was at the time an active member) summarised its reservations, which to a large extent mirrored the opinion of the vast majority of economists in Germany, as follows:

> The underlying idea of the Delors Committee regarding the path towards monetary union is for monetary policy in Europe to be gradually communitised. Many of the individual arrangements for the two preliminary phases during which the Community is to become ready for monetary union serve this end. With all due respect for the difficult task of giving the EC countries the necessary guidance (towards ever greater convergence in stability policy) during this readying process: the Council of Experts considers this idea wrong. In matters of monetary policy, the Community is presently being guided, and guided well, by the Bundesbank, as the Delors Committee also acknowledges. At a later date, the objective is that it shall be guided equally well by a European Central Bank. In the interim, it is unwise increasingly to entrust this guidance de facto to co-ordinating bodies at Community level, with the national central banks only formally retaining ultimate responsibility until the end of Stage II.

The division into three stages can be traced back to the Delors Report of 17 April 1989. Meeting in June 1989, the European Council decided on the following: Stage I in the implementation of EMU would begin with the removal of all obstacles to capital movements between member states on 1 July 1990; Stage II would be marked by the establishment of the European Monetary Institute on 1 January 1994; finally, Stage III would commence on 1 January 1999 with the transfer of responsibility for monetary policy to the European Central Bank. For the sake of simplicity and conciseness, we refer in what follows to the start of monetary union on this date.

In its statement of 19 September 1990, the Central Bank Council of the Deutsche Bundesbank had pronounced itself in favour of a European Economic and Monetary Union. At the same time, however, the Council pointed out that clear and binding conditions for monetary union needed to be agreed on beforehand in order to put it on a sound footing. Following the Maastricht Treaty, the *European Monetary Institute (EMI)* was established with the start of Stage II of EMU on 1 January 1994. The EMI was given no monetary policy powers; rather, it was intended to be the central institution for preparing the third stage of monetary union. Headed by Alexandre Lamfalussy and with a very small team, especially in the early stages, the EMI carried out sterling work. Not least, the staff of the EMI would later form the nucleus of the ECB's personnel.

To outsiders, the fixing in Maastricht of a latest starting date (1 January 1999) for entry into Stage III of EMU came as a complete surprise. It accorded with the desire not just of the French President François Mitterrand but also of Germany's Federal Chancellor Helmut Kohl to set an irreversible deadline for the start of monetary union. In so doing, the Maastricht Treaty reflected 'monetarist' principles, but at the same time it took account of 'economistic' considerations by laying down preconditions – the so-called *convergence criteria* – for entry: only those countries which were sufficiently prepared for a single monetary policy regime would be allowed to take part in Stage III.

The years between Maastricht and the start of monetary union on 1 January 1999 would be marked by the tense relationship between these two approaches. The more the convergence process created the conditions for a lasting, stable monetary union, the more its inception would come to resemble a coronation. The more remiss future members were in doing their homework, that is, in putting domestic policy on a lasting, stable footing and thereby mutually converging, the more their entry into monetary union would be premature from the 'economistic' standpoint, and hence the more the monetarist thesis – adjustment to the conditions of monetary union *post festum* – would be tested.

Without anticipating the analysis to follow, it can be said that, right up to the present day, these two explanations have conflicted with each other, or, more accurately, competed with one another in a dynamic process. The setting of a deadline for the start of monetary union inevitably triggered a process of adjustment. But the fact of monetary union has not in itself sufficed to ensure its optimum functioning. Nine years on, the necessary economic policy adjustment to the conditions of monetary union has by no means been fully achieved.

In its statement of February 1992, the Central Bank Council of the Deutsche Bundesbank expressed its satisfaction that the planned institutional design for the final stage, in particular the Statute of the future European Central Bank, was largely in line with the Bundesbank's recommendations. To successfully pursue a policy of stability in the monetary union, it was crucial that the convergence criteria be strictly applied in selecting the countries that would participate. At the same time, the Central Bank Council reiterated the comment in its 1990 statement to the effect that a monetary union is 'an irrevocable joint and several community which, in the light of past experience, requires a more far-reaching association,