Debates and Comments

Some reflections on monetary governance and European institutions

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Since the beginning of their activity, the heads of the European Central Bank abounded in declarations reversing the well-known principle of the Radcliffe Report: "When you do a policy, never announce it". Considering the impact that announcements and policies have sown, it is time for a critical review of the story of the euro. The single currency entered into circulation on 2 January 2002, the fruit of a great idea that has been poorly executed, however, in three respects: the institutional regime governing the euro, monetary management and policy communication.

The euro was and remains a grand idea because the single currency: *i)* testifies to the will to have a truly single European market, which must necessarily speak in a single monetary "language"; *ii)* has generated greater economic cohesion among the euro-area countries than there would have been if the national currencies had remained alive; and *iii)* has brought out the existence of structural economic and social disparities within the Union of a magnitude that no well-organized society can accept.

The birth of the euro sent a powerful warning to a Europe that intended to pursue political growth by constructing a "social market" with constraints, controls and sanctions and only marginally through coordinated action by the member states. This approach worked as long as the conditions that gave impetus to the idea of cooperation among European states persisted; now that they have ceased to exist, the continent's new leaders have fallen far short of the mark in grappling with the difficulties, particularly those that the new currency has faced in its first five years.

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The euro has been poorly implemented because the design was inspired by the monetarist school without equipping the new currency with the antibodies necessary to cope with the complex reality in which it would operate and the gamut of problems created by the other Maastricht Treaty institutions, primarily those bearing on fiscal policy. The problems range from the non-optimal nature of the euro area to the constraints placed on the operation of fiscal policy, which ought to have had a good deal of built-in flexibility in order to compensate for the monetary anomaly.

Management of the euro has stumbled amidst the constrictions and incompleteness of the European institutions, most notably with regard to exchange rate management, which is still in the hands of the national governments. The governments have opted to delegate "everyday" decisions to the ECB and to retain power over "fundamental" decisions. However, the latter are made by the Council of Economic and Finance Ministers (Ecofin) in which the euro-area countries are still a minority, an absurd institutional arrangement. In truth, the ECB has been more preoccupied with the "weakness" of the budgetary situation and "robustness" of wages in many member states, sending out a stream of warnings, than with its own monetary management. That is, the ECB most carefully minded other people's business but paid little attention to its own, and now it tells us that, having looked at us, it does not rule out a monetary tightening in order to avert the inflationary risks that it itself has spawned.

In addition, all the national and European institutions committed a serious blunder when they put the euro into people's pockets. No instructions were given on how to avoid the dangers that were attendant to the cash changeover, while there was (and still is) lavish praise for the supreme benefits of the euro's advent. Unfortunately, not only do the majority of people not believe in these benefits, but they are inclined to fault the euro for things for which it is not to blame.

In short, we have gone through a lackluster lustrum. Plain proof of this is the fact that public opinion holds the euro responsible for inflation even if the statistics do not corroborate this. The response of the ECB, the governments and experts – who instead of lighting the way trumpet the governments' line – is that public opinion is wrong, or, to put it in polished terms, perceived inflation is higher than measured inflation. They maintain, that is, that they are in the right. Now, there is only one way to endow this response with a modicum of meaning: to construct a frequency distribution of the price increases whereby the mean is that observed. Such an exercise, however, would show that this mean has no significance because it is not the result of a normal distribution of inflation, thus disproving the ECB's self-proclaimed "successful policy". Alternatively, one could demonstrate that the basket of products and the weights used for measuring inflation do not correspond to the actual consumption of European households and require revision, thereby shifting attention and responsibility onto the Union's statistical institutes.

Beyond doubt, some sectors and areas of the European market have experienced considerable inflation since the introduction of the euro. Denying this breeds lack of confidence in the euro, for, as we learned from Luigi Einaudi, who calculated inflation using his wife's accounts, people know the value of the currency better than do the statistical institutes.

The problem should be addressed by explaining that inflation depends on the competitiveness of markets, and that the introduction of the euro gave sellers an opportunity to wield market power in certain sectors or parts of Europe. Taking advantage of widespread ignorance and confusion about the working of the new monetary regime, they exploited their position of rent, successfully raising prices until they ran into a sharp slowdown of demand, which is what we have seen the last three years. The disgruntlement of the majority of the population originates in this mistaken idea of the cause, not in inflation perceptions, but this has not been properly elucidated.

Instead of encouraging the growth of competition in services and agriculture after advancing it far in manufacturing, Europe's leaders have struggled against the Bolkenstein directive, sterilizing its positive effects on the purchasing power of wages. Wages cannot increase in Europe until India and China, to name two key competitors, vent their need for wellbeing in more generous compensation of labour. Those who should have discerned and eliminated the error that the less affluent classes paid for following the introduction of the euro – the continent's politicians, trade unionists and central bankers – worked in the opposite direction, maintaining less-than-fully competitive conditions for some four fifths of European output and thereby preserving conditions conducive to inflation. So it is not the euro that should be in the dock, but an entire cadre of leaders at Community and national level.

Inflation notoriously hurts the disadvantaged more than the affluent, working counter to the income redistribution legislated by parliaments. It undermines the democratic principle of no taxation without representation on which the delegation of autonomous powers to the central banks is founded. If the ECB ceases to consider inflation as depending exclusively on the conduct of monetary policy, claiming the merit when things go well but blaming others when they go badly, it deprives itself of the logical and practical basis of its autonomy – all the more because its statute assigns it a narrow mandate for action (inflation) rather than, more sensibly, a dual mandate like that of the US Federal Reserve (inflation and economic growth).

Monetary stability depends not only on domestic prices but also on external prices. Consequently, the failure to establish the ways in which the external value of the euro is determined – or, more precisely, the fact that its determination is entrusted to an international market dominated by the US dollar and to the effects of the monetary policy decisions of the ECB in Frankfurt – leaves the responsibility for safeguarding the purchasing power of European incomes up in the air, creating a wholly incomprehensible and socially unacceptable institutional arrangement. The failure to complete the political design renders the already weak democratic structure of the European Union more vulnerable still.

Small wonder, then, if the voters in France and Denmark rejected the draft European Constitution. What is surprising is that the politicians lacked the courage to submit the question to European public opinion in its exact terms, preferring to insist on terms whose efficacy is utterly exhausted and even accusing the public of failure to understand, when actually it is the terms themselves that are incomprehensible. And yet the president of the European Parliament rightly affirmed that what was rejected was not the text of the Constitution but its context, which I have sketched out above. The president's observation, certainly intelligent, is too generic, however, to turn the tide of European public opinion. What is more, the European Parliament itself belied the thrust of his remark, gutting the directive on the liberalization of services by eliminating the country-of-provenance clause, i.e. competition between workers. As with any international treaty, rather than rendering the directive virtually toothless, it would have been possible to approve it as initially proposed and strengthen the safeguard clause in the event of serious harm to workers' welfare from competition.

The "institutional question", vigorously posed by Angela Merkel as rotating president of the European Union, cannot be limited to a renewed campaign for the Constitution but must also extend to a revision of the institutions that preside over European economic policy. The most urgent problem remains the governance of the external value of the euro; failure to solve it clouds the outlook for growth.

The euro area, already undermined by the countries that have stayed out and by its internal economic and regulatory divergences, is certainly not in a position to persuade the United States to forgo the world monetary sovereignty that America believes it still has. Nor can the euro area induce China to pledge to maintain the unilateral pegged exchange rate regime that protects the euro from sudden appreciation. Nevertheless the lack of clear ideas or an unwillingness to propose solutions is in itself a serious fault, and this despite the fact that there are valid arguments with which to bring the United States to a new world monetary conference. The strongest is that world monetary sovereignty has in fact passed into the hands of China, with its still fast growing trillion dollars of official reserves, so that the Chinese can set the exchange rate of the dollar or the euro as they like – all the more if they intend to use their reserves to buy up strategic raw materials on the world markets.

One neither reads nor hears a single word about this crucial problem for the future of a Europe that has lost its *raison d'être* in the ideals of peace, having attained them internally, and seeks its justification in a material wellbeing that has so often produced only disenchantment. Yet every declaration by a multinational corporation or foreign country that it intends to use the euro is greeted with mounting jubilation, showing that pure prestige outweighs the accompanying handicap of a depreciated dollar. Recently, gratification has been voiced for the fact that the euro has overtaken the dollar in terms of the amount in circulation, which at best is only a sign that the euro-area payments system is less efficient than that of the United States. In other words, we are far from being a cashless society and find this reason to rejoice!

We have also criticized the rigidity of the deficit parameter, set at a level – 3 per cent of GDP – that has no scientific basis and is unacceptable because the euro area is not an optimal currency area. In a rapidly changing world that demands flexible response of all players and in an area where pronounced economic disparities persist, tying the deficit parameter to the level established during the run-up to the Maastricht Treaty of 1992 on the basis of the ratio then obtaining in Germany and close to that in France can only be considered a grave political error.

Apart from the logical and practical arbitrariness of the choice of a fixed parameter, one political and two technical considerations tell against it. The political observation is that the rigidity of the parameter was dictated by the self-styled virtuous countries in order to protect themselves from those they deemed less virtuous, an assessment not devoid of justification at the time but later belied by events. The worry was that the less virtuous would take advantage of the single market to preempt the savings of the virtuous and use these resources in unproductive or competition-distorting ways. One can object that the rigidity built into the system was not an appropriate device to dispel this concern.

The technical points regard the denominator of the parameter, GDP. It is consistent neither with the variable to be safeguarded, saving, nor with the reality of things. In fact, the parameter should have been set as a ratio to saving, not GDP, since it is the volume of saving that represents the limit of utilization by a country, unless the idea was to use the worry to achieve the opposite end, i.e. to permit the "virtuous" countries to capture any excess of saving in the "non-virtuous". Nor is the parameter acceptable in the light of the host of structural differences in production and labour in Europe. In countries, like Italy, where there is considerable self-production for own use – this refers not to the underground economy but to non-market household production not captured by the national accounts – the Maastricht parameter is structurally higher in statistical terms than in the member countries where more women work outside the home and basic needs such as cooking, washing, ironing, home-cleaning and routine repair and maintenance are satisfied through market transactions, raising the level of GDP "by definition" and consequently lowering the deficit/GDP ratio.

But who distinguishes what is good in Europe from what is bad? It has been written that the Community's governance system is now based on the power of the Commission to make proposals, the power of the Council of Heads of State and Government to make decisions, mitigated to a modest but increasing extent by that of the Parliament, and the control powers of the Commission. European construction is concentrated on the third of these pillars, and naming, blaming and shaming is the Commission's main focus. The Commission operates in part like a policeman and in part like a judge, depending on the issue and country.

Little work has been done on this aspect, which came to light with the Lisbon Strategy or, to be precise, with its relaunching in 2005. The Strategy had transformed the Commission from controller to facilitator, much to the displeasure of the Ecofin Council, which succeeded in reducing its implementation to the former function as examiner. This for three main reasons: *i)* because the offices of the Commission were set up to do this and the task entered into the habits of the Community's officials, becoming a "corporate culture". The officials are and remain controllers; *ii)* because the role of facilitator makes them responsible for results and they do not intend to shoulder the consequences, for it is easier to be a critic than a performer; and *iii)* because the resources the member states assign to the Community institutions are insufficient for these to play a direct role as promoters of development.

Only the third of these reasons has a practical foundation, but it is afflicted by circularity: the member states do not provide resources owing in part to their lack of confidence in the Commission's ability to use them as well as to their reluctance to transfer the decisions on development, i.e. further portions of their economic sovereignty. This state of affairs is defended by influential countries, such as the United Kingdom and Denmark, that partake of the benefits of the single market without speaking the same monetary language and not infrequently criticize the countries that ceded monetary sovereignty to the Union. Those who remain outside the euro area can decide their own currency's interest rates and exchange rates (or the quantity of money, thus influencing the other two variables) and break the unity of the European market in their own interest. There can be no common currency without political unity, and the sooner this is recognized, the sooner the factor responsible for the Union's deficit of democracy and its attendant injustice will be eliminated.

The roots of this difficult situation go far back, but something must be done, and fast, if we want to "save" the European Union. The solution lies in what Carlo Pelanda and I call "round-trip sovereignty". The proposal starts out from the observation that the problems are many and that no single member country is in a position to solve them by itself. The Commission should accentuate its specialization as a secretariat for Community problems and limit its activity to creating dossiers on the matter to be passed on to the Council of Heads of State and Government, which in its turn can decide whether to submit them to the European Parliament for examination. Accordingly, the Commission would not be the "executive", as it now claims, but a "secretariat" whose role should be modeled on that of the World Trade Organization, which has developed an institutional culture as a facilitator rather than as a controller. Once the solutions to common problems are decided, the individual member states would be responsible for implementation, reclaiming their full sovereignty. Since the same institution cannot be at once initiator and controller, a new institution charged only with reporting deviations from collective decisions must be created. In serious cases of non-compliance, the reports would be transmitted to the European Court of Justice; in minor ones or where problems of implementation are raised, they would be sent to the Commission, which would assemble the dossier and pass it on to the Heads of State and Government for re-examination.

This year marks the fiftieth anniversary of the Treaty of Rome, when the decisions that have led to the current situation were first taken. We can celebrate that landmark event by swamping public opinion with rhetoric while leaving matters as they stand, or else we can choose to come to grips with the causes of such widespread dissatisfaction and proceed with the necessary reforms. Opting for the latter course, Pelanda and I recommended:

- giving the European Central Bank a mandate not limited to inflation only;
- defining a strategy for action within the international monetary system to bring the exchange rate of the euro under European control;
- eliminating the rigidities to which government budget balances are subject and increasing coordination of national budgetary policies;
- assigning the Commission tasks as facilitator and creating an independent European controller.

How the event is celebrated will tell us whether the European Union has lost sight of the global habitat in which it operates and the direction in which it must move in order to assure its citizens a better future. In the final analysis, it will tell us whether we are faced with a soluble “crisis of the European rationale” or with an intractable, full-blown “European crisis”.