Monetary Policy for a Larger Europe

On June 27, it was decided to let three new members join the European Monetary System (the ERM II), which is one requirement for later admission to the monetary union. Therefore, if all things go smoothly, Lithuania, Estonia and Slovenia will become members of EMU in about two years' time. Membership in the EMU is part of the acquis communautaire and as such it is mandatory for new members (Denmark and the UK have an opt out, while Sweden has decided not to fulfil the criteria for membership by not joining the ERM II). Other criteria for being admitted to EMU concern the nominal interest rate, the rate of inflation, and the infamous fiscal criteria relating to budget deficits and the debt stock. All statements from the Commission and the Council of Ministers suggest that these criteria will be interpreted strictly. This is in contrast to earlier decisions where debt levels or membership in the ERM were interpreted quite generously. Especially the deficit criterion looks rather odd now, given recent experiences. But apparently the EU is firmly committed to treating some countries more equally than others. At least, however, former Commissioner Solbes did not get his way as regards viewing the "normal" bands of fluctuation allowed in the ERM II as ± 2.25 per cent (which was the standard when the Maastricht treaty was signed) rather than ± 15 per cent (which was the normal rate when current members joined).

However generous or otherwise newcomers are treated, admitting these three will pose no problem. Estonia had a currency board to the euro (before that to the deutschmark) since introducing its own currency, Lithuania also had one for many years (earlier to the US dollar but changing to the euro in preparation for EU membership), while Slovenia had a managed float. All three countries have been generally stable with consistently low rates of inflation. The danger of speculative attacks against these currencies is thus considerably lower than in the cases of Poland or the Czech Republic, which have experienced pressure on their currencies in the past. It can therefore be expected that other countries will not have such a smooth ride into EMU. The crisis of the European Monetary System in the early 1990s at least suggests that even "strong" countries can come under pressure if their will to join EMU at all costs is doubted. Italy and the UK were among the victims then, the UK being pushed out of the ERM for the foreseeable future.

It thus seems that strict adherence to the ERM II requirement for membership is dangerous and can have adverse consequences that could easily be avoided. Many argue that it will only invite speculative attacks that can hardly be resisted, given that the ECB is likely to stand by without intervening to support currencies under attack. Accordingly, it would be more sensible to let countries join immediately once they are considered ready for membership. Since many of those waiting for membership have tight pegs to the euro, they can be considered "passive" members of EMU already. Others have opted for more flexible arrangements, not least because of the dangers of speculative attacks. Not wanting to go all the way to a currency board, their only option was a flexible exchange rate. Very tight pegs only make sense for very small economies, such as the Baltic states, while larger economies such as Poland or Hungary do not necessarily fare as well under a tight peg. In addition, the growth differences that lead to higher rates of inflation also suggest that fast growing transition economies should not have too tight pegs. It is thus certainly no coincidence that the first new members of the ERM II are very small economies.

The conclusion from this would be to let countries join EMU immediately once they are considered fit to do so without those two years in which they are vulnerable to attacks. The ECB, however, is reluctant to accept this, even indicating that it is not happy with currency boards and that it views unilateral pegs and full euroisation (the adoption of the euro as domestic currency by some states) as not being in accord with the Maastricht treaty. This for the hardly convincing reason that the exchange rate is not set "as a matter of common concern". Hence, one cannot expect the ECB to advocate a more relaxed interpretation of the entry criteria. But since this decision has to be taken by the Council of Ministers, they could show the same degree of flexibility when it comes to interpreting the entry criteria for new members as they show when it comes to assessing their own performance with respect to the Growth and Stability Pact.

Another open issue in need of reform is the design of decision-making in the larger monetary union. With currently 18 people sitting around the table, six of them members of the board of the ECB, plus twelve presidents of national central banks, this group is already too large and will become unmanageable once all the new members of the EU have joined. There would be 22 national representatives, or even more if Bulgaria, Romania, and possibly Turkey, Croatia and others joined the EU. It is clearly high time for finding better arrangements than the current one.

Unfortunately, the present reform proposal cannot be considered an improvement. The proposal, designed by the ECB and approved by the Council of Ministers, pending confirmation in national parliaments, envisages that national representatives form three groups, with each group having a certain number of votes that rotate among their members. The five largest countries will form a group with four votes, so that each of them will have voting power in 4/5 of all cases; a middle group of eleven countries will have eight votes, and the rest (of the planned 22) will have three votes. This is not only a complicated system but it implies that almost as many people actually vote as currently. There is hence no improvement in terms of efficiency. In addition, time-consuming discussions about monetary policy are only moved to another level; it is hard to imagine that not all the members of a subgroup will want discussion and consensus in their group if they are not presently able to vote themselves. In addition, since the groups are formed on the basis of country size, without taking similarities of industrial structure and levels of economic development into account, conflicts among group members can be expected that could have been avoided if groups had been formed on the basis of economic criteria.

A much better solution would be to centralise the operational decision-making power with the board, possibly enlarging the board by a few persons. The board would be charged with daily decision-making while the large group of all national members would meet about twice a year to discuss the overall strategy and goals for monetary policy. This would at once make operational decisions more efficient. It would ensure that all members are treated equally, although large countries would necessarily be more important than small ones, and it would avoid conflicts among countries because they do not feel adequately represented in their group. It would not be an ideal solution; the issue of whose national candidate would join the board would gain even more prominence than now, so that a rotation here would make political sense. The centralisation of monetary policy with adequately qualified board members and a further professionalisation of monetary policy would certainly be resisted by some member states. But this seems a small hurdle in comparison to all the problems that other solutions entail.

With the process of EMU that has now begun, serious institutional and economic challenges await the ECB and European monetary policy in the future. The simpler steps have been taken but the real test of the ECB and European policy-makers is still ahead.

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