The Euro's Start-up Phase is a Success

One year on from the launch of the euro, it is fair to say that European monetary union (EMU) has got off to a fortunate start. To begin with, this is true of the technical tasks which, apart from some slight teething troubles with the TARGET system of gross settlement, have all been successfully dealt with. But apart from that, it is true in an economic sense too. Because of the dip in economic activity following the Asian and Russian crises, inflationary pressure was limited from the outset, and did not increase significantly during the year. That allowed the European Central Bank (ECB) to accomplish its task of maintaining price stability without having to build any additional uncertainty premium into interest rates, even in spite of the limited information available to it on the demand-for-money function across the euro area as a whole and on the monetary transmission mechanisms in individual countries. Indeed, the ECB managed to substantially reduce money market rates without triggering off any new inflationary impetus or fuelling fears of future inflation (as borne out by the historic lows attained by long-term bond yields). In doing so, the central bank supported economic policymakers in their endeavours to boost activity. So political conflicts between the ECB, national governments and the two sides of industry were not a major issue, though in the early days, up to the resignation of Germany's finance minister Oskar Lafontaine, the Bank did have to withstand heavy political pressure from that quarter.

The ECB has proved very steadfast amid the force-field of politics. By stating at an early stage how it defines price stability as a target to be attained in the medium term (a year-on-year increase of less than 2% in the harmonised index of consumer prices [HICP] for the euro currency area), the central bank provided a compass for both the markets and the general public to travel by. Beyond that, however, it also countered any tendencies to leave the-task of defining the inflation target to the EU Council. Another point that has been firmly clarified is that the benchmark will not be the level of price inflation in any single member state or group of member states, but in the EMU zone taken as a whole.

The ECB withstood with self-assurance the persisting political pressure to cut its key interest rate (on its main refinancing operations) coming from Germany in the first quarter of 1999. Of course, it is impossible to say for sure whether the 0.5 percentage-point rate cut to 2.5% on 8th April 1999 was entirely economically founded or to some extent ultimately driven by a wish to reduce the political pressure on the Bank. While the cut undoubtedly had its economic justifications, it was not urgently needed. The rate increase on 4th November had more logic to it. The ECB did not meet any appreciable political resistance to this measure, but that picture is liable to change with any future rate hikes.

In its approach to the euro's exchange rate, the ECB has pursued a "benign neglect" policy along American lines. This has been greeted by a lack of understanding and by criticism, especially from abroad, as the euro's substantial depreciation in its first year has been a disappointment to many actual and potential investors, both private and public. Nevertheless, one has to endorse the Bank's position. Given that the large euro area taken together is not a very open economy, the "EMU 11" can afford to let the euro fall quite a long way without subjecting themselves to imported inflation. Moreover, the weak euro has boosted the revival of Europe's economic fortunes. In any case, even large-scale intervention on the foreign exchanges can onjy produce fleeting results unless it is backed up by economic policy, a situation that Japan's experience has again demonstrated in 1999. Looked at the other way round, the weakness of the euro does indeed point out the need for policy action in Europe, and not least in Germany.

The ECB has been criticised for a supposed lack of transparency in its decision-making on monetary policy. Anyone looking for clear indicators - or indeed just one single indicator - around which the ECB determines its policy will be in for a disappointment. Yet even the formal abandonment of the present "two-pillar" strategy in favour of just one target (intermediate or not) or reference value would by no means put paid to the underlying problem: monetary policy inevitably has to be based on a forward-looking assessment of a large, mixed bag of data and information. Even Germany's Bundesbank, which formally pursued a money-supply target for 25 years, quite rightly did not concentrate on this to the exclusion of everything else, and at times consciously disregarded it. Of all people, the financial analysts and bankers who have been bemoaning the lack of transparency ought to be aware that markets don't put up flags to tell us what they will do next.

That having been said, the Bank did not spring any surprise on the markets when it decided to raise interest rates. On the contrary, its President Wim Duisenberg and the other members of the ECB's Executive Board and Governing Council prepared the ground by giving the public strong hints in their speeches during the preceding weeks. There is good reason to doubt whether the Bank's publication of an inflation forecast as recently announced will really help to enhance transparency. In the event, it is more likely to encourage false interpretations and, following on from these, renewed criticism. Moreover, the forecast might provoke wrong decisions by wage negotiators from one case to another, making the ECB's task of maintaining price stability all the more difficult. Another unhelpful development for the purpose at hand is the greater ECB accountability as currently called for by the European Parliament, particularly the publication of the minutes of ECB Council meetings. This will probably encourage individual members to speak to the gallery (i.e. to their own perceived public), and in particular to make them more closely oriented to the supposed national interests of their home countries. That would inevitably be detrimental to the quality of the Governing Council's ultimate joint decision.

In economic terms, the euro's first year continued to show differing levels of activity around the currency zone. The substantial range of growth rates in 1999 spanned from Italy (1.0%) and Germany (1.4%) at the lower end to Ireland (8.6%), Luxembourg (5.1 %), Spain and Finland (3.7%) at the upper end. Differentials were similar when it came to growth in employment and the rate at which the unemployment rate is being cut back. This demonstrates a number of points. Firstly, growth rates and employment trends are evidently not linked to interest rates first and foremost, and the ECB's monetary policy was not "too tight". Secondly, monetary union is not proving an obstacle to lower-income countries as their economies close the gap with others. Differentials in inflation rates, which ranged from 0.4-0.6% in Austria, Germany and France to 2.4% in Spain and Ireland, did not give cause for concern in 1999. Nevertheless, an eye will need to be kept on whether these differentials become firmly established. If that were to happen, the countries with faster inflation would suffer a loss in competitiveness within the euro area in the medium term.

Entry into monetary union has often been bound up with expectations that this quantum leap on the institutional level would act as a catalyst for much-needed reforms in labour markets, in fiscal and social welfare policies, and in the public sector. So far, however, this can only be said of a small number of EMU participants. In Germany, the changes have been almost entirely confined to budgetary and fiscal policy, with the federal government adopting international standards in its latest legislative proposals to reform income and corporate taxation. Meanwhile, the same old, outdated rituals and taboos persist in wage bargaining and labour-market policy, where the arguments put forward are all too frequently those of a closed economy engaged in a struggle to distribute income and wealth. If we want to turn EMU's good start into a lasting success, there is still a lot of consciousness-raising to do and a lot of effort to be made, in Germany and elsewhere. A properly functioning monetary policy framework cannot, by itself, guarantee that success.

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