The Dynamics of Convergence towards European Monetary Union: A Comment *

PAOLA CASELLI and GIORGIO GOMEL

1. Premise

De Grauwe's severely critical appraisal of the Maastricht Treaty furnishes an appropriate occasion to return to the reasons and purposes of the convergence criteria on inflation, exchange rates, long-term interest rates and public deficits and debt. In the view of some observers, compliance with these criteria could trigger a European recession, further raising an already alarmingly high unemployment rate, and foster a climate of divisiveness if not hostility among the candidates for Union membership.

De Grauwe's critique can be summed up essentially in three points. *First*, the convergence criteria set forth in the Treaty are neither necessary nor sufficient to form the monetary union; such standards are totally alien to the literature on optimum currency areas, which instead cites price and wage flexibility, factor mobility and the presence of suitable instruments for resource reallocation (e.g., a large federal budget) as the requirements for a single-currency area. *Second*, the philosophy underlying the Treaty will not favour but will actually impede economic convergence by imposing deflationary monetary and fiscal policies on the "divergent" countries. *Third*, since the Treaty criteria are not suitable for the proper selection of the countries that should form the Union, the focus should be shifted

□ Bank of Italy, Research Department, Rome (Italy).

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from convergence to the institutional strengthening of the European Central Bank, which will be called upon to conduct the common monetary policy.

In the present comment we offer a reasoned rebuttal touching on three aspects: *i*) the relationship of the Maastricht convergence criteria with the theory of optimum currency areas; *ii*) the position of Italy, which De Grauwe cites as a representative "divergent" economy for which the fulfilment of the criteria would constitute an impediment to actual convergence; and *iii*) the problems inherent in the institutional strengthening that De Grauwe advocates.

2. The convergence criteria and optimum currency areas

De Grauwe asserts, in peremptory fashion, that the logic of the convergence criteria has no historical precedent, arguing that past monetary unions have not imposed such requirements. His conclusion is a hasty one, namely that the Maastricht criteria may not really be necessary to form a monetary union. Yet the only historical instance mentioned is the recent German monetary unification, whose features distinguish it radically from the case of Economic and Monetary Union.

De Grauwe is quite right in starting that the Treaty's convergence criteria are not grounded in the traditional literature on optimum currency areas. Yet it can be objected that the implicit referent for that literature has been the United States, a single-currency area with pronounced regional disparities in economic structure. In that framework, without the equilibrating action of the exchange rate the prerequisites for absorbing predominantly asymmetric shocks are a high degree of price (and wage) flexibility, great factor mobility and a federal budget that serves to redistribute real resources. In this regard, however, the European Union is quite different, its member-country economies being much more similar to one another.[1] The unlikeliness of asymmetric shocks accordingly diminishes the importance of price/wage flexibility and factor mobility.[2]

These structural differences between the American and European economies were certainly borne in mind in drafting the Treaty, and this helps to explain its emphasis on price stability and the need to provide monetary policy with a "habitat" conducive to the fully independent pursuit of that objective. Today, this emphasis is generally considered excessive by those who view the plan for Economic and Monetary Union as the *de facto* imposition on quite different countries of the objectives of the Bundesbank. This, however, is not De Grauwe's position. He favours a European Central Bank on the German model and instead criticizes the requirement that in order to join the single currency area a country must first achieve a relatively low inflation rate. This, he argues, is not a necessary condition, or a sufficient one, for the ECB to attain its objective of price stability.

The problem is unquestionably a significant one. A few years of good inflation performance will probably not suffice to reassure the markets of the monetary authorities' anti-inflationary determination.[3] Other conditions must also be satisfied. Among these, the most relevant would seem to be the independence of the national central bank, a requirement laid down by the Treaty for admission to the third stage of EMU but regularly neglected in the current discussion.[4]

The purpose of the Treaty, therefore, is not to eliminate the central banks with poor reputations, as De Grauwe seems to maintain (p. 35), but to spur them to improve those reputations by achieving low inflation and greater independence.

According to De Grauwe, in order to ensure that Union-wide inflation does not exceed that of the virtuous countries it would be sufficient to deprive the "divergent" countries' governors of voting

[1] As we know, the findings of empirical studies are not fully concordant on this point. For example, Bayoumi and Eichengreen (1994) show that in Europe only the countries of the "German bloc" have truly similar economic structures. Helg *et al.* (1994) are less definitive; in their view, only Greece, Portugal and Ireland have productive structures that are significantly out of line with the other Union members. The results of Bini Smaghi and Vori (1993) also validate the thesis of greater homogeneity in Europe than in the United States.

[2] In any event, in recent years there has been a significant increase in European labour market flexibility, with reforms affecting all countries. Factor mobility, though still limited today (especially as regards labour) will increase with the implementation of the single market.

[3] A pertinent example is that of France. In the Nineties its inflation rate has been lower than that of Germany, on average, but the markets have been slow to credit the disinflationary stance of the French central bank, requiring substantial risk premia on short- and long-term interest rates and repeatedly attacking the exchange rate of the franc.

[4] The requirement of "institutional convergence" has already led several European central banks (those of France, Spain and Portugal) to undertake a radical revision of their statutes and organization, expressly incorporating the objective of price stability in conformity with the Treaty's provisions for the European Central Bank.

rights on the ECB Executive Board. In our opinion, not only does this run counter to the spirit of the Treaty, it is also weak from the strictly economic standpoint.

For this inflation result to hold, in fact, two quite stringent conditions must be met: prices must be perfectly flexible in all countries (both virtuous and not) and the markets must instantly adjust expectations to the inflation rate of the virtuous countries. If these conditions are not satisfied, it is easy to show that the inflation rate of the Union will be higher than that of the virtuous countries.[5] Germany and the Bundesbank would thus be right in requiring the "divergent" countries to demonstrate their ability to achieve low inflation before being admitted to the third stage of EMU.

3. Italy

De Grauwe, in his presentation, uses Italy as the paradigm of a "divergent" economy for which the convergence path based on the Maastricht criteria would be dysfunctional with respect to the convergence objectives themselves. Worse, he holds, that path would be damaging to output and employment. He envisions a "fatalistically" vicious circle for Italy: the country's poor anti-inflation reputation necessitates disinflationary measures with severe costs in unemployment; but during the transition, before inflation is reduced, the lira (whose exchange rate is fixed in nominal terms by virtue of compliance with the convergence standard) appreciates in real terms, triggering a speculative attack that forces another devaluation and the resurgence of inflation (p. 35).

In short, the Bank of Italy's poor reputation for fighting inflation is to be done away with by the formation of the monetary union, which De Grauwe sees as a monetary reform that, at a stroke, "eliminates" the lira and the Bank of Italy. Expected and actual inflation decline swiftly and the economy converges.

[5] To prevent prices from being perfectly flexible, it is enough that in some countries wage bargaining is conducted in a time frame of two or more periods (see Bini Smaghi and Del Giovane 1992). In the first year of the EMU this would entail a higher inflation rate than that expected by the markets and announced by the ECB. In these circumstances it is most likely that the latter's credibility would suffer even if the governors of the "divergent" countries did not take part in the conduct of EMU monetary policy.

Even leaving aside his overstretched judgements, De Grauwe's argument inverts both the sequence of events and the causal nexus. In his version it is monetary union that leads to convergence, not convergence that forms the precondition for Italy's participation in the union. His whole case depends on the postulate that the persistence of comparatively high inflation is due to the poor reputation of the monetary authorities rather than to the state of Italian public finances. But if, as we believe, the latter is the key factor, then Italy's primary interest is to achieve fiscal adjustment before joining EMU. Only in this way, in fact, can the country be assured of reaping the greatest benefit in terms of lower interest rates.

In his numerical exercise (p. 41), De Grauwe assumes that with the launch of EMU long-term interest rates fall automatically and instantly to German levels, well before the deficit/GDP ratio is brought into line with the 3% Maastricht norm. But this is not the case. In reality, different ratios of deficit and debt to GDP will be associated with different risk premia, and hence different long-term interest rates, for some considerable time after the launch of EMU. The average interest rate for the area will thus be higher than that of Germany.

4. Institutional strengthening

De Grauwe is certainly correct in emphasizing the importance, for success in the construction of Europe, of strengthening its institutions beyond what the Treaty, with its shortcomings, envisions in this area. However, we do not believe that such strengthening can be disjoined from the convergence process, nor that by itself it can miraculously guarantee the efficient transition to EMU.

Two points warrant careful consideration.

The first concerns the European Central Bank: to whom is that institution accountable for its success or failure in achieving the objective of price stability? De Grauwe maintains that establishing a procedure for removing the Executive Board if the Bank fails to ensure price stability would be an effective incentive. This suggests an arrangement like that in force in New Zealand, whereby the governor of the central bank can be dismissed if the inflation target is not achieved.

In the case of EMU, the members of the Executive Board are appointed by the member state governments after consultation with the European Parliament and the governors of the national central banks. Can it not be presumed that a similar procedure will apply to their dismissal? Otherwise – that is, if the Bank were not accountable to any outside body for its actions and its performance – the very credibility of the ECB would be affected.

The second point concerns budgetary discipline and its enforcement under monetary union. Although the philosophy and basic spirit of the Treaty presuppose that after the third stage is launched the constraint of fiscal discipline will continue to be operative, the machinery devised by the Treaty does not appear sufficient to ensure full compliance with "virtuous" rules of public finance. Even the 3% ceiling for the deficit/GDP ratio, one of the requirements for admission, may prove too high. As an alternative, a medium-term cyclically adjusted target could be set for the average budget for the Union to be close to balance, with national differentiations suitably graduated to reflect the disparity in initial deficit and debt levels and take account of the need for some of the less advanced economies to converge towards the per capita income of the more prosperous, and hence to finance public investment to that end.

Even if more stringent constraints were adopted, the problem of enforcement would remain. What "sanctions" should be contemplated to "punish" non-compliance or effectively deter potential deviance? The Treaty itself sets forth in the excessive deficit procedure (Article 104c) a list of such sanctions for non-compliant members as public censure, non-interest-bearing deposits with the Community and fines. These are mild enough compared with sanction envisaged prior to participation, namely non admission to the third stage.

What reassurance can be offered to the financial markets, public opinion and other member state governments that budgetary discipline will be maintained under EMU even though, once admitted, a country cannot be expelled and national governments retain full discretionary budgetary powers? We feel that the only way this can be done is by adopting Constitutional amendments that expressly impose the public finance criteria set for the Union, which would thereby be made binding on future governments.

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