

Keeping Anchored to the European Monetary Union: A Radical Option for a Laggard Country

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1. Introduction

It is difficult to write a paper on the European Monetary Union (EMU) in the early days of 1996: most of what could be said about it from the point of view of positive economics has already been said, while normative economic arguments run the risk of getting obsolete by the time the paper is printed, as the Maastricht project may either be abandoned, postponed or shelved for an indefinite future, which are all possible outcomes at present.

Faced with this difficulty, we advance and analyze a proposal that has the ambition, perhaps hazardously founded, to be weather-proof, in the sense of providing a new institutional framework for monetary policy, which could be useful for a country lagging behind, such as Italy, both in the case that the Maastricht project were to proceed according to schedule, and in the case that the project were to be partially or completely abandoned. In the following pages, however, we shall basically assume that the Maastricht design will not be completely redrawn or abandoned.¹

As the opening time of the Inter-Governmental Conference of the European Union approaches, the future of monetary unification seems to depend more and more upon political evaluations of its economic aspects.

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¹ Paolo Onofri and Davide Squarzoni have provided comments and computational assistance that have been of great help in preparing this paper.

Thus in the current debate on EMU, particularly in Italy, positions have been taken that are valid on the economic level, and can therefore be shared on that level, and yet debated and opposed at the political level. In particular, with respect to the strategy chosen with the Maastricht Treaty and the convergence criteria that characterize it, most economists agree that there are dangers inherent in the gradualistic approach to monetary unification, and admit that the convergence criteria established by the Treaty have little economic meaning: in any case, they are neither necessary nor sufficient economic conditions for the attainment of the final objective of monetary unification.

It is also possible to argue that strategies alternative to that chosen at Maastricht would have been preferable. However, since during the last year, and ever more inexorably in the last few months, the political character of the debate has finally prevailed over technical considerations, it is necessary to come to grips with this reality. Far from betraying one's role as an economist, this means recognizing that, in the end, it is at the political and not at the economic level that economic choices of such momentum must be made.

From this point of view the convergence criteria of Maastricht are nothing more nor less than political conditions, which Germany in particular has required in order to convince her citizens, and the international investors, that abandonment of the DM and Bundesbank monetary independence will not mean taking a leap into the dark.

However, the game of bidding up the price of participation in EMU – a game that more or less officially the German authorities have been playing during the last year – can be accounted for either as confirmation of the political character of the convergence criteria, given the growing reluctance of the German public opinion to abandon the DM; or, in the other direction, as a "Machiavellian" attempt to induce the European partners to take upon themselves the responsibility of giving up the whole enterprise. In substance, such a game can be interpreted either as an increasingly rigid approach to a strategy played in good faith, or, on the contrary, as bluff based on serious second thoughts about the whole project.

Moreover, a strategic element has, more recently, also started to loom behind the benevolent interpretation of Germany's attitude, i.e. that of a more rigid position in a strategy still played sincerely.

In fact, the exclusion of countries like Italy from the number of those that would first start the EMU – exclusion made even more likely by such a rigid stand – would increase the danger of non-cooperative behaviour on their part, with consequent disrupting forces in the EU that may even endanger its nature as an integrated market for goods, services, and productive activities. Thus the rigid stand could be a bluff, aimed at inducing those countries to adopt policies rigorous enough to make their currencies appreciate *vis-à-vis* the DM, and thus reduce the competitive pressure on German producers.

If, one way or another, this is the game, then countries such as Italy may be tempted to call the bluff, giving up the attempt to be part of EMU (essentially "opting out"), and going their own way without the straightjacket of the convergence criteria.

It is in fact possible that such a threat would induce the German government to reconsider its strategy, giving more weight to the pressures coming from industrialists and trade unions within Germany. With this threat, however, Italy would be taking a dangerous bet, because it is hardly likely that the German government will convince the Bundesbank to submit to the primacy of political decisions, for the second time in less than ten years. When this occurred, at the time of German monetary unification, public opinion was in favour of abandoning the Ost Mark for the Deutsche Mark, regardless of the conversion mechanism and the costs involved. On this second historical occasion, however, the Bundesbank would have public opinion on its side.

For countries like Italy to call their bluff thus would be extremely dangerous. In the absence of a more general reconsideration of the Maastricht design by the other major countries, and most notably by France, it seems more in line with the political-economic interests of countries such as Italy to adopt the alternative way of calling bluff – if it exists in the German position – i.e. to play their game in good faith, and possibly even more rigorously, leaving the leading country with the responsibility of calling the game off, should it not be really convinced by it.

It is, however, necessary to devise a strategy for such countries, and more specifically for Italy, that will keep them linked to the leading countries of Europe, in either case: i.e. of positive, even though partial, progression in the Maastricht programme, or of its abandonment.

2. The options for a laggard country

As is well known, Italy cannot be ready by 1 January 1999, in line with all convergence criteria, if they are strictly applied. In particular, it cannot possibly meet the debt/GDP criterion.

Given this situation, few possibilities remain open. One is to try to speed up on convergence; another is to try to convince the other countries to accept a further prolongation of the probation period; a third one is to follow the UK example, although belatedly, and invoke the opt out clause; a fourth and more radical one is to try new avenues towards monetary unification, such as the shock therapy of a monetary reform. We have argued elsewhere against the first three possibilities.² Let us then consider the fourth one.

2.1. *New avenues towards monetary unification: a collective approach*

The more radical approaches to monetary unification may be classified into *collective* ones, i.e. referring to the whole group of EU members or some subsets of them, or *individual* ones, i.e. regarding individual countries. They may also be classified in two types: *cooperative* or *non-cooperative*.

If we consider the *collective* approaches of the *cooperative* type, an interesting example is the proposal advanced by De Grauwe (1995). This is based on the upfront recognition that Germany has no incentive to form a monetary union with countries that are either more inflationary or less credible, or both. In addition, it recognises the weaknesses implied by the conditional and gradual approach that characterizes the Maastricht design. The alternative proposal is based on three principles:

a) all EU members qualify to join the EMU. Those willing to join should take on a commitment to join at a date set in advance.

b) all convergence requirements are dropped, i.e. they are not considered as preconditions for entering the union.

² Basevi (1995).

c) all the other rules defined in the Maastricht Treaty remain in force. This means that countries surrender their monetary sovereignty to the European Central Bank, which will issue the new European currency displacing the national currencies. It also means that the ECB will be politically independent and will be forbidden to finance government budget deficits.

As pointed out by the proponent, "the philosophy underlying this alternative strategy is that membership in the union will be determined by the free choice of each EU-member. Those members that believe it is in their interests to join can do so freely. They cannot be excluded by the others (as is the case in the Maastricht Treaty). Those that believe it is not in their interests to join are free to stay out of the union" (De Grauwe 1995, p. 489).

The first advantage of this strategy is that it avoids the occurrence of political conflict over the question of membership. It will be clear long in advance who will be in the club and who will be out.

A second advantage of the strategy is that it explicitly recognises the weak incentives Germany has in joining a monetary union, and that it creates better incentives for Germany to join. In fact, if Germany decides, at least initially, to stay out of such a union, the variability of the real exchange rate of the Mark is likely to increase, since it will fluctuate *vis-à-vis* the common currency of the Union. This creates a cost for Germany to stay outside the Union. However, the countries in the Union will now have an incentive to make their own common currency as inflation proof, and therefore as attractive, as the Mark. The independence of their central bank will be instrumental in this, and thus their union will become more attractive to Germany. In contrast with the case of the Maastricht Treaty, whereby past good performance on the inflation front does not guarantee Germany that national representatives will perform as well once the Union is formed, with this alternative Germany does not "leap into the dark. It can make the step when it is convinced by the evidence that the European Central Bank is committed to low inflation" (De Grauwe 1995, p. 490).

In proposing this alternative strategy, the author does not hide its political difficulties and provocative nature. However, one reason why we report it here is that this strategy would cooperatively bring about a result that may otherwise risk coming about in a non-

cooperative, and thereby more disruptive, way, i.e. with the union forming in opposition to Germany and her leadership. The political and economic consequences of a non-cooperative version of this strategy would be truly disruptive for the EU.

In fact the danger of non-cooperative upshots in the process towards EMU should not be taken lightly. The least that may happen is the threat, or the effective enactment, of competitive devaluations by the set of countries left outside EMU. We have already tasted a bit of this recently, in the form of official complaints by the French government about the "unfair" competitive advantage that Italy allegedly obtained through its sequence of depreciations since September 1992.

Faced with such accusations and threats, a common front may even develop among the more inflationary countries left out of EMU, with the danger that they draw up a sort of monetary arrangement among themselves. This would probably be both technically and politically difficult to manage, besides being a dangerous boat to embark upon. What might be less unlikely, and both economically and politically more justifiable, would be the formation of a group of laggard countries under the loose leadership of the UK. Such a prospect might become a more credible threat, as an alternative to the central European monetary area, particularly in the case that it were backed economically and politically by closer links with the dollar area. In such a case, it might even be possible that France also would prefer such an alternative area.

The scenarios that such developments open to the imagination are certainly not reassuring for European unification, economic and political. We thus mention them in the hope that they may remain as improbable as they are politically unattractive.

2.2. *An individual approach: the currency board option*

We now wish to consider an alternative strategy that a country like Italy, lagging behind those that should first be entering upon EMU, could follow individually in order to overcome the unpleasant position of being just left out in the cold, even though temporarily. This alternative strategy belongs to the class of shock therapies in the

form of monetary reforms, but it has some features specific to the Italian case.³

According to this strategy, Italy would re-enter the exchange rate mechanism of the EMS and, at the same time, give up its monetary independence, anticipating what would otherwise be the result of the final stage of EMU. By so doing, it would also definitely eliminate the fear of uncooperative behaviour through competitive devaluations; a fear that the countries first taking part in EMU would otherwise hold *vis-à-vis* a laggard country, like Italy.

As is well known, the base for expanding the money supply can flow from three sources: the domestic credit operations of the central bank, the monetary financing of the Treasury, the central bank operations to settle the balance of payments. By forbidding monetary financing of government deficits, the Treaty of Maastricht has closed the second source. There remain the other two sources. In the strategy proposed here Italy, and possibly other lagging countries, would also close the first source of money supply.

The Bank of Italy would reduce its functions to those of a "currency board", creating or withdrawing monetary base only by exchanging its money against foreign money, i.e. through the balance of payments, at a fixed exchange rate. In other words, the Bank of Italy would still control the monetary base, but only through its foreign exchange operations, not through its domestic credit policy.⁴

Such a monetary reform could proceed, in a sequence of steps, as designed in a package of announcements: (i) that the lira will re-enter the exchange rate mechanism of the EMS with a "round" parity, e.g. lire 2000 for 1 ecu;⁵ (ii) that in due course a new lira will be issued equal to 2000 old lire; (iii) that the Bank of Italy will only create or withdraw monetary base through the foreign exchange operations required to keep the new lira at its parity; (iv) that, in due course, the new lira will be substituted by the ecu, or by the new currency that will

³ The strategy has been presented on various occasions and with small variants in Prometeia (1994, 1995), and *Maastricht Watch* (1995). For a very recent suggestion of a "currency board" solution, see also Giovannini (1995).

⁴ In a more radical form of this proposal, the international reserves of the Bank would be transferred for their management to the European Monetary Institute (EMI), which would become the "currency board" for Italy. This second solution should be possible on the basis of Article 6 of Protocol 4 of the Maastricht Treaty, which regulates the statute of the EMI. See in particular paragraphs 6.2. and 6.4.

⁵ An alternative parity, which by now is probably too low, is 1000 lire to 1 DM.

take the place of the ecu (now the euro) as the EMU common currency, when this is in force.

It is clear that the creation of the "heavy" lira would be only a nominal element in itself; yet, as part of the proposal it is instrumental both in emphasizing its definitive nature and in making abandonment of monetary sovereignty more acceptable. This should not be lightly dismissed even in a country like Italy, which still takes top place in the ranking of the countries favouring the idea of European monetary unification.

Like various proposals presented by economists, as for example by De Grauwe as summarized above, this may appear "naïf" or too adventurous. Before discarding all of them, however, we should consider how increasingly risky and possibly disruptive for the whole cooperative structure of the EU, the monetary architecture designed by the Maastricht Treaty appears to be as we come closer to its final stage.

3. A simulation exercise

In order to evaluate the effects of the currency board proposal, we have tried to simulate the way it operates by making use of an econometric model of the Italian economy.⁶

We first explored what might have happened if establishment of the currency board had taken place after the lira had temporarily held the level of about 1000 *vis-à-vis* the DM. We did so both because that level was reached at about the time of the first presentation of the budget for 1995, during the summer of 1994, before exogenous or non-economic factors – the new political uncertainties internally, and the Mexican crisis externally – started weakening the lira again at the end of 1994; and because the appeal of the "round" exchange rate of 1000 lire for 1 DM could have been the basis for converting the old lira into the new "heavy" lira precisely at the "easy" rate of 1000 to 1, and then keeping fixed the parity between the heavy lira and the DM at 1 to 1. Thus the starting period for this simulation on the econometric model is the first quarter of 1995.

⁶ The model used for forecasts of the Italian economy produced by Prometeia quarterly in Bologna.

Alternatively, we explored the effects of establishing the currency board at the present time, i.e. at the beginning of 1996, by fixing the parity directly *vis-à-vis* the ecu, at the rate of 2000 lire for 1 ecu (and the rate of conversion of the old into the new "heavy" lira at the same parity). Thus the starting period for this second econometric simulation is the first quarter of 1996.

In both cases we considered that the limits to the Bank of Italy's ability to supply monetary base only as a "currency board" were not fully credible from the outset. Thus, we assumed that the differential between domestic and foreign (German) interest rates did not fall immediately to zero, but "only" to 1.5 percentage points initially, and then kept decreasing until it reached zero by the end of 1997.⁷

Let us consider some of the results of the first simulation. Table 1 shows, for the variables of most importance in the Maastricht debate, the difference between their path in the simulation, and the path that has actually been followed, or is forecast, without the currency board, i.e. under the present exchange rate regime and with the institutional characteristics of the Italian monetary authorities.⁸

Table 1 shows the rate of inflation substantially dropping during the first year of the exercise, but then picking up again, surpassing and again reaching the same path that it would have followed in the control solution.

This result is particularly disturbing. In fact the advocacy of currency boards – as a recipe for monetary stabilization in some formerly hyper-inflating countries (in particular Argentina), or to keep a country like Italy from drifting apart if it does not qualify for EMU from its inception – is based on the anti-inflationary potential that their mechanism should theoretically have. While such potential seems to have been fully at work in the case of Argentina, at least until now, our simulation exercise for the Italian economy appears less successful. On this basis, the working of the "currency board", at least over the horizon relevant for the probation period of the Maastricht criteria (1996-'97), does not seem to guarantee convergence of the Italian inflation rate to that of the more virtuous

⁷ This is roughly the order of magnitude, at present, of the "political risk" for the debt of the Italian Republic, as measured by the difference between interest rates on debt denominated in the same currency but issued by other countries or by international institutions.

⁸ This path is in fact the one designed in the December forecast published by Prometeia.

TABLE 1

"CURRENCY BOARD" WITH NEW PARITY AT LIRE 1000 = 1 DM FROM 1995.I

	1995	1996	1997	1998
CPI inflation (%)				
control	5.3	4.7	4.6	4.0
simulation	3.4	4.2	5.1	4.1
difference	-1.9	-0.5	0.5	0.1
GDP growth (%)				
control	3.0	2.2	2.0	2.5
simulation	1.1	3.4	2.6	1.8
difference	-1.9	1.2	0.6	-0.7
deficit/GDP ratio (%)				
control	7.7	6.7	5.1	4.1
simulation	6.1	4.5	3.2	2.4
difference	-1.6	-2.2	-1.9	-1.7
debt/GDP ratio (%)				
control	123.3	122.4	120.1	116.6
simulation	123.1	121.0	115.9	111.6
difference	-0.2	-1.4	-4.2	-5.0
current account balance (billion lire)				
control	40207	44036	60613	68031
simulation	32302	29317	47890	59202
difference	-7905	-14719	-12723	-8829

countries in the EU. Thus, we must explore the reasons for its failure in the present exercise, which might be due to inadequacies both of the econometric model and of the design of the exercise.

The resurgence of inflation from the second year is partly due to the resurgence of GDP growth. More fundamentally, however, it is due to the lower rates of interests (nominal and, even more, real) favouring this increased growth. These were drastically reduced in one step from the beginning of the simulation period, and then further decreased in a step-by-step way as explained above. To make such a drop consistent with the structure of the economy, the model has to allow for a very large increase in the money supply,⁹ all coming from an inflow of monetary base through the balance of payments. Such an increase seems unlikely, in the light both of the historical record in Italy, and the probable working of a currency board if it

⁹ In the first year the "total" elasticity of the quantity of money (M2) with respect to GDP doubles.

were adopted by Italy in the present situation.¹⁰ In other words, it is unlikely that the markets would, from its beginning, eliminate all exchange rate premium on Italian lira interest rates, and only allow for a progressively decreasing country premium, as we have assumed. It is more likely that the rates of interest would be higher and capital inflows lower. As a result, inflation, but also growth, could be lower, and more in line both with some actual examples (Argentina, again), and with the intended result of the board, which is to be of help for the Maastricht convergence criteria rather than allowing higher growth.

We may therefore consider the results of our simulation as due to an exercise structured in such a way as to give the less favourable scenario for the proposed arrangement, at least on the score of its anti-inflationary potential. A scenario designed with a less rough and radical reduction of interest rates may prove to be both more credible and less likely to produce the danger of excessive short term capital inflows and monetary relaxation, which could eventually trigger a Mexican (or Argentinian?) type of crisis should Italy, for political or other reasons, fail to complete this strategy with her actual acceptance into EMU.

More satisfactory, on the other hand, are the results of the exercise in terms of the two fiscal convergence criteria of the Maastricht Treaty. In particular, Table 1 shows that the required deficit/GDP ratio is finally reached by 1997 and further reduced in 1998. As for the debt/GDP ratio, although improved, it cannot possibly fall below the threshold required by the convergence criteria in so short a period.

In any case, the relative success of the exercise on these two grounds lies in the positive aspect of the defective characteristic assumed above: in fact, the dramatic and abrupt reduction in interest rates strongly contributes to the improvement of the budgetary situation in a heavily indebted public sector.

As for the second exercise – assumed to start during the first quarter of 1996, and with reference to the ecu at a rate of 2000 lire for 1 ecu – the main results are presented in Table 2. They are not substantially different from those of the first exercise. The main

¹⁰ Notice that more than all of the increase in the monetary base has to come from capital inflows. In fact, because of the fixed exchange rate applied in the control solution, the balance of payments on current account deteriorates in the currency board solution.

TABLE 2

"CURRENCY BOARD" WITH NEW PARITY AT LIRE 2000 = 1 ECU FROM 1996.1

	1996	1997	1998
CPI inflation (%)			
control	4.7	4.6	4.0
simulation	4.4	5.1	4.0
difference	-0.3	-0.5	0.0
GDP growth (%)			
control	2.2	2.0	2.5
simulation	2.9	2.4	1.7
difference	0.7	0.4	-0.8
deficit/GDP ratio (%)			
control	6.7	5.1	4.1
simulation	4.6	2.8	2.6
difference	-2.1	-2.3	-1.5
debt/GDP ratio (%)			
control	122.4	120.1	116.6
simulation	118.5	114.0	110.5
difference	-3.9	-6.1	-6.1
current account balance (billion lire)			
control	44036	60613	68031
simulation	30612	47036	61631
difference	-13424	-13577	-6400

positive difference is in the debt/GDP ratio, due to the reduction of interest rates being more rapid, as it is squeezed within a shorter time span.

On the whole, it appears that – besides the institutional and technical difficulties involved in limiting the Bank of Italy to function as a "currency board" in its capacity to supply monetary base – the results of the econometric simulations are less than fully satisfactory.

4. Concluding remarks

The simulation exercises presented in the previous section showing the possible effects that the institution of a currency board would have on the path of the Italian economy are not, and cannot,

be conclusive. On the one hand, the reform here proposed, although sweeping, tackles only the monetary aspects of the Maastricht convergence criteria, even though its most beneficial effects are, paradoxically, on the fiscal side, due to the implied reduction in interest rates. On the other hand, econometric simulations cannot give more than suggestions of how the economy would react to such a structural change. In fact this change cannot but affect the behaviour of economic agents in a way which is not incorporated in the econometric estimates of their past behaviour. Thus a closer analysis of actual experience with currency boards would be in order.

In the end, however, only the actual effects that the reform itself would produce on the "patient" is the definitive answer. In this respect, our opinion is that, although the proposal may seem an extreme and excessive solution to the impasse in which a laggard country such as Italy would be left, it is worth trying; particularly considering that, after all, its main political-economic aspect, i.e. the effective loss of monetary independence, is nothing but an anticipation of what would in any case result from participating in the EMU.

To this it may be objected that participation in the EMU would not mean a complete loss of monetary sovereignty, as the ECB would be the central bank of all countries taking part in EMU. However, since the ECB should be independent from political influence, and, for the reasons so often recalled in the current debate, as inflation-proof as the Deutsche Bundesbank, it is not obvious what would be lost by a country surrendering monetary independence individually to that institution – as in the case in which the currency board fixes its parity *vis-à-vis* the euro – even without fully participating in the EMU. As for the period preceding the actual beginning of EMU, the currency board solution would imply surrendering monetary sovereignty either to the group of central banks as weighted by the residual composition of the ecu, should parity be fixed to the ecu, or to the Deutsche Bundesbank, if parity were established *vis-à-vis* the DM.

A more substantial objection to the currency board proposal could be based on the possibility that sudden and huge capital flows, which are feasible under the present regime of free capital mobility and highly developed international monetary and financial markets, correspondingly change the monetary base and possibly generate crises among the country's commercial banks.

To this objection there are two answers. First, particularly in the initial period, some margins of fluctuation could be maintained around the new fixed parity, in principle as wide as those holding in the EMS at that time. Thus the market exchange rate would in part absorb the impact that large swings in the balance of payments would otherwise have on the monetary base. This, however, would run against one essential aim of the proposal, which is to let changes in the fundamental variables affecting the balance of payments be adjusted through their monetary repercussions on the economy at a fixed exchange rate, in view of the final substitution of the European currency for the national currency at that same specific rate. Letting the lira fluctuate within a large band (as with the present EMS) around the parity of 2000 lire for 1 ecu may endanger that very parity.

The second answer is that a final tool for monetary control is held by the country's central bank, even with the currency board solution (apart from the possibility, not to be resorted to, of changing the parity itself). This tool is the bank's required reserves ratio, which could be changed should serious banking difficulties develop as a result of excessive capital movements or other exogenous shocks affecting the balance of payments to an excessive degree. From this point of view, it is a lucky feature of the Italian economy – one not to be thrown away too soon – that the required reserves ratio still in force for commercial banks is high in comparison with that of other European countries, thus leaving room for manoeuvre in controlling the money base multiplier, with a view to avoiding banking crises that might endanger the very credibility of the currency board system.

In the end, however, what we see as being at stake in this criticism of such a system is the function of lender of last resort, which would also be lost by the country's central bank. Yet this function too must, sooner or later, be transferred to the ECB. In the proposal here analyzed, this is done sooner than later; indeed, it comes even before the ECB becomes operational, if the system is adopted as a way to convince the laggard country's partners of her serious commitment to keep anchored to their progress toward EMU. This is a high price to pay, but the odds at stake are also high.

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