Comments on the article

"Towards a more perfect EMU"

by Charles Wyplosz

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The current conditions of macroeconomic stability are, undoubtedly, appropriate for the start of Monetary Union (EMU). The interim period is unfolding smoothly and harmoniously, despite the deep-seated world financial crisis. As a result, the two most serious factors of uncertainty overshadowing the start of EMU have been dispelled. Many thought the inclusion of the peripheral countries would cause problems for the stability and credibility of the new area, resulting in the weakness of the new currency. Many also thought the period between the selection of the countries and the start of EMU would be prone to speculative attacks that could destabilise the entire project at its most delicate phase. Fortunately, compliance with the convergence criteria and the pre-announcement of the conversion parities have proven sufficiently powerful mechanisms to ward off these dangers.

While is important to stress this in order to keep things in their proper perspective, preparations cannot be considered to be complete. Moreover, the launch of Monetary Union will require new and complex problems to be tackled, and the success of the project will hang on their solution. From this standpoint, the paper presented by Charles Wyplosz raises a stimulating series of issues and is a valuable contribution to the discussion of the problems that the imminent onset of EMU poses. I shall refer to some of the economic policy issues raised so as to offer my opinions, which are logically those of a central banker adopting an insider's view of the whole process.

As regards the definition of the governing bodies of the European Central Bank (ECB), I do not consider it right to emphasise the distribution of powers between the members of the Executive Board and the other members of the ECB Governing Council (the governors). Neither group is a uniform bloc and there is nothing in either the Treaty, the Statutes or the recently approved rules of procedure obliging Executive Board members to maintain voting discipline within the Governing Council. On the contrary, they may sustain different positions. Without breaching any rule of confidentiality I can, as a witness to meetings of the Governing Council, attest to the fact that, since this body was set in place, not in a single instance among the hundreds of decisions adopted has debate turned on the respective positions of the Executive Board and of the remaining members of the Governing Council.

There is no doubt that the decision-making body has to be the Governing Council, where the members of the Executive Body and the Governors are on an equal footing. It is thus appropriate that this body should meet as frequently as is necessary to enable it to take all substantial monetary policy decisions. The problem does not lie in the potential rupture between the Executive Board and the Governors, but in attaining the cohesion required so that the Governing Council may function as a collegiate body with a European mission. In this respect, the development of the necessary institutional mechanisms in the European System of Central Banks (ESCB) and of an appropriate analytical framework to ensure that ECB discussions and decisions always reflect an EMU-wide perspective is vital. This is by no means easy to achieve when sufficient accuracy of the main macroeconomic aggregates of the area cannot be assured, and when the integration of money and financial markets is far from complete, since practices and habits stemming from various national institutions' traditions will persist for some time. In this situation, the efficiency of centralised decisions rests on a proper perception of the complexity of the area as a whole. And here, co-operative interaction between the National Central Banks (NCBs) and the ECB is crucial. It would be a serious mistake for the ECB to try and supplant the NCBs' Research Departments. The reports for Governing Council decision-making should be based, as is foreseen, on constant, fluid communication with the NCBs, entailing co-operative development of the macroeconomic scenarios on which monetary policy decisions should be based.

Establishing a single monetary authority starting from eleven national central banks is a complex task and an unprecedented experiment in monetary history. But it is the only way possible. A European central bank with marked centralising intentions and one inadequately co-ordinated with the NCBs would not be suited either to the current reality of European money and financial markets or to the political and institutional architecture of the European Union (EU). Serious tensions and conflict might then ensue.

A matter of greater import is the problem arising from the existence of a single monetary policy in a set of national economies that might show significant differences in their cyclical patterns, in the response to potential shocks and in the very transmission of monetary policy. Charles Wyplosz reports interesting results in the differences perceived in the estimation of the Taylor reaction function. The Banco de España Research Department has obtained results convergent with those of Wyplosz (though likewise vulnerable to the Lucas critique) in the field of the stability and controllability of the monetary aggregates, which are destined to play a key role in the single monetary policy and in inflation developments as a result of the differences in the economies' productivity growth and flexibility. You discussed yesterday a paper by Enrique Alberola and Timo Tyrvanien addressing this topic.

In this sphere the only acceptable rule is that monetary policy should be governed by the conditions of the area as a whole. That means not taking local or regional conditions into consideration (though these should be thoroughly known and studied). Two significant consequences stem from this. Inevitably, as a result of the differences in size of national economies, the single monetary policy stance will be more influenced by the conditions prevailing in the larger countries. A surge in inflation of one percentage point in Spain would scarcely imply a rise of one-tenth of a point in the average inflation of the euro zone, whereby a reaction by the common monetary policy could hardly be expected. The situation would be different if the same problem arose in Germany. The second consequence is that monetary integration necessarily increases the onus on the other national economic policy components to ensure the compatibility of national macroeconomic conditions with the single monetary policy stance.

Although there are grounds for thinking that asymmetric shocks will not be particularly frequent or significant in EMU, it should not be concluded that there is no need for any instruments at all to counter them. The euro will involve a far-reaching structural change in these economies, which will be deprived of a demand-management instrument that has played an important role in the past. The sound working of monetary union requires two fundamental changes in this respect: greater flexibility in European economies and a new design for macroeconomic policy instruments, enabling these to recover their full margin for manoeuvre.

Flexibility in European economies is essential not only with a view to monetary union, but as a condition for competing in increasingly globalised markets. Admittedly, the continental industrial relations model has not been known for its flexibility, and its traditional rigidity has been one of the causes of the high unemployment hindering these economies. In recent years some steps have been taken towards a more flexible labour market and one closer, therefore, to the Anglo-Saxon model; but progress has been uneven in the continental European economies, most of which still require far-reaching structural reform in this area. Clearly, structural labour market reform is a particularly sensitive and delicate area, as it affects a social consensus forged at great cost over decades. Resolute headway towards efficiency and flexibility which does not jeopardise social stability requires cautious and carefully planned policies. That explains why, at times, the overriding impression is that progress in this field is very slow. Monetary union will, insofar as it calls for faster microeconomic adjustments, help accelerate it.

In any event, the exceptional situation whereby a single monetary authority is in league, through the ESCB, with eleven national governments makes a compelling case for tighter economic policy co-ordination, on a two-pronged front comprising fiscal policy and structural reform, with labour market reform clearly to the fore.

As regards fiscal policy, compliance with the Stability and Growth Pact is a necessary but not a sufficient condition.

First, more effective channels must be institutionalised for relations between economic ministers themselves and between them and the ECB. Such channels are required for designing the most suitable *policy mix* for the Union as a whole and for considering the specific conditions of the national economies, in accordance with more efficient arrangements for the monitoring of each country.

Second, I mentioned earlier that national fiscal policies should be conducted in a manner which allows them to have some margin for manoeuvre to counter the impact of the cycle or of unexpected shocks. But in the medium term, mechanisms will also be needed to offset asymmetric shocks at the level of the area as a whole, via inter-regional transfers within the EU that are significantly bigger than is currently the case. Supranational budgetary policy in the EU is a thorny issue as it affects aspects of the political union which, to date, have scarcely been developed. These types of mechanisms should not be confused with others already in place, such as the Cohesion Funds, which are aimed at alleviating the disadvantages of the peripheral countries in terms of infrastructure endowment, with a view to their competing in an integrated economic and monetary area. Both are necessary for the efficient and balanced working of monetary union, but their aims are quite distinct.

As for the labour market, I agree that EMU will have contradictory effects on the attitudes of unions. The disciplinary effect stemming from the loss of the devaluation safety valve must be set against the possible encouragement to unions to behave like *free riders* as a result of their not feeling responsible for the behaviour of overall inflation. Crucially, the probability that the first of these effects will prevail will be all the higher the more flexible are the workings of the labour market and the more decentralised is the wage bargaining structure. Hence, the importance of labour market reform.

The creation of a monetary union with an independent central bank that targets price stability tends to make the link between wage dynamics and employment more visible. In the absence of the possibility of an adjustment via the exchange rate and with low inflation the norm, excessive wage increases will, in those areas where they are applied, tend to lead more rapidly and sharply to losses in competitiveness and a decline in employment. Perception of this should enable decentralised wage bargaining to be compatible with output and employment growth in a context of price stability. Yet for this to come about, far-reaching reforms according sufficient flexibility to national labour markets must be rapidly introduced. In any event, moves towards a greater centralisation of wage bargaining at the level of the whole area of future European Monetary Union would generate shocks on a much greater scale.

It is in fact difficult to conceive of a centralised bargaining mechanism for EMU. Such a framework would enormously hamper any consideration of the productivity differences prevailing among EMU countries. It could prompt an artificial and damaging process of wage levelling, unwarranted by the course of fundamentals. And it might, finally, introduce rigidities into labour markets, countering their necessary tendency towards greater flexibility.

I consider the need for more flexible labour markets to be of particular importance. As reiterated in the recent literature on EMU, forgoing the exchange rate as an adjustment mechanism, in a monetary union where there are very few fiscal mechanisms to soften the impact of asymmetrical shocks, requires a more active role by the labour market to absorb such shocks. More flexible labour markets, in which wages are adjusted to the productivity conditions of each sector and each firm, are hardly compatible with centralised wage bargaining arrangements, whether EMU-wide or at the national level.

I would like to conclude by emphasising my agreement with Charles Wyplosz regarding the ECB's role as lender of last resort. The model of the ECB corresponds to a narrow conception of a central bank, whereby it is attributed solely monetary policy functions, without addressing explicitly the attribution of the inseparable functions of providing emergency liquidity and of preserving the stability of payments systems and financial markets. This narrow central bank definition is based on the belief that the ambiguity in the definition of these functions avoids the problems of moral hazard and interference with the role of monetary policy in combatting inflation.

The weakness of these arguments is particularly glaring in the circumstances under which EMU is set to commence. These include no perceptible inflation risks along with serious problems of financial stability, as a consequence of the weakness of the Japanese financial system, the dire situation of certain *hedge funds* and the impact of the stock market crises on the major investment banks.

Under these circumstances, in which the risk of global credit crunch can not be totally discarded it is essential that the ESCB's role as lender of last resort be visible and devoid of ambiguity. Suitable mechanisms must also exist to enable this role to be efficiently performed, with the support of the

NCBs and in co-operation with the supervisory authorities of the member countries.