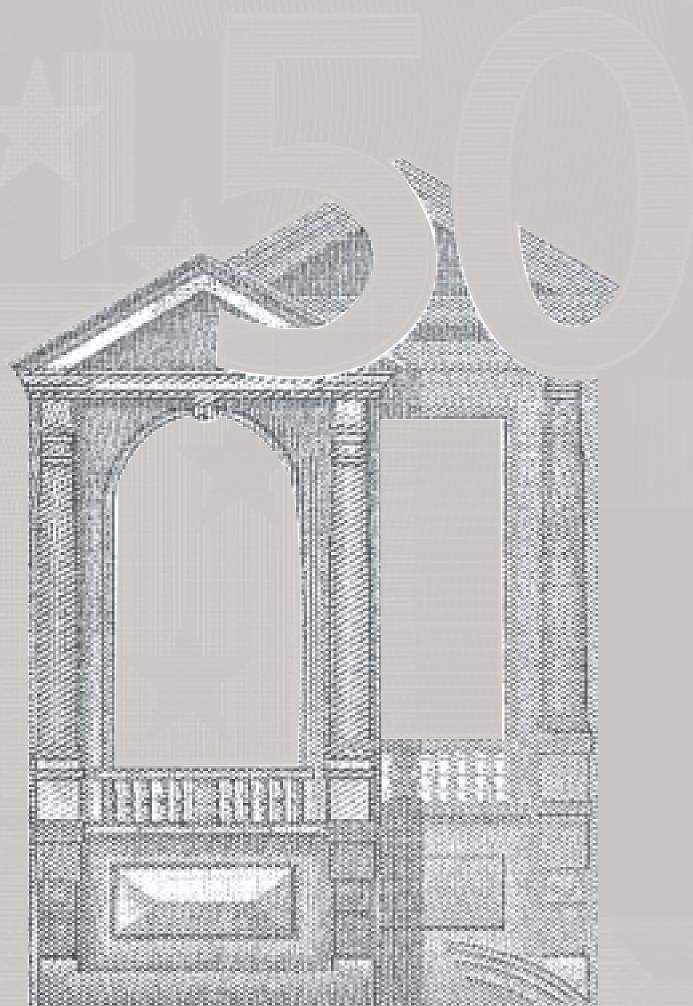
EUROPEAN CENTRAL BANK

THE EUROSYSTEM, THE UNION AND BEYOND



THE SINGLE CURRENCY AND IMPLICATIONS FOR GOVERNANCE

An ECB colloquium held in honour of Tommaso Padoa-Schioppa
27 April 2005

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Address	Kaiserstrasse 29 60311 Frankfurt am Main Germany
Postal address	Postfach 16 03 19 60066 Frankfurt am Main Germany
Telephone	+49 69 1344 0
Internet	http://www.ecb.int
Fax	+49 69 1344 6000
Telex	411 144 ecb d

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I WELCOME SPEECH BY JEAN-CLAUDE TRICHET

PRESIDENT OF THE EUROPEAN CENTRAL BANK

Dear governors,

Dear members of the Executive Board,

Dear colleagues,

Ladies and gentlemen,

My dear Tommaso,

It is my great pleasure to welcome you to the colloquium the European Central Bank is holding today in honour of Tommaso Padoa-Schioppa. This event takes place some 35 years after Tommaso entered the profession of central banking, which he has practised almost without interruption. He was hired by the Banca d'Italia in 1968, and in the 1980s and 1990s his work involved active participation in the establishment of the European Monetary Union. In this, he provided both vision and expertise, from the paradigm of the "inconsistent quartet", to the drafting of the blueprint for the single currency, to the preparatory work for the actual start of the European System of Central Banks. In 1998 he joined the ECB to serve a currency and an institution that was assigned one of the most extraordinary missions a central bank had ever had: to deliver to 11 and, soon after, 12 nations and 306 million Europeans a currency which would have the best level of confidence and credibility from the start.

Today's three sessions cover three fields of great importance to which Tommaso has contributed greatly: central banking; Europe; and international cooperation. In each of these three fields Tommaso developed a remarkable capacity to combine practical activity with reflection and thorough analysis, without which action would be ineffective.

First, *central banking*. Here we are at the heart of our institutional responsibilities as central bankers. Over the course of his banking career Tommaso has substantially contributed to the development of a general paradigm on central banking. This paradigm is drawn from the evolution of modern central banks over the last 200 years, from the adoption of banknotes to their final disconnection from gold. These changes have shaped the two other functions that most central banks have derived from the original payment system function: *monetary policy and banking supervision*. Man-made money made monetary policy possible. Commercial bank money made supervision necessary.

The three functions have most often been entrusted to the same institution, because they are intrinsically linked. Just as money has the interrelated roles of a means of payment, a unit of account and a store of value, so central banking has – in Tommaso's words – a *triadic* function that refers to the three roles of money. Ensuring price stability refers to money as a unit of account and a store of value;

operating and supervising the payment system refers to money as a means of payment; and pursuing the stability of banks refers to money as a means of payment and a store of value. It is through *practice* that Tommaso came to see how much central banking is about issues other than monetary policy. When he was a young economist, the payment function and banking supervision were hardly considered by the literature and the ordinary textbooks on money and banking.

Over the last 30 years central banking has profoundly changed throughout the world. The profession Tommaso joined in 1968 was one where currencies were still anchored to gold through the gold exchange system and central banks were dependent on the government. Many central bankers and a large part of the academic profession were convinced that there was a trade-off between inflation and unemployment. Most central banks were in charge of banking supervision. Today currencies are no longer anchored to gold, while central banks are independent and have been assigned the mission of preserving price stability. Theory has firmly re-established the long-run neutrality of money. Information and communication technologies have profoundly transformed the payment system.

All these changes have not altered the triadic paradigm. Central banks are most prominently involved in monetary policy and payment system issues and, even where prudential control is entrusted to a separate agency, no central bank in the world regards the stability of the financial system as lying outside its sphere of interest. The paradigm still provides a single and consistent order, in which all the activities of a central bank have their place. To each of these activities – from monetary analysis and policy to banknote printing, to market operations, banking supervision, payment systems, relations with other policies and other public institutions, dialogue with the financial community and international cooperation – Tommaso has been assigned at different stages of his professional life. In all these activities the central bank pursues and represents the public interest of a sound currency, one that preserves its value over time. All are instrumental in that interest. From the point of view of the perceptions of people and markets, all relate to one and the same public good, which we call confidence.

The central bank of the euro is a special one. It is a team of 13 central banks. For many generations, its components have performed the full range of central banking functions under their own responsibility and in a national context. Differences existed, and partly remain, in their tasks, organisation, statutes and cultures. In this situation, Tommaso has seen since the beginning the challenge of making the full body of the Eurosystem an effective, continent-wide central bank. Making the Eurosystem the effective central bank of the euro is a demanding challenge because it requires drawing the appropriate line between preserving the diversity of the traditions, cultures and institutional arrangements of our countries, which is an aspect of the richness of Europe, and being *European* or euro area-wide in the definition of the policy missions and of the public interest to be pursued.

E pluribus unum is, I know, the title you had first proposed for one of your recent books, "The Euro and its Central Bank". You explain in the book that the publisher objected, saying that such a title would mislead a computer, or even a person in a bookstore, making them believe that the book was about the United States, whose seal carries this motto. You also explain that philologists say that the right interpretation of the motto should be derived not from classical Latin, where it means "*one among* many", but rather from a later tradition where it means making "a union *out* of many". You know the extent to which I trust our team to be important and decisive in the Eurosystem. The ECB is the captain of that team and we are all players in the field.

Turning from central banking to *Europe* – the theme of the second session – the relationships among European states have changed immensely over the same third of a century in which Tommaso has served as central banker. As you are a central banker by profession, so you are an advocate of a united Europe by political conviction. As a child you had seen the bombing of bridges and cities and witnessed the passing of soldiers through the streets outside the house. As a teenager you listened to your history teacher explaining that the day before (25 March 1957) an important treaty had been signed in Rome. Six European countries had just committed themselves to establishing the free movement of goods, persons, services and capital. To achieve this goal – in which solid peace would be established after centuries of war – they were prepared to renounce part of their sovereignty. The project was economic in content and political in nature. That a united Europe was a worthwhile objective then became the strongest of your personal convictions.

The project moved from the establishment of the four freedoms to the adoption of pervasive common economic legislation, to the creation of the Single Market and of a single institution to enforce common competition rules. This is what you called the economic road to the euro. Along this road, there was the "inconsistent quartet", the proposition you put forward in 1982 to explain the difficulty the European Community had had since 1957 in implementing the free mobility of capital in a system of fixed exchange rates, while leaving monetary policy to national authorities. The incompatibility between the three had been referred to in the literature as the "inconsistent trinity". You suggested turning the trio into the "inconsistent quartet" by adding a fourth element, free trade, a pillar of the Treaty of Rome. In your view, the circle could not be squared: one element had to be surrendered in order to avoid inconsistency. The single currency was the way to square the circle.

By a fortunate accident, both the path of European integration and the central banking path to the euro – the one that led to the intellectual recognition, then the political acceptance, and finally the actual implementation in the Treaty, of price stability as the primary objective of monetary policy and of central bank independence – occupied your life when money became a leading project for further European integration, just at the time you were in the prime of your professional life. Your profession and your European conviction then became a single activity, convinced as you were that Monetary Union, i.e. the confluence of the two paths, was desirable and possible. You served at the European

Commission from 1979 to 1983, the early years of the European Monetary System. You were directly involved in the Delors Committee for the preparation of the blueprint for the single currency in 1987-89, in the 1989-91 negotiations that led to the Maastricht Treaty, and in the 1993-97 preparatory work for the launch of the euro.

Over the last 50 years Europe has invented and implemented, through its own integration, principles of international governance whose validity goes beyond the time and space horizon of its own borders. This leads me to the third session, the *single currency and the world*.

As the central bank of an economy roughly the same size as that of the United States and as the guardian of one of the major currencies in the world, the Eurosystem is gradually developing its international role and policy. The creation of the euro, however, not only involves the development of the role of the euro and the Eurosystem, it also affects global policy cooperation. In this activity too you have remained throughout your work at the ECB a most fervent advocate of the central bank of the euro pooling its forces, acting as a system and playing a role consistent with its institutional mission and interests.

Your belief in international cooperation is founded on a conviction that there are on the global agenda a great number of economic issues – including trade, finance, global imbalances, energy and the emergence of new global and regional players – which, because of the size of the problem or the very nature of it, call for policy efforts that go beyond national borders and make cooperation at the global level desirable and feasible. In a recent series of lectures you gave at the European University Institute, you argued that the long-run solution, what you had earlier called the "royal way", would be to adapt institutions to today's policy needs, to reform them with a view to enhancing their effectiveness and representativeness, extending in many cases some of their operational and decision-making practices. Today, on the occasion of this colloquium, we have the unique opportunity to gather together extraordinarily high-calibre personalities who are playing a decisive role in shaping today and tomorrow international cooperation at a global level. You all know how profoundly the ECB and the Eurosystem are devoted to cooperation, not only at the level of formal or informal groupings at a global level, but also on a bilateral basis with our friends from Africa, from Asia, from Latin America and from the Mediterranean countries, with whom we have established regular encounters. In this domain, particularly, you have brought about a decisive impulse during the first seven years of the ECB's existence. And Wim and I have been profoundly touched by your tireless and very efficient action.

Dear Tommaso, we thank you most gratefully for all these achievements. I look forward to our discussions today. The extraordinary wealth of personalities of immense talent, friends of Tommaso and friends of the ECB that are present in this room promises a highly stimulating and inspiring debate on major issues for Europe and for the world. It is now time for the first panel to commence. Wim, you are chairing.

2 SESSION 1:
A SINGLE CURRENCY AND A TEAM OF 13 CENTRAL BANKS

INTRODUCTION BY WILLEM F. DUISENBERG

FORMER PRESIDENT OF THE EUROPEAN CENTRAL BANK

What a joy it is to be back amongst so many friends, among all of you! I would like to thank you for this, Tommaso, because it was you who brought us here together. We are supposed, as a panel, to talk about "a single currency and a team of 13 central banks".

Are we a team? At the level of the Governing Council, I would say yes, we became a team very quickly. Have the 13 central banks become a team? In my view, this is a process that could take quite a few presidents before it is completed. If you were to ask a staff member of the Federal Reserve Bank of San Francisco or Boston: "Where do you work?", his/her answer would be: "At the Fed". If you were to ask a staff member of the Bundesbank, or De Nederlandsche Bank or the Banca d'Italia: "Where do you work?", he/she would probably still mention the respective national central bank. It may take quite some time before the feeling of belonging to one system is fully integrated in people's minds.

What are the elements that have helped the Governing Council to become a team so quickly after the start? Most importantly, the members of the Governing Council act in complete independence of any political influence. Moreover, the Governing Council takes votes according to the "one man, one vote" principle and by simple majority (not that we ever actually voted during my time, to the best of my recollection, save once).

In the EMI, the voting system required unanimity. Even though this did not make Alexandre Lamfalussy's job very easy, he succeeded in doing a marvellous job in preparing for the establishment of the ECB. However, since we needed unanimity, the most important issues were often endlessly discussed. On very important issues we could, sometimes, not reach agreement at all, so they had to be postponed.

Take, for example, the decisions on the monetary policy strategy and on the definition of price stability, which were postponed until the ECB had been founded. But then they were decided upon in a matter of weeks. Indeed, if there was only one governor who had objections to a certain decision, and if he saw that he was alone on this issue, he would quickly consent, and the Governing Council could rapidly take a final decision.

The "one man, one vote" principle is a crucial element in the decision-making process of the ECB. The principle of independence is at the heart of the ECB's functioning. I remember a discussion I had with the prime minister of one of the larger countries of the euro area, who for an hour and a half tried to persuade me to lower interest rates. Apart from the fact that I didn't take such decisions on my own, I resisted and reasoned against it. At the end, when he waved me out, he

said: “I am sorry, Mr Duisenberg, I apologise to you. I know it is in the law that the European Central Bank is independent of politics. But you have to understand, it is not yet part of our culture”.

Well, that will come. And I believe it has already come to a great extent. Not that we haven’t been under pressure: Messrs Lafontaine, Schröder, Berlusconi, Chirac, have all – at times – tried to influence the ECB, and when this was done publicly, the markets reacted. However, it was more counterproductive than anything else. We listened but we didn’t hear.

As regards decision-making, we had to learn – and we were quick learners – that as members of the Governing Council we were members ad personam. We represented neither the national central bank nor the country we came from. We always had to think in terms of the euro area’s wider interests. I remember – and I am allowed to quote this incident – the first time that the Governing Council took a monetary policy decision to lower interest rates back in April 1999. A couple of days before we actually met, I used to call my colleagues in the Governing Council to announce that it was likely that they would be confronted with a proposal to change interest rates at our forthcoming meeting. I spoke, amongst others, to Matti Vanhalla, our much missed late colleague of Finland. When I told him of the inclination to lower interest rates he shouted to me down the telephone: “Oh no, not for Finland”. When I started muttering, he said: “Stop, Wim, I know what you are going to say. I have to take a euro area perspective”. I said: “Precisely, Matti”. He replied: “Well, I have reflected on it already. You have my support”.

As you can see, we were quick learners. But then, to my mind, monetary policy was almost the easiest task among our responsibilities, because we were all experienced central bankers and our noses always pointed in the same direction. We had intensive discussions on the size of the move – for instance, should it be 25 basis points or 50 basis points – but the direction itself was never in doubt. The size was also quickly decided when a predominant view emerged from a tour de table, making it easy to conclude what should be done.

By contrast, I must confess that reaching agreement on issues other than monetary policy, such as payment systems or banknote printing, wasn’t always that easy. Admittedly, on occasions, national interest still cropped up in the back of the minds of the governors. It was, therefore, more difficult to come to decisions, but nonetheless we always succeeded and, as far as I recall, always without voting.

As far as accountability is concerned, I believe that the decision not to publish the results of votes in the Governing Council – as some other central banks do – was correct. Indeed, since votes were never actually taken, we would have faced the embarrassing situation of being compelled to hold votes in order to publish their outcome. And that would indeed have made our lives even more difficult.

Turning to the group of experts sitting next to me, I don't have to introduce them since they are all known to you. Alexandre Lamfalussy, the first President of the European Monetary Institute, will address the subject of "the ECB and a team of 13 central banks", both as a former central banker and as an academic. Alexandre will be followed by Charles Goodhart, a genuine academic representing – if I may put it like this – one of the Member States still outside the euro area. Charles will be followed by our colleague Roger Ferguson, who, without doubt, will compare his observations of the Eurosystem with his experience as a member and Vice Chairman of the Board of Governors of the Federal Reserve System. Finally, Hans Tietmeyer, whom I also don't have to introduce, will speak as a former central banker.

STATEMENT BY ALEXANDRE LAMFALUSSY

FORMER PRESIDENT OF THE EUROPEAN MONETARY INSTITUTE

I propose to focus my initial remarks on a topic – accountability and transparency – which, as I learned by reading his thoughtful "The Euro and its Central Bank" – is also close to Tommaso's interest.

My starting point is the recognition that what has come to be known as the ECB's "two-pillar" approach to monetary policy strategy can just as well be described as a "diversified" strategy (this is the expression used in most of the Bank's publications) or (a description I would prefer) an "eclectic" policy strategy.

The Bank's monetary policy strategy carries several features which would seem to warrant my use of words. First, the monetary pillar has become a sort of control device which performs two eminently respectable services. It may signal that conclusions drawn from the economic analysis should, in a medium to long-term perspective, be reconsidered (or at least qualified) – for instance, when economic analysis does not warrant concern about potential inflationary developments, but excessive growth of monetary aggregates does. At the same time, any such conflicting signal would force the Governing Council to make a choice, and to explain the reasons for its choice.

But this is not the whole story. As one can learn from the Bank's candid and very articulate book ("The Monetary Policy of the ECB", 2004), the economic analysis itself is not based on a single forecasting model. It has recourse to various models and (I suspect) quite often to piecemeal bits of analysis. No wonder that economists, who abhor such untidiness, dislike this approach, which, however, is made unavoidable by the time pressure imposed on those who advise policy-makers.

My sympathy for this eclectic strategy rests, in a nutshell, on two sets of arguments. One is that the euro area's monetary policy operates in a remarkably uncertain environment. This observation does not refer solely to "external" shocks – such as oil price hikes, terrorist attacks, geopolitical surprises, natural disasters or fiscal misbehaviour by governments. More important are waves of innovation, the accelerating pace of globalisation or changes in the behavioural pattern of consumers or investors. You may find a good example of such "surprises" in the growing influence of asset price developments on the behaviour of US market participants, which, combined with unpredictable (and unpredicted) changes in the rate of growth of the productivity of labour and capital, has not made life easier for the Fed's policy-makers. Fortunately, or perhaps unfortunately, the euro area has not been exposed, or at least not to the same degree, to these challenges. But our policy-makers have to put up with other challenges: the sluggishness of our rate of growth; persistently high unemployment; the very slow pace of supply-side reform initiatives; the anaemic response of domestic demand to low interest rates in some countries, contrasting with worrying real estate price developments in others; uncertainty about how financial integration could affect the transmission mechanism of monetary

policy; and not least, the relatively large liquidity overhang, with its potential impact on asset prices, and perhaps also, from a longer-term perspective, on inflation.

But uncertainty does not prevail only in the economic environment. It also affects the thinking of economists. Monetary targeting as properly defined has gone out of fashion, yet few economists would question the fact that in the long run inflation is a monetary phenomenon – and not only in the sense given to this statement in an after-dinner remark by the late Henry Wallich, who quipped that "inflation is a monetary phenomenon in the same way as shooting people is a ballistic phenomenon". At the same time no one doubts that in the short to medium run the rate of change in the price level is heavily influenced by such non-monetary factors as unit labour costs, the output gap, entrepreneurs' ability to transfer input price increases to their customers, exchange rate and commodity price developments and, naturally, inflation expectations. But I am not aware of any broadly accepted model which would integrate economic and monetary influences into one single, robust and reliable model – nor indeed one that would credibly describe, hic et nunc, the working, over time, of the monetary policy transmission mechanism.

In such a situation, adopting an eclectic monetary policy strategy is an act of intellectual and professional honesty, for which the ECB deserves praise, rather than blame. At the same time, such a strategy deprives the ECB's policy-makers of the possibility of enjoying what we would call in French a "confort intellectuel". They have in fact opted for a high degree of "inconfort": indeed, all eclectic policy strategies impose a heavy burden, in terms of communication, on policy-makers. Let me briefly look into this matter by taking up, one after the other, the two distinct but interconnected topics of accountability and transparency.

The ECB has recognised that as a corollary to its independence it has to practise accountability: it has to explain publicly why it took, or why it did not take, a given monetary policy decision. This is done four times a year by the President reporting to the European Parliament's Economic and Monetary Affairs Committee, as well as in the President's monthly press conferences, but is also done in the Annual Report and in the highly informative Monthly Bulletins – most authoritatively in the editorials introducing these Bulletins. I have found that in terms of accountability the quality of these Bulletins has been steadily improving over time. Witness, in particular, all the trouble they have been taking to explain why the persistent overshooting of the "reference" rate of growth of M3 has not triggered monetary policy reactions. These "ex post" explanations match (and I would argue exceed) in quality and candidness similar efforts made by most large central banks, which, for reasons of courtesy, I would prefer not to name.

Yet at the same time a number of observers, and almost all academics, deplore the fact that the minutes of the meetings in which monetary policy decisions are taken are not published. Let me spell out the reasons why after a lot of soul-searching and hesitation I have come to the conclusion of not sharing their view.

They go back to the point I have just made, namely the fact that the Governing Council has to operate in a very uncertain environment.

Minutes that would clearly identify the positions taken by individual Council members and which, on top, would also reveal their arguments, would carry the risk of boxing in these members in positions which they would be disinclined to abandon. Human nature being what it is, it is asking a lot to change your view, or even worse, to acknowledge that you might have been mistaken. Nobody wants to appear to be volatile or making mistakes in analysis. Yet this uncertain environment requires the ability to react to new information, while at the same time it enhances the risk of an overreaction. An uninhibited discussion among the members, where changing views even during the meeting as a result of a frank dialogue may become a way of life, goes a long way towards creating a framework which could allow the right balance to be achieved between these two conflicting outcomes. A discussion which would be made public a few weeks later would not. It could become almost as counterproductive as a publicly televised meeting.

But there is more to it – and this brings me to the requirement of transparency, which I take to be a more forward-looking concept. Transparency, so it is argued by many, enhances the effectiveness of a price stability-oriented monetary policy and at the same time contributes to financial stability. It does so by providing guidance to the markets about the likely future course of policy decisions, which is liable to shorten the policy transmission process, and which at the same time avoids destabilising "surprises" for markets. It is then also argued that any such guidance, provided for example by the President in his Introductory Statement to the monthly press conferences, could be strengthened by publishing the minutes of past meetings. By reading these minutes, market participants could make up their own minds about the persistence of a balance, or a possible shift in the balance, between, say, "hawks" and "doves". Incidentally, I suspect that one of the reasons for market participants disliking so much the ECB's two-pillar strategy is precisely because an eclectic strategy makes it more difficult to extrapolate the possible shifts in this balance.

I have a great deal of difficulty in espousing this line of reasoning. First, because it is far from being obvious that revealing the course of discussions would necessarily strengthen the guidance provided by the President. It would, if the President's statements, as a rule, turned out to have been supported by an overwhelmingly strong and stable majority. Not if either the "strong" or the "stable" had been missing over time.

Second, and far more importantly, I am beginning to fear that in the current uncertain environment the argument in favour of strong guidance can be overdone. Sure, the guidance must contain the unequivocal message that the Governing Council is committed to fully respecting its primary mandate of maintaining price stability – without which we would be running the risk of losing a remarkably flat yield curve, which in itself is among the most convincing evidence that the ECB's strategy, which by now is more than six years old, has performed quite well. But the argument for strong guidance does not hold when

it comes to pre-announcing the likelihood of small changes, and the direction of these changes, in short-term interest rates. I am impressed by the reasoning of those who argue that such utterances by a central bank which has achieved credibility – and the ECB, despite its tender age, falls into this category – provide the best possible guidance not only to what its Governing Council is likely to do in the near future, but also to what will become the predominant view of market participants, which would dispense these market participants from doing their homework. Yet the uncertain environment in which we live requires more, rather than less, diversified and independent analysis. Not to mention the obvious: that unambiguous guidance is equivalent to a straitjacket for policy-makers. And when policy-makers are central bankers, they run the risk of not being able to get out of this straitjacket without endangering their credibility, and creating what they wanted to avoid: market turbulence.

STATEMENT BY ROGER W. FERGUSON, JR.

VICE CHAIRMAN, BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM

THE EVOLUTION OF CENTRAL BANKING IN THE UNITED STATES

This conference honours the many contributions of Tommaso Padoa-Schioppa. As a staff member at the Banca d'Italia starting nearly four decades ago and as a member of the Executive Board of the European Central Bank since 1998, Tommaso has been deeply involved in what central banks do and how they are organised.

Tommaso has stated: "In shaping monetary policy operations, the role of the financial environment is not less important than the charter".[1] That observation was made in the context of the way open market operations ought to be conducted, but I would like to interpret it more broadly in my remarks today. In particular, I will address the question of whether a central bank's operations depend in an important way on the architecture of the financial system and the economy it serves. The charter imposes a certain framework, but events may require changes to procedures and, on rare occasions, changes to the charter.

To explore this topic, I would like to discuss the evolution of central banking in the United States, with particular reference to currency, relations between the regions and the centre, mandates and communication. Along the way, I will compare our experience with that of the ECB. I will, of course, be speaking for myself and not my colleagues at the Federal Reserve. To start, let me address the title of this session: "A single currency and a team of 13 central banks". How did the United States develop a single currency, and what are the parallels that we can draw with the euro?

A single currency

Although the notes of the First and Second Banks of the United States achieved relatively wide circulation, not until the 1860s, during our Civil War, did a national paper currency become established. The first step was an issuance of Treasury currency, commonly known as "greenbacks" because of the colour of the ink used to print the notes. Shortly thereafter, the Congress authorised the establishment of national banks, which issued notes that were backed by holdings of government bonds. National banknotes of different banks were similar in design and widely accepted in transactions, but the system had some flaws – the main one being that there was no means of quickly adjusting the supply of national banknotes to changing circumstances. In other words, we had established a national currency system but not a central bank to manage it.

This beginning contrasts with the way the euro was established as a single currency out of many European currencies. Rather than having no central bank,

[1] Padoa-Schioppa (2004), p. 86.

what was to become the euro area had, in fact, 12 national central banks, each managing its own currency. Those currencies were brought into line with one another, first through the exchange rate mechanism and later by the permanent fixing of exchange rates. The ECB was then created as a central bank to manage the euro even before a euro paper currency came into existence.

Federal Reserve notes began to circulate in 1914. The System's treatment of these notes serves as an example of Tommaso's observation that central bank operations respond to financial events. Initially, notes issued by one Reserve Bank could not be reissued into circulation by another Reserve Bank. A person could travel from Boston to New York with notes from the Federal Reserve Bank of Boston in his pocket, spend the notes in New York, and have them accepted. But when the notes made their way to the Federal Reserve Bank of New York, that Bank returned the notes to Boston for re-issue. With regard to currency, then, the Federal Reserve System's charter established 12 banks issuing similar, but not identical, currency. Over time, however, financial practice made this distinction unimportant, and the treatment was later discontinued. Today, currency is treated fungibly by the Reserve Banks, regardless of which Bank issued the note. The notes still carry identifiers that let us track the Reserve Bank to which the notes were originally assigned, and they are still allocated as liabilities to individual Reserve Banks. But there is no practical distinction between the notes of the Reserve Banks.

My understanding is that euro banknotes circulate in a similar fashion within the euro area and that any national central bank can re-issue fit euro banknotes regardless of the original issuer. Although the country that originated the production order is indicated by the letter prefix to the euro banknotes' serial number, even that designation is becoming less important as the Eurosystem moves to a pooled system of printing banknotes. Even though the Eurosystem contains the central banks of sovereign nations, the unified treatment of euro banknotes recognises the unifying force of a single currency.

Clearly, then, as one considers currency, the history of the Federal Reserve supports and reflects the truth of Tommaso's statement. As our economy evolved from regional to national, our currency moved more completely in that direction. I would argue that the euro reflects a different perspective, with the currency playing a catalytic role in the development of a continental economy as well as reflecting developments in that regard.

Regions and the centre

In 1913, the very idea of a central bank was contentious in the United States. The result of the Federal Reserve Act was a compromise, with regional Reserve Banks owned by their member commercial banks and a Board in Washington to provide oversight. Although the integration of US financial markets was considerable by the time the Federal Reserve Act was passed, remaining segmentation made it possible to have different prices for Reserve Bank credit in different regions during the System's early years. To be sure, these differences were not huge – basic discount rates differed by as much as 1-1.5 percentage points, with differences of 50 to 100 basis points persisting for long periods. In

Tommaso's terms, monetary policy operations – that is, discount policy – reflected both the regional nature of the System's charter and the partial segmentation of the financial environment.

Further integration of the money market over time shifted the focus of policy from 12 regional discount policies to a single national policy. In addition, concern about operational efficiencies and about the level of borrowing led to a move from discount rates to open market operations as the policy instrument of choice. This shift may also have been aided by the expansion of the government bond market during and after World War I. The use of open market operations accelerated the desire for coordination of policy at the national level, so that one Reserve Bank was not draining liquidity at the same time that another was adding liquidity. Again, the financial environment contributed to developments in policy implementation.

The balance of policy power shifted from the regions to the centre, when the Banking Act of 1935 established the Federal Open Market Committee in its modern form, with the Board having the majority of votes. From the perspective of monetary policy, it was at that point that the Federal Reserve System became a single central bank rather than a confederation of regional central banks. Thus, as Tommaso might suggest, charter changes also played an important role in the structure of policy.

In the Eurosystem, the balance between the centre and the regions is still evolving. The composition of the Governing Council, the Eurosystem's equivalent to the FOMC, and the administrative roles of the Governing Council and the Executive Board reflect the relative strength of the national central banks. This difference in the relative power of the centre, however, should not have great significance for the conduct of monetary policy. As in the Federal Reserve System, each Eurosystem policy-maker is expected to act in the interest of the entire currency area.

In the United States, once policy implementation boiled down to managing the consolidated balance sheet of the Federal Reserve Banks, it made sense to concentrate open market operations in New York, where most major banks and dealers had offices. New York bought and sold on the FOMC's orders, but the resulting portfolio was allocated to each Reserve Bank based on its capital. In the Eurosystem, open market operations are conducted in a unified but decentralised manner. Each national central bank collects bids from financial entities in its country and relays those to the ECB, where they are ranked and allocated accordingly.

I would argue that these slight variations in the implementation of monetary policy reflect the financial circumstances under which each institution operates, with a unified money market in the United States and more fragmented (but consolidating) money markets in the euro area.

Internal dynamics

Although the 1935 legislation that created the Federal Open Market Committee of today shifted monetary policy power from the regions to the centre, important

questions remained about the internal workings of the FOMC itself. With only five of the 12 Reserve Bank Presidents on the Committee at any one time, how were these seats to be allocated?[2]

The FOMC finally settled on a rotation system that was a compromise between strict equality and relative importance of each District in the financial system. New York was given a permanent seat. Cleveland and Chicago were grouped together, and the remaining Reserve Banks were put into groups of three. Thus, Presidents of Reserve Banks other than New York would be FOMC members every other year or every third year. That rotation structure has remained unchanged since 1942.

The FOMC operates through formal votes on policy questions, yet in recent years dissents in the recorded votes have been remarkably rare. Through discussion and with the leadership of the Chairman, the Committee often crafts a policy action that all members can agree on. Yet, if one looked only at the final vote, one would miss the lively and wide-ranging debate that goes on within the meetings themselves. We try to give the flavour of this debate in the minutes released three weeks after each meeting, and we do release detailed transcripts with a lag of five years.

My understanding is that the ECB's Governing Council operates by consensus, although a procedure is in place for a majority vote to determine the course of monetary policy. So far, the ECB has maintained the principle of one member, one vote, with the six Executive Board members and the 12 national central bank governors voting equally regardless of the economic size of the country that they represent. The ECB has had to wrestle with how to adjust voting as the euro area expands over the next decade or so. The European Council has accepted a proposal from the ECB to cap the number of voting national central bank governors at 15 and to begin rotational voting once the number of countries in the euro area exceeds 15. The voting rotation would look a bit like that initially established by the Federal Reserve, with the frequency of voting by individual members depending in part on the economic and financial size of their regions. The big difference, however, is that the national central bank governors would have 15 votes versus the six votes of the Executive Board members, whereas Federal Reserve Board members have a seven-to-five voting advantage over regional Fed Presidents.

Clearly the system that we follow, with strong regional representation but a majority in the centre, reflects the judgement made in 1935 regarding the primacy

[2] At any given time, the FOMC consists of only 12 members – the seven members of the Board of Governors and five of the 12 Reserve Bank Presidents on a somewhat complicated rotating basis. By custom, however, all 12 Reserve Bank Presidents attend the meetings of the Committee. The extra seven presidents are not considered non-voting members of the FOMC; they are just not on the Committee at that time. Since there are no non-voting members of the FOMC, the term "voting member of the FOMC" is redundant. A more accurate term is "non-voting participant". To complicate matters further, some of the extra seven Reserve Bank Presidents are designated as alternate members of the FOMC, depending on the rotation group arrangement.

of political appointees with a national mandate. I would argue, although those closer to the scene might correct me, that the ECB's approach to its regional representation reflects an evolving compromise that attempts to balance the ongoing legitimacy of national monetary authorities with the need for a practical solution to the challenges posed by the increasing number of nations within the euro area.

Mandates and approaches to monetary policy

The original Federal Reserve Act contained almost no explicit macroeconomic goals for the System to follow. The gold standard was thought to be sufficient to produce price stability, and the central bank's lending to meet the needs of trade ("real bills") was seen as fostering financial stability and the smooth functioning of the economy. Nonetheless, fairly early in its history, the Federal Reserve interpreted its mandate to be the promotion of monetary and credit conditions that would foster sustainable growth and a stable value of the dollar. After the Great Depression and World War II, the federal government took a more active role in managing the macroeconomy. The Employment Act of 1946 committed the federal government to use its resources to foster maximum employment. This act provided some broad guidance for the Federal Reserve but not explicit goals for monetary policy.

Against the backdrop of poorer economic performance in the 1970s, the Congress gave the Federal Reserve explicit goals in a 1977 amendment to the Federal Reserve Act. These goals were stated in terms of maintaining long-run growth of monetary and credit aggregates that would promote "maximum employment, stable prices and moderate long-term interest rates". Thus, the mandate really contained three goals, but the last one has been widely interpreted as those long-term interest rates consistent with the first two goals, giving the Federal Reserve a "dual mandate" of maximum employment and stable prices.

Many times in recent decades, the Federal Reserve has stressed its long-run goal of stable prices, linking it with the other half of our mandate by noting that in the long run the two do not conflict. However, at times the Federal Reserve has used the flexibility that our dual mandate provides to consider the variability of real output in policy-making.

For the ECB, the Maastricht Treaty mandated that price stability would be the primary objective. That Treaty also established that the ECB should support the general economic policies of the European Community, aiming at growth and employment but only insofar as price stability is not endangered. This focus on price stability helped establish credibility for the new central bank and has helped anchor inflation expectations among the public. A case can be made that the primacy of the inflation goal also reflected the Bundesbank's distaste for inflation in light of the German hyperinflation of the 1920s and that this legacy was bequeathed to the new European Central Bank. Still, policy-makers need to be free to act when severe supply shocks occur. The ECB has wisely interpreted its mandate as maintaining price stability "over the medium term", giving it flexibility to deal with temporary shocks.

Obviously, in both the United States and Europe, external conditions and experiences have guided the development of the mandate, as Tommaso would have suggested and common sense dictated.

Communication and transparency

As the conduct of monetary policy has changed over time, it has become increasingly important that the central bank communicate in an effective and transparent manner. The Federal Reserve's communications efforts are a work in progress, with several significant advances being implemented over the past few years. In March 2002 the FOMC began to release the votes of its members immediately after its meetings. In December 2004 the FOMC accelerated the release of its minutes from an average of six weeks after the meetings to just three weeks after the meetings. As part of its communication efforts, the Federal Reserve, since the late 1970s, has been providing forecasts of inflation and real economic activity twice a year, as several other central banks have elected to do more recently. Until recently these forecasts had a horizon that could be as short as one year. This past January the semiannual FOMC forecasts reported in the Monetary Policy Report were extended to include the following calendar year.

ECB communication practices differ in some notable aspects from those of the Federal Reserve, with the differences partly reflecting the ECB's unusual situation as a multinational central bank. The ECB does not release minutes or transcripts and does not provide information on Governing Council votes. Rather than detailing the differing views of individual members, who might feel pressure to represent their national interests if their votes were made public, the ECB focuses on explaining the analysis behind the Governing Council's consensus. In particular, the ECB follows its monetary policy meetings with a news conference in which the President reads a statement reflecting the Council's deliberations and then answers questions.

Changes to ECB communication policy in recent years also have reflected the ECB's multinational status. In December 2000, when the ECB started releasing twice-yearly forecasts of gross domestic product and inflation, it chose to release its staff forecasts, in contrast to the practice of the Federal Reserve, which releases the range and central tendencies of projections of the individual FOMC members.

I would argue that the Federal Reserve's ongoing process of transparency may also reflect the highly developed state of our financial markets and a growing recognition that, against that financial backdrop, shaping the expectations of market participants can on occasion be an important adjunct to monetary policy. I would be curious to learn the degree to which the ECB's approaches to communications reflect the financial circumstances as well as the multinational nature of the institution.

Conclusion

In conclusion, I would like to stress the importance of Tommaso's observation about policy that I quoted at the outset. Monetary policy arrangements do, and

should, adjust over time to changes in the economic and financial environment. This brief review of the history of the Federal Reserve shows this adjustment process at work over our 90-year history. The charter lays out a structure for policy implementation that is appropriate for the financial system of the day. The financial system then changes and policy implementation must adapt. Eventually, changes in the financial system can trigger changes in the charter that give policy implementation a new context. While there is no single best way to arrange monetary policy and central bank functions within a multiregional system, I am struck by the broad similarities between the Federal Reserve and the Eurosystem as each grapples with a large, complex and ever-changing macroeconomy. In some ways, your experience has collapsed into several years changes that evolved over decades for the Federal Reserve. But both experiences, and the ongoing changes in the economic environment in which we operate, suggest that the art of central banking is certainly likely to undergo further changes.

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STATEMENT BY CHARLES GOODHART

NORMAN SOSNOW PROFESSOR OF BANKING AND FINANCE, LONDON SCHOOL OF ECONOMICS

A SINGLE CURRENCY AND A TEAM OF 13 CENTRAL BANKS

The money-macro procedures and policies that the ESCB has established have been remarkably successful. The decisions of the Governing Council have enabled the ESCB's primary target of price stability to be closely attained. The evidence from bond markets, and from direct surveys of inflation expectations, indicate that its commitment to do so has become fully credible. The single euro currency was introduced with spectacular efficiency. If imitation is the sincerest form of flattery, then the decision of the Bank of England last summer to remodel its own money market operations upon the (corridor) design established earlier in the ESCB is praise indeed.

Of course, there have been a few minor glitches, the original form of the weekly auction tender being one such, and there remain some areas for discussion, notably the relative advantages of individual or collegial responsibility for policy decisions, and, of far greater importance, the relationship between a federal monetary policy and national-dominated fiscal policies, on which I shall have more to say later.

In promoting these developments, Tommaso has been both a visionary and a practical exponent of making them work successfully. His three main books on European monetary development have already been mentioned several times, as has his famous impossibility theorem of the "inconsistent quartet". Those contributions are justly renowned.

Tommaso's main focus of work over the last 20 or so years has, however, been in the field of financial regulation and supervision, and this has remained a much more unsettled and challenging area than that of money-macro strategies and policies. There do, of course, remain problems in the money-macro arena, not least how to incorporate the accession countries into the decision-making mechanisms of the ESCB, and indeed the EU more widely; this is a subject which may, perhaps, be approached much more extensively in the second session today. But these problems strike me as less severe than those connected with the structure and conduct of financial regulation.

In this respect there is a tension, as Tommaso has frequently emphasised, between the federal nature of macro-monetary policy and the continuing national characteristics of supervisory and crisis management/systemic stability policies. As he has emphasised, there is no longer a "coincidence between the area of jurisdiction of monetary policy and the area of jurisdiction of banking supervision", and this is an "important novelty of the new euro area constitution".

Beyond that, the operational arrangements to handle supervisory and crisis management functions vary from country to country both within and outside the ESCB, ranging from financial services authorities covering the whole financial system, with differing degrees of central bank involvement, to countries in which the central bank continues to do all the banking supervision itself.

No one could sensibly describe the present arrangements for the maintenance of financial stability as "tidy". As financial integration in the EU extends further, increasingly now even at the retail level, the likelihood of any financial crisis having cross-border implications becomes greater. How would such a cross-border crisis be handled? Would it be managed in existing trans-European committees such as the CEBS, or through ad hoc meetings? What would be the role of the ECB or the Commission? Can a crisis really be handled by a committee anyhow? So it is, perhaps, not surprising that the prayer of some regulators is to have a *small* cross-European crisis, just big enough to have a proper trial run of the non-system, but small enough that any coordination and management failures do not seriously matter!

The ECB could not stand entirely on the sidelines in the event of a financial crisis, even if it wanted to do so, which I am sure that it would not. If I was in charge in a national central bank during a crisis in my own country (through some malign quirk of fate) and I had decided that lender-of-last-resort action was necessary, then I would like to have the ECB participate with me in that action, partly to provide a seal of approval and partly to spread the risks. So, the ECB should formulate a policy in advance about how to respond to any such overtures. I have, however, been led to understand that the ECB would refuse any such overtures, pushing all the risks of LOLR actions back onto the relevant NCBs. Then again, the ESCB has overall responsibility for the trans-European payment system(s) and money markets. The ECB could not simply stand on one side if serious bank failures, and perhaps ham-fisted local, national responses, should endanger the smooth working of these systems, and has a mandate for this under Article 105(5) of the Treaty.

Some have argued that national, NCB handling of LOLR support could disrupt ESCB control over euro area interest rates, and thus monetary growth. I have never accepted that argument. The NCB would be bound to report to the ECB how much extra credit it had injected via LOLR, and the ECB could then just adjust its weekly auction amounts to leave the overall monetary base unchanged. What is, however, true is that any serious crisis may affect both confidence and the demand for liquidity severely, and hence make it much more difficult to assess what would now become the correct macro level for interest rates and the monetary base. So, the ECB has an inbuilt concern that any banking crisis be handled expeditiously and conclusively, but that remains the same whoever might be in the driving seat for crisis management at the national level.

It is, indeed, extraordinary, and historically almost unparalleled, for the central monetary authority, the area's central bank, to have no formal role in the maintenance of financial stability in that same domain. Indeed some central banks, notably the US Federal Reserve, were initially established primarily to

maintain financial stability, and their macro-monetary functions, notably of setting interest rates to achieve price stability, developed subsequently. Thus of the two wings of any central bank, that of maintaining financial stability and that of achieving macro price stability, it is at least arguable that the former has had historical precedence.

There are at least four reasons that have been adduced for leaving supervision and crisis management at the national rather than the euro area level. The first is subsidiarity, the idea that such actions are done better by those closer to the banks and to the domestic market place, particularly since the responsibilities involved are so multi-faceted, including licensing, monitoring, enforcement, etc., and have been differently shaped by the laws, cultures and histories of the separate nations. So long as the main retail banks in the euro area were primarily sited in their own nation states, and not cross-border, this argument had some considerable force. But cross-border retail banking is now increasingly common in the smaller EU countries (the accession countries, Scandinavia and Benelux) and the Santander/Abbey merger may be a harbinger of more cross-border mergers in the larger EU states.

The second reason for leaving affairs in this area as they are is inertia, or as the Americans would say, “turf”. With the NCBs no longer setting their own domestic monetary policies, how else are they going to continue giving their myriad employees something, apparently useful, to do?

This consideration links with the next formal reason, which is that under the EC Treaty (Article 105(6)), additional competences in this field can only be transferred to the ECB with the unanimous approval of all the members of the Council of Ministers. In view of the fervent desire of many NCBs to keep this function national, it is hard to see such unanimity for such a transfer for the foreseeable future. That said, this is a formal, constitutional obstacle, and does not derive from any rigorous economic analysis.

I am aware of the previous Bundesbank view that there could be inherent conflicts of interest between monetary management and price stability objectives, though it was ironic to discover, once an FSA for Germany was mooted, that the Bundesbank had been active in bank supervision itself all the time. In any case, I believe that claims about such potential conflicts of interest, like many (but not all) moral hazard arguments, are grossly exaggerated. However, if a real cross-border financial crisis did break out, and its management was perceived as having failed because of contention and disharmony between the various national protagonists, then I could just see a momentum building up for the transfer of competences to a more central body, though even then there could be contenders for this role outside the ECB. But this is just pure conjecture...

The crucial barrier, in my view, preventing any major transfer of supervision, LOLR and crisis management powers to the centre is that the exercise of these powers often, perhaps usually, requires (at least potential) fiscal support. Resolving financial crises can be extremely costly. Losses may have occurred and banks need recapitalisation. By the time commercial banks come to their central

bank for liquidity support, they may well have pledged, or sold, most of their safe liquid assets, so even pure lending (of last resort), let alone recapitalisation, may involve large losses.

The national central banks nowadays can, and do, coordinate with their national ministry of finance; the days when central banks could bully their own commercial banks into a "voluntary" levy to support an injured member of the bankers' club are now in most cases over, in part a victim of the globalisation of financial intermediation.

So financial crisis management nowadays not only is, but really has to be, a joint exercise between the central bank and the supervisory agency on the one hand, and the ministry of finance (or treasury) on the other. At the national level, such a relationship, though occasionally it can be frosty, comes quite naturally; central banks and their treasuries coordinate and cooperate on a wide variety of issues and at many levels, from regular minister/governor meetings to myriad working level committees and interactions.

There is just no equivalent at the euro area level. I am not aware of any federal, EU source of funds that could be tapped – indeed probably tapped at short notice – to shore up a failing financial system in the euro area as a whole. Moreover, how would any such funding, if it could be found, be made consistent with Community rules preventing state aid to bolster declining companies? At the national level, during a crisis, they would have the executive power to resolve the crisis first and worry about maintaining consistency with EU directives at some later date. I doubt whether such single-minded executive determination could be achieved at the federal EU level. Failing any such external fiscal support, the capacity of the ECB *by itself* to provide assistance is strictly limited. Lending against the collateral of already fully liquid assets does not do much to inject extra liquidity. Lending which is uncollateralised on the other hand involves the risk of loss, and the ECB, like other central banks, does not have unlimited capital, and will be concerned to maintain its own solvency. Again my understanding is that the ECB is not, at least currently, prepared to take on any such risks.

This is just another example of the many problems raised by having transferred the conduct of monetary policy to the euro area level whilst keeping fiscal policy relatively strictly to the national level. As some of you may remember, I was a member of the Expert Committee at the Commission in the early 1990s, whose report, "Stable Money – Sound Finances" (European Economy, No 53, 1993), tried to resolve that dichotomous problem. Our report was first pigeon-holed and then rejected. Many of the EU's subsequent difficulties have stemmed from that rejection.

If the funds, essentially tax-payers' money, to resolve a financial crisis are to come from national treasuries, then resolution of cross-border problems will ultimately have to depend on negotiations between such national bodies. He who pays the piper, calls the tune. The ECB may have an advisory, consultative role – perhaps it could even admonish – but I cannot see it going much beyond that, under present fiscal structures.

As Tommaso has often noted, this has given rise to a structure that is neither tidy, nor coherent, in which the domains of macro-monetary policies and financial stability are divorced. The remedy for this, however, depends on first rewriting the domains of monetary and fiscal policies more broadly. If you want to centralise crisis management and the responsibility for financial stability in the euro area, then you must first address the question of how to provide sufficient supporting fiscal competences at the associated federal level to make such crisis management effective and credible. Without such fiscal reform, the present hotchpotch will remain.

STATEMENT BY HANS TIETMEYER

FORMER PRESIDENT OF THE DEUTSCHE BUNDESBANK

Thank you very much, Mr Chairman. I was indeed involved, for a long time, in the process of preparing for EMU and the single currency, but – and this is the big difference – you, Alexandre, were the President of the EMI and you, Wim, were the President of the EMI and the ECB, whereas I was a simple member of the Council of the EMI and, for a short time, of the Governing Council of the ECB.

I have listened very carefully to what has been said so far. I will not go into details and I will not tell you new stories. Neither do I intend to give an academic lecture. I will simply address some specific points which came to mind when I looked at the title "a single currency and a team of 13 central banks".

Contrary to many fears expressed, especially before the introduction of the single currency, the euro is today without doubt a currency which enjoys a worldwide reputation and whose importance is growing, as all indicators show.

While this statement clearly holds true today, there is no guarantee for the future. Rather, future developments will depend very much on how we deal with the risks that we are currently facing both in the world economy and in the euro area. In particular, while global growth rates are still robust, a number of problems can be detected inside the euro area itself. I will today touch upon just some of those problems.

Indeed, as has already been mentioned by some of the previous speakers, there are still a number of unresolved structural, economic, social and political problems – especially in some of the larger euro area countries – resulting in persistently low growth rates, high unemployment and growing public debt. In my view, the reform efforts have, until now, been too short-sighted and not sufficiently consistent to generate new domestic growth dynamics and stimulate job creation. In particular, European markets lack flexibility.

Another big concern is the growing potential for serious conflicts resulting from overly permissive budget policies in a growing number of Member States. The so-called "improvement" of the Stability and Growth Pact agreed at the European Council in March will, in my view, mainly entail a loosening of the rules of the Pact, which carries the risk of undermining the credibility of rule-based commitments by the Member States. I therefore fully share the serious concerns expressed by the ECB and some national central banks. Lasting fiscal discipline was rightly regarded – both in the Maastricht Treaty and in the Stability and Growth Pact – as crucial for the sustained stability of the single currency and the peaceful coherence of national economies within a single currency area.

Against this background, the efficient supervision of budget policies can be considered the second pillar of EMU, in addition to monetary policy, given that,

inside a monetary union, market control via exchange rate movements ceases to function. Hence, there is a lack of efficient control by markets while, at the same time, the non-bail-out rule alone is not sufficiently credible.

Lasting fiscal discipline is especially important in Europe, where the shares of the public sector and public debt are traditionally high compared with many other economies. Moreover, demographic developments will inevitably bring new challenges. Further corrosion of fiscal discipline inside EMU could trigger conflicts, not only among Member States, but also with the single monetary policy. I am not talking about the next month. I am looking ahead, say five years or so. Against this background, much will depend on the way in which the European Commission and governments implement the rules of the Stability and Growth Pact.

Let me turn to the single monetary policy. The team of 13 central banks, as the title of our session says, has – according to my assessment – all in all done a good job over the last six and a half years – even without having faced the challenge of a financial crisis! Charles Goodhart appeared to argue somewhat in favour of submitting us to such a test, but I am happy that we could avoid it.

Tommaso, in whose honour this colloquium is being held, has contributed greatly to the success of the ECB. He even found time to deliver numerous lectures and to publish interesting books, as has already been mentioned.

However, before dealing more closely with the ECB's success, I cannot avoid making a short remark on the expression "a team of 13 central banks". True, there are 13 central banks in the euro area, but are they really equals? They are indeed all part of the same system. However, they have different functions, which must be acknowledged.

The ECB is, of course, different – stronger and weaker at the same time. It is clearly responsible for monetary policy decisions. However, the responsibility for these decisions ultimately lies with the Governing Council, in which, in addition to the six Executive Board members, all the 12 national central bank governors have a vote. Moreover – and this is probably even more important – the Executive Board can only decide on its own where the Governing Council has assigned to it the responsibility for a certain issue. This is very different from the former structure of the Bundesbank, where the Executive Board had its own defined responsibilities.

The 12 national central banks are – in the area of monetary policy – responsible for the execution of the policy decided by the Governing Council. Thus, in this field, there is limited room for independent decisions. However, as far as other areas such as the supervision of banking and payment systems are concerned, the national central banks continue to have the final decision-making powers.

All 13 central banks clearly belong to one family: the Eurosystem. At the same time, it is not easy to define who is actually the mother and who are the children. That depends very much on the functions. At least, the children have a lot of

responsibilities of their own, and the governors have their personal responsibilities and cast their own vote.

The structure of the ESCB is clearly more complicated than the expression "a team of 13 central banks" seems to show. True, all 13 central banks are involved in the common task of preserving a stable single currency, reflected by lasting price stability. This goal can, of course, only be reached if they work together as a real team. The team must, however, realise and respect the fact that, in line with the Treaty, the individual team members have to perform different tasks. In the Governing Council, all 18 members – the six Executive Board members and the 12 national central bank governors – have to vote in their personal capacity and not – and I should like to stress that – as representatives of their respective institutions.

Votes on issues relating to the ECB and the ESCB must not be motivated by national considerations. This important requirement needs to be recognised not only by the individual Governing Council members, but also by politicians when they decide on new Executive Board members. The qualifications of candidates are, in my view, more important than their nationality.

All 18 members of the Governing Council must be good team players. Without the appropriate team spirit among the relevant individuals, neither the ECB nor the ESCB could accomplish its tasks. You, Wim, were – as far as I can judge – very successful in bringing together different personalities and different national experiences and traditions inside the ECB and the Eurosystem. That was and is a challenging task, also for Jean-Claude, but you have both managed the task with great success.

This spirit of teamwork must, however, prevail not only within the Executive Board and the Governing Council, but also at staff level. This is particularly important, because staff members are contributing to a large extent to the success of the Eurosystem and of the single currency.

Let me make a short remark on the question of whether consensus is the appropriate rule for decision-making in the Governing Council. During the first few years, this practice was important and probably decisive for the success of the ECB. However, in my view, this does not necessarily imply for the future that the ECB should always wait with a decision until a consensus has been reached. Sometimes voting on a majority basis might be unavoidable in order to reach a timely decision. Waiting for a consensus can, in special cases, mean missing the right point in time. Let me stress that this was a general remark only; I am not referring to any specific decisions. Nonetheless, I think this should be taken into account.

As far as transparency is concerned, I don't regard the criticisms – coming mainly from Anglo-Saxon voices – as justified. The ECB has been doing a lot to improve transparency, as evidenced by its press conferences, Monthly Bulletins and testimonies before the European Parliament, etc.

At the same time, I should like to add one remark on the question of the publication of economic projections. The publication of economic projections drawn up by staff experts has already become a tradition. To be frank, this goes somewhat beyond what I personally find appropriate. Of course, the Executive Board and the Governing Council need as much information as possible. But the official publication puts an official stamp on the detailed projections, which – in the event that these do not materialise – could harm the reputation of the institution. One should, therefore, be careful with this instrument.

The issue of the publication of minutes has already been mentioned, and I can only share Alexandre's view that the present practice is appropriate. I don't see how the publication of minutes could really bring about a big improvement in the internal discussions and provide additional information.

Let me turn to the monetary policy strategy. One of the most important achievements of the ECB was the concrete definition of its main objective, price stability, and the publication of its strategy for monetary policy. With a clear definition of the target and of the two-pillar strategy – both have, in the meantime, been somewhat, but not substantially, revised – the ECB has not only clarified its objectives and policy line. It has also, from the outset, given an important orientation to the public and the markets.

Particularly important in my view are two aspects. First, there is no specific target for the exchange rate. The exchange rate is, however, taken into account when assessing the risk for internal price stability. Hence, the exchange rate is not neglected. This is a very important point, since, at the beginning, there was neither a full understanding nor a full consensus on this question. Moreover, in addition to the first pillar, the second pillar – developments in monetary aggregates – plays an equally important role. For example, the present debate on the question of whether and how asset price bubbles could be prevented or addressed has been, eventually, coming to the – correct – conclusion that a preventive policy should closely observe developments in monetary aggregates and take full account of such developments in the taking of monetary policy decisions. Of course, monetary aggregates cannot be the sole pilot. But such developments should not be neglected either.

Let me make a comment on the question of cooperation within the Eurosystem and on the question of external representation. In addition to monetary policy, there are, of course, also a lot of other points where close cooperation among the 13 central banks of the Eurosystem is useful and necessary. The large number of committees and working groups shows how intensive this cooperation in the euro area is today. I consider this cooperation very positive, even if there are often different opinions on the allocation of responsibilities between the ECB and the national central banks, as well as among the national central banks.

In this context, one point seems to be of special importance, namely the question of external representation vis-à-vis other international organisations such as the IMF, informal groups and European institutions. It was Tommaso who, within the Executive Board, was – and is – very much involved in this debate. This question

is not clearly resolved by the Treaty. It might have to do with the fact that the Delors report left this issue wide open, whereas the Werner report was much clearer on this point: external representation should be fully transferred to the ECB or a European government. The subsequent step was to establish the two institutions.

The reasons for avoiding a clear solution in the Treaty are clear. The competences of national central banks in the euro area have, traditionally, been very different. Therefore, some national central banks fear losing too much by transferring further responsibilities to the ECB. In the meantime, the team of 13 central banks has, in most cases, found practical solutions, at least for the foreseeable future. But I am sure the team will be confronted with this question again in the future, especially against the background of enhancing the formal status of the Eurogroup through a longer-serving President.

In this context, the controversial discussion about the EU Constitution could stimulate a new debate. Even though discussion is likely to concentrate mainly on the distribution of responsibilities between the governments and the ECB, the question of external representation could also be addressed, especially as regards external representation in informal political groups.

All in all, further discussions on this point seem unavoidable. In addition to the debate on the distribution of responsibilities between the ECB and the other EU institutions, there will also be some further reflection within the Eurosystem on the distribution of responsibilities between the ECB and the 12 national central banks.

Let me conclude with a general assessment. The establishment of EMU and the introduction of a single currency was clearly a historical step. The monetary part has to date worked better than many sceptics feared. This is to a large extent the result of the positive teamwork within the Eurosystem.

This positive assessment should, however, not be misinterpreted. A lot of challenges remain: weak growth and high unemployment in some countries, mainly as a result of unresolved structural problems and a lack of flexibility and mobility; the erosion of fiscal discipline in some Member States, despite public debt, both open and hidden, which is already high and continues to grow; and the conflicts that have already started among the euro area countries, as well as between the governments and the central banks. Against this background, it is becoming increasingly clear that the euro is not only a great opportunity, but also a great challenge.

GENERAL DISCUSSION – SESSION I

In response to the questions raised by Roger Ferguson, **Christian Noyer** pointed out that the open market operations conducted by the Eurosystem worked, in effect, like one single operation. He felt that, in view of the differences between the legal systems of the euro area countries, it was preferable to keep the current decentralised approach, all the more so as progress in information technology and telecommunications had rendered the centralisation of open market operations in one market place unnecessary.

Jacob A. Frenkel, supporting the views expressed by Alexandre Lamfalussy, underlined the fact that the need for an eclectic approach to monetary policy decreased if monetary policy focused on medium-term objectives, given that the influence of non-monetary factors on price developments was diminishing over the medium term. He cautioned against the assignment to central banks of objectives beyond price stability, as such objectives could expose central banks to pressure to support government policies incompatible with price stability. Finally, he felt that the diversity within the Eurosystem should be recognised as an asset as long as they were teaming up harmoniously under the guidance of a skilful conductor, which he felt had been the case.

In response, **Roger Ferguson** argued that, in the view of many academics, monetary policy was a more efficient tool than fiscal policy to support – although not to fine-tune – financial and macroeconomic stability, given that monetary policy could react more rapidly and flexibly. Against this background, the question of whether central banks should play a role in these areas remained legitimate, as reflected by the dual mandate of the Fed.

In response to the observations of Charles Goodhart on the absence of a federal finance minister in the EU framework, **Alexandre Lamfalussy** stressed the need to distinguish between macroeconomic policy issues and financial stability issues. As regards the former, it was questionable whether the establishment of a federal finance ministry in the EU would lead to better fiscal results than the current institutional set-up. In this context, he pointed out that a number of EU Member States were conducting reasonable fiscal policies within the current policy framework, while, by contrast, the United States was experiencing fiscal problems despite the existence of a federal finance ministry. At the same time, he agreed that the case for establishing an EU federal finance ministry was stronger in the field of financial crisis prevention. He felt, however, that enhancing the institutional stability of the Eurogroup – in particular by extending the mandate of its President, by providing appropriate staff and by intensifying the network among finance ministers – was clearly a step in the right direction in order to address these concerns.

Christa Randzio-Plath suggested that the poor performance of the EU in terms of growth and employment was due not only to the lack of structural reforms, but also to shortcomings in macroeconomic policy coordination, a question that had also been raised within the European Parliament. In her view, the inefficiencies

in EU macroeconomic policy coordination stemmed from central banks' anxiety about losing their independence. By contrast, in the United States the dialogue between the Fed and other economic policy-makers was not considered to jeopardise the Fed's independence. Turning to the issues of central bank transparency and accountability, Mrs Randzio-Plath felt that the ECB was endowed with a particularly high degree of independence, given that the ECB – unlike other central banks – had the competence to define price stability. She wondered whether there were certain borderlines that the ECB did not want to cross in terms of transparency, accountability and communication with other actors.

In reply, **Roger Ferguson** pointed to the experiences of the "quadriad group", consisting of the Chairman of the Fed, the Secretary of the Treasury and economic policy-makers from the White House. During the 1960s this group had attempted to coordinate macroeconomic policies on an ex ante basis. However, this attempt had failed, as inflationary pressures had built up and fiscal policies had got out of hand. Today, fiscal policies in the United States were set by the Administration and Congress according to their preferences, while the monetary authority set its policy to accomplish its objectives, with primacy accorded to price stability. This strategy had yielded better results in terms of price stability than the arrangements prevailing during the 1960s. While monetary policy would certainly need to take account of fiscal policy developments and the economic outlook, there was no case for establishing formal coordination mechanisms.

3 SESSION II:
A SINGLE CURRENCY AND A UNION OF 25 MEMBER STATES

INTRODUCTION BY GIULIANO AMATO

FORMER VICE-PRESIDENT OF THE EUROPEAN CONVENTION

First, let me say what a joy it is to be back in the club of central bankers, a club where I learnt a lot and became acquainted with very interesting people. I therefore thank you, Jean-Claude, for giving me the opportunity to rejoin the old club.

The topic of this panel discussion is the single currency and the Union of 25 Member States. All of you know that following Mr Delors' famous report in the late 1980s, the decision was taken that the single currency should be compatible with national fiscal and economic policies. Consequently, the context would not be one of integration, but rather one of coordination. This was the main bet for our future, the obvious consequence of which was that each of the Member States, at the time fewer than now, could both benefit from the new single currency and/or damage the new single currency through the conduct of its economic and fiscal policies. The main problem that we now face, therefore, is how to increase the benefits and reduce or avoid the damage through coordination.

We should focus on the errors where they are most significant, i.e. the Single Market. When the euro was introduced, it was perceived and envisaged as the completion of the Single Market through the elimination of the competitive distortions that resulted from the changing values of different currencies. But somehow the benefits of the single currency also presuppose that a single market exists and, in this respect, another problem arises. In recent years, we have seen that by not completing the Single Market, by preserving fragmented national markets in several areas, our Member States are increasing the damage not for the others but for themselves. As they no longer have recourse to competitive devaluations to counterbalance these negative externalities, they pay a direct price for them. In other words, preserving national markets means that you pay the price of higher costs without having the safety valve of competitive devaluations. Thus, suicidal policies are sometimes pursued by some of our Member States, where vested interests prevail over national ones. Is this not one of our problems?

The topic of our session also relates directly to the Stability and Growth Pact and to what we have been trying to do to improve it. Personally, it is my opinion that some sort of discretion may be better than the legal tricks we have witnessed during the last few years. Instead of a Stability Pact that has been bypassed for years through legal devices that only formally demonstrate that part of the debt of the public administration is not public by giving a private legal personality to branches of the public administration, I would prefer discretion. But I am strongly against this discretion being given to ministers; discretion is only better when it is put in the hands of a true defender of the European interest: in other words, in the hands of the Commission. This was what I fought for during the Convention, but I was largely defeated, although not completely. As it now stands, the Pact is

no better than it was before, even though political discretion has taken over the role that legal tricks had in the past.

Certainly, the single currency is also closely linked to the issue of structural reforms. We know that the open method of coordination is a very weak method of coordinating policies. Is it possible for us to effectively coordinate political action related to what we, in jargon, call “positive integration”: social policies, industrial policies and so on? Or is Vítor Gaspar right when he says that positive integration is beyond what is feasibly possible, because diversities are so deep and so numerous that all efforts to converge on positive European actions are doomed to fail? In this case, the final question arises: would it make sense for us to fill the existing hole in the triangle of economic integration, monetary integration and political integration? Were political integration to make sense, should it be limited to removing obstacles, without going further towards positive political actions at the European level? Vítor is very sceptical about this and he has written a wonderful paper on this topic. In my view, Vítor is perhaps a little too sceptical, and according to him, both Hamilton and Monnet lost. But was there not a “New Deal” in the 1930s that you somehow fail to consider?

STATEMENT BY VÍTOR GASPAR

SPECIAL ADVISER, BANCO DE PORTUGAL[1]

MARKETS AND POLITICS: "FROM WAR TO SWEET COMMERCE"

Benjamin Friedman has characterised Tommaso Padoa-Schioppa as a "European Patriot". Jacques Delors refers to him as "a patient propagator of monetary cooperation in Europe".[2] The images are apt. As Tommaso himself stresses, his involvement in the construction of Europe reflects strong commitment and conviction. His attitudes, towards European integration, stem from his memory of the 20th century. Memories of a continent divided by war and scarred by political tyranny. He likes to quote Montesquieu[3] when surveying the history of European integration: "Politics: from war to sweet commerce".[4]

Montesquieu's remarkable text is worth quoting in full:

"Commerce cures destructive prejudices, and it is an almost general rule that everywhere there are gentle mores, there is commerce and that everywhere there is commerce, there are gentle mores. Therefore, one should not be surprised if our mores are less fierce than they were formerly. Commerce has spread knowledge of the mores of all nations everywhere; they have been compared to each other, and good things have resulted from this. One can say that the laws of commerce perfect mores for the same reason these same laws ruin mores. Commerce corrupts pure mores, and this was the subject of Plato's complaints; it polishes and softens barbarous mores, as we see every day. **The natural effect of commerce is to lead to peace. Two nations that trade with each other become reciprocally dependent; if one has interest in buying the other has interest in selling, and all unions are founded on mutual needs.**"[5] [6]

My contribution to the panel "A single currency and a Union of 25 Member States" will focus precisely on this theme from Tommaso Padoa-Schioppa: "Politics: from war to sweet commerce". Thus, the paper will focus on a special aspect of the close interrelationship between politics and economics. In general, it is fair to say that, in the process of European integration, politics and economics are co-evolutionary and co-determined. To discuss the specifics of the

[1] The views expressed are my own and do not necessarily reflect those of the Banco de Portugal or the Eurosystem.
[2] Preface in Tommaso Padoa-Schioppa, Efficiency, Stability and Equity, 1987, Oxford, Oxford University Press.
[3] Montesquieu, The Spirit of the Laws, edited by Anne Cohler, Basia Miller and Harold Stone, Cambridge Texts in the History of Political Thought, 1989, Cambridge, Cambridge University Press. Originally published in 1748 as "De L'Esprit des Lois".
[4] Tommaso Padoa-Schioppa, The Euro and Its Central Bank: Getting United After the Union, 2004, Cambridge, MIT Press. The quote in the above text is the title of Sub-Section 1.1 (page 1) in the book.
[5] Montesquieu, op. cit., page 338.
[6] The text in bold is the excerpt chosen for inclusion in the book The Euro and its Central Bank. The quotes are included on page 4 and in footnote 4 on page 186. The translation of the last sentence included in footnote 4 is slightly different from that here (which is taken from the Cambridge University Press edition cited above in footnote 4).

case of economic and political integration, we will consider the arguments put forward by Friedrich Hayek in an article published at the beginning of World War II, *The Economics of Interstate Federalism.*[7]

As early as 1939, Hayek stated that one of the main benefits from interstate federations derives from the removal of impediments to the free movement of goods, services, people and capital. An interstate federation should make it possible to develop a common rule of law, a common monetary system and joint control over communications. The benefits from such developments would be considerable. Importantly, in line with Montesquieu, Hayek saw economic integration as a necessary condition for the sustainability of political union, aiming at interstate peace. More explicitly, in the absence of economic union, the divergence of well-identified interests, along national borders, would strain unity and, eventually, lead to the fragmentation of the union. Thus economic integration is not simply a fortunate concomitant of political union, but rather a crucial condition for its sustainability. Hayek illustrates his argument, pointing to the absence of any historical example of a political union in the absence of economic union.[8]

Trade integration allows the size of markets to expand. Large markets lead to important benefits, in terms of efficiency and growth. Large markets allow comparative advantage, economies of scale and scope, contestability and competition to play their roles fully. On the financial side, market integration allows the allocation of savings to the best investment opportunities, provides incentives for the production and processing of relevant information, and creates opportunities for risk spreading and risk diversification, thereby improving the social ability to cope with the hazards of entrepreneurship, thereby fostering research and development, innovation and productivity growth. Trade and financial integration interact in important and complex ways. For example, the increased financing means, opened up by financial integration, allow entrepreneurs to explore investment opportunities created by the expansion of markets.

At the same time, economic integration ("commerce") is a tremendous spontaneous force for political integration. Market intercourse leads to a multiplicity of interests, reconciled in the market place. The multiplicity of interests and the heterogeneity and instability of relevant coalitions of interests limits the relevance of special interest politics. Importantly, the limited relevance of special interest politics does not imply, in this setting, that general interest politics substitute for partial interest politics. On the contrary, an extension of the role of the competitive market place leads to a global limiting of the role of active politics, in general. However, no conclusion follows from the previous remarks. In order to establish it a further political fact is necessary. That political fact is the fact of diversity. As a federation becomes larger it is bound to become more diverse. This remark is particularly relevant in the European context.

[7] New Commonwealth Quarterly, V, 2, September 1939, pages 131-49. Reprinted in F. A. Hayek, Individualism and Economic Order, 1948, Chicago, University of Chicago Press.

[8] The presentation of Hayek's position closely follows John Gillingham, European Integration 1950-2003, Cambridge, Cambridge University Press, page 10.

To repeat, Hayek stresses that economic integration limits public authorities in their ability to act. Clearly, economic integration sets constraints on the economic policies of individual states. Moreover, Hayek continues, the fact that a given function cannot be performed at the level of the individual states does *not* mean that it will be performed at the level of the union as a whole. It does follow that some functions will have to be performed at the union level or not at all. The difficulty with performing them at the union level is political. Given the fact of political diversity, in a large union, there will be serious difficulties in reaching agreement on policies aimed at promoting *any* particular interests. Some powers not exercised by individual states cannot be exercised at the union level either. The consequence is devolution of power to lower levels of government (regional or local – in line with a generalised "subsidiarity" principle[9]) or even to the level of private economic agents and citizens.

Thus, in this paper, we will also want to make use of a very important fact about Europe stressed, among others, by Ortega y Gasset.[10] It is the fact of Europe's diversity, of its plurality. It is worthwhile to recall again the words of Montesquieu, who said, "Europe is only a nation made up of several".[11] The fact of Europe's plurality and diversity is key to understanding the dynamic and evolving features of its unity. Ortega y Gasset also quotes Guizot, who stressed that European civilisation contrasts with all others in that no principle, idea, group or class has ever triumphed in absolute form and that explains its progressive character and growth.[12]

Market integration and liberalisation were key challenges in Europe in the post-war period. Creating a single and integrated continental market among a plural and diverse polity were also challenges confronting the US founding fathers in the late 18th century. Moreover, the political challenge associated with size and the corresponding diversity and plurality was one of the main themes, from Montesquieu, that justified James Madison's attention and efforts in *Federalist*. The Philadelphia Convention was called in order to guarantee the end of discriminatory commercial practices, by individual states. The debate led to the so-called "commerce clause".[13] It may be argued that the spontaneous play of

[9] Subsidiarity provides a criterion for the allocation of policy function between central government and the constitutive states of a federal system. The criterion specifies that power should lie with the lowest level of government capable of carrying out the function in an effective and efficient manner. Robert Inman and Daniel Rubinfield – in Subsidiarity and the European Union, in The New Palgrave Dictionary of Economics and the Law – attribute the concept of subsidiarity to 20th century Catholic philosophy. They quote Pius XI: "Just as it is wrong to take away from individuals what they can achieve by their own ability and effort and entrust it to a community, so it is injury and at the same time serious evil and disturbance of the right order to assign a larger and higher society what can be performed successfully by smaller and lower communities (...) The more faithfully this principle of subsidiarity function is followed and a graded hierarchical order exists among the various associations, the greater also will be both social authority and social efficiency, and the happier and more prosperous too will be the conditions of the commonwealth".

[10] José Ortega y Gasset, Unity and Diversity of Europe, Chapter 2 in Toward a Philosophy of History, 1941, W. W. Norton & Company.

[11] Montesquieu, Monarquie Universelle: Deux Opuscules, quoted in Ortega y Gasset, op. cit.

[12] Ortega y Gasset, op. cit., pages 55-56. Quoting Guizot "La coexistence et le combat de principes diverses" in L'Histoire de la Civilisation en Europe, page 35.

[13] Article 1, Section 8, Clause 3 of the US Constitution.

market forces, under protection from discriminatory practices by individual states, under the commerce clause, has been key in shaping the economic order in the United States. It is an interesting challenge to draw some analogies for Europe. It has been done before, for example, by Russell Hardin.[14]

Emphasising that politics and economics are co-determined and co-evolutionary is not to say that only economics is important. European integration is a political process and it is driven by the political motivations of Member States. The outcome of the process reflects inter alia Member States' bargaining power. It also reflects their efforts to develop institutions, which will foster cooperation durably over time. From this viewpoint, economics plays its role influencing Member States' preferences and constraints.[15]

In the main section of the paper, we will try to establish a parallel between the early history of the United States, after the war of independence, and the early history of European integration, after World War II. The idea will be to illustrate the mechanisms (presented by Hayek in his 1939 paper) at work. We will illustrate how the political fact of diversity constitutes a powerful obstacle to integration based on active interference in market dynamics. We will argue that these forces were ultimately responsible for the defeat of Alexander Hamilton's vision (in the United States) and Jean Monnet's (in Europe). The approach claims no originality. It relies heavily on research produced by John Gillingham and Russell Hardin and it is inspired by the tradition of *law and economics* associated with the Freiburg School.

The commerce clause and the Treaty of Rome

The commerce clause

The Philadelphia Convention of 1787 was called to bring to an end disruptive trade practices under the Articles of Confederation. Specifically, its main end was to eliminate tariffs and other trade barriers among the 13 states. The problem originated in the fact that, after the war of independence, individual states imposed restrictions, taxes and tariffs on interstate trade that proved disruptive to harmonious commercial intercourse. It was clearly understood, at the time, that the main objective of the Convention was to establish national power over commerce. The relevant notion of commerce encompassed both international trade and interstate trade.

James Madison[16] wrote a clear statement about the discriminatory effects of state trade practices, allowed under the Articles of Confederation:

[14] Russell Hardin, Constitutional Economic Transition, Chapter 6 in Liberalism, Constitutionalism and Democracy, Oxford, Oxford University Press, 1999. This account of the history of the commerce clause, and the analysis of its consequences, largely follows Hardin's.

[15] See, for example, Andrew Moravcsik, The Choice for Europe: Social Purpose and State Power from Messina to Maastricht, Cornell, Cornell University Press, 1998.

[16] Federalist Papers, 42, 22 January 1788.

“The defect of power in the existing Confederacy to regulate the commerce between its several members, is in the number of those which have been clearly pointed out by experience. (...) Were [individual States] at liberty to regulate trade between State and State, it must be foreseen that ways would be found out to load the articles of import and export, during the passage through their jurisdiction, with duties which would fall on the makers of the latter and the consumers of the former.”

The commerce clause reads:[17] “The Congress shall have the Power (...) To regulate Commerce with Foreign Nations and among the several States, and with the Indian Tribes”. The commerce clause achieved what it aimed at.[18] It ended discriminatory commercial tariffs and regulations enacted at the level of individual states. Moreover, the federal government itself could only tax particular categories of transactions on a uniform (non-discriminatory basis). The commerce clause transformed the United States into a single market.

Alexander Hamilton[19] affirms that the purposeful action and regulation of the federal government should replace that of the states. Alexander Hamilton believed that, in order for his vision to triumph, positive, activist policy at the federal level was necessary. Such policy was not barred, as a matter of principle, by the Constitution. It only proscribed certain discriminatory practices by individual states. However, Hamilton’s efforts to enact policies to provide federal incentives for business and commerce were blocked. They were blocked by people like Jefferson and Madison, who did not share Hamilton’s vision. Hamilton’s failure, at the legislative level, led to a tradition limiting the scope of government’s intervention in the US economy. It stemmed from basic disagreements on the nature of the US economic system going forward.

Russell Hardin, in his recent paper, stresses that the commerce clause did not motivate a transfer of power from state governments to the federal government. Instead, it led to the devolution of power to individual, private economic agents, acting on their own. Limits to discriminatory exercise of state power did not imply, contrary to Hamilton’s vision, a necessary transfer of power, for positive action, at the federal level. The commerce clause served businesses much more than it served the federal government. The main point is that commerce takes care of itself as long as particular interests (vested, in this case, as state interests) are prevented from interfering with it.

Russell Hardin’s history of the origins and effects of the commerce clause brings us back to Hayek. Firstly, the commerce clause was necessary in order to prevent individual states from disrupting commerce among the 13 states. A unified market was a crucial prerequisite for political union. In its absence, the Union would be fragmented by interstate conflicts over commerce. Secondly, the consequences from freedom of commerce and market integration went much

[17] Article 1, Section 8, Clause 3 of the US Constitution.

[18] Russell Hardin, Constitutional Economic Transition, Chapter 6 in Liberalism, Constitutionalism and Democracy, Oxford, Oxford University Press.

[19] For example in Continentalist, 5, 18 April 1782, reproduced in Philip Kurland and Ralph Lerner, The Founders Constitution, vol. II, pp. 477-479.

further than economics. They were fundamental determinants of the Union's own cohesion. Thirdly, the commerce clause, by helping to restrict the overall scope for government interference in the economy, fundamentally shaped the form of the US economic constitution. The last aspect follows from the difficulties associated with agreement on positive action at the federal level. These derive from the diversity and dispersion of particular interests in a large federation. Finally, the economic constitution that emerged in the United States proved favourable to US long-run prosperity. Business interests were effectively protected under the constitution and private initiative was allowed to thrive. Haberler makes the point very clearly when he writes:

"The American economy had the good fortune of having been integrated at a very early stage. When the War of Independence ended, economic relations among the states resembled those of the German States after the Congress of Vienna. Under the articles of Confederation, each of the 13 states pursued its own tariff policy. But through the Constitution a huge free trade area for the unimpeded movement of goods and services, labor and capital was created, which was surely a major factor in US economic development".[20]

The Treaty of Rome

European integration is one of the great historical enterprises marking the second half of the 20th century and the launch of the 21st century. Even before the end of the war, a number of intellectual visionaries produced the idea of a united Europe as the outcome of a voluntary transfer of sovereignty from the existing nation-states. Altiero Spinelli issued a manifesto as early as 1941. It led to a General Declaration, in 1944, proposing a federal structure for Europe. The document was subscribed by the resistance leaders from many European countries.[21] Jean Monnet was immediately attracted to the idea. The post-war period brought to power a generation of statesmen of vision, favourably inclined towards European integration, including Gasperi and Sforza; Bidault and Schuman; Adenauer, Bevin, Spaak and Beyen.

In 1950, the Schuman Declaration launched the process leading to the signature, in Paris, in 1951, of the Treaty establishing the *European Coal and Steel Community* (ECSC). Clearly, European integration stems from political motivation: to put the horrors of the past behind, ensuring lasting peace and prosperity. At the same time, it is clear that in the immediate post-war period Europe was characterised by highly segmented markets, along national borders. In continental Europe, international trade was conducted in accordance with some 200 bilateral trade agreements. National governments imposed a maze of exchange controls and import restrictions, struggling to balance their trade. In the absence of an international financial system, all deficits had to be settled in dollars or gold. Both were desperately scarce in Europe at that time. Under these constraints, the benefits that are normally associated with international

[20] Gottfried Haberler, Integration and Growth of the World Economy in Historical Perspective, American Economic Review, vol. LIV, no 2, part I, (March) 1964, page 4.

[21] See Sidney Pollard, Integration of the European Economy since 1815, London, Unwin Hyman, 1981.

trade could not be realised. At the time, it seemed more difficult to recover from the overall disorganisation of the economic system in Europe than to recover from the physical destruction caused directly by war. Indeed, by 1948 industrial production in continental Europe had already reached pre-war (1937) levels.

The situation was such that it brought vivid memories of the mistakes made during the inter-war period. The period was dominated by nationalism, an exuberant trust in the power of the nation-state, fortified inside the walls of protectionist policies. During the 1920s, many countries tried unsuccessfully to return to the gold standard. Later, faced with deflation and depression, some countries resorted to competitive devaluations justifying the adoption of protective measures elsewhere. In the end, events proved incompatible with a well functioning international monetary system and even with well ordered multilateral trade. It is possible to argue that autarkic policies not only threatened economic prosperity but may also have laid the ground for World War II.[22] Gottfried Haberler, in his Presidential address to the American Economic Association in 1963,[23] characterised the inter-war years, a period of sharp decline in international trade and disintegration, as an interruption in a secular trend (encompassing about 200 years) towards increased economic integration.

Autarkic policies followed in the inter-war period laid the roots for the forest of quantitative trade restrictions and bilateral agreements and settlements existing by the late 1940s. After World War II, there was a widespread consensus that it was fundamental to avoid the mistakes of the inter-war period.

Government interference was not confined to international trade and payments. These were times of extensive government interference in the economy. In order to do so the government resorted to a panoply of instruments (now all but forgotten), including administrative pricing, quantity rationing, directed credit, investment planning and much else. Two years after the end of the war, in 1947, it was far from clear that a European return to prosperity would be successful.[24]

In an important moment for European integration, General George Marshall, US Secretary of State, delivered a speech at Harvard University.[25] The main topic of the speech was European economic recovery and the US role as a facilitator of the process. Jean Monnet, Robert Marjolin, Georges Bidault and Ernest Bevin led the way. Two important initiatives occurred in the early 1950s.

[22] The argument would be that it is not sensible to insist on the payment of war reparations in the context of widespread protectionism.

[23] Gottfried Haberler, Integration and Growth of the World Economy in Historical Perspective, American Economic Review, vol. LIV, no 2, part I, March 1964, pp. 1-22.

[24] The story, in this section, is, obviously incomplete. It focuses far too much on Europe. Global developments such as the Bretton Woods Agreements of 1944 and the creation of the General Agreement on Trade and Tariffs (GATT) are most relevant. Taking these explicitly into account would expand the narrative without much affecting its thread.

[25] Available from the Department of State Bulletin, XVI, no 415 (15 June 1947), pp. 1159-1160. The speech was delivered on 5 June 1947. The General Agreement on Trade and Tariffs (GATT) was also launched in 1947.

The first development, the Schuman Plan, led to the ECSC. The second, the European Defence Community, failed in the French National Assembly in August 1954 and led nowhere. Since trade liberalisation was high on the agenda, it was clear that the way out of this *cul-de-sac* was economics. Politicians turned eagerly towards Montesquieu's "sweet commerce". Many new proposals basing a re-launch of Europe on trade liberalisation were put forward. The most important and influential of these proposals was under the responsibility of the Dutch Foreign Minister Willem Beyen. The Beyen Plan envisaged a customs union as the next step forward for European integration. It provided the kernel for the "Benelux Memorandum", which, in turn, provided a basis for the work in Messina, under the Chairmanship of the Belgian Foreign Minister Paul-Henri Spaak (from May 1955 onwards). Such was the path that led to the Treaty of Rome.

The similarities with the commerce clause are striking. The motivation was, in both cases, the removal of barriers to the creation of a continental market with freedom of movement of goods, services, people and capital. Second, the commerce clause led to a situation limiting the scope of overall government intervention in the economy (at all levels of the administration). In other words, states' powers were limited without a corresponding increase in policy action at the federal level. Similarly, according to Gillingham,[26] the Treaty of Rome emphasises market competition and freedom over the Community's pro-active interference. Russell Hardin makes a closely related point. He says that today, when countries in Europe complain about the transfer of power to the European level, they are reliving the misguided nature of the Constitutional debate in the United States.

Markets and diversity constrain politics: Alexander Hamilton and Jean Monnet

Interestingly, in 1962, in the first issue of the *Journal of Common Market Studies*,[27] Jean Monnet affirmed that the Treaty of Rome did not prejudge the future economic system in Europe. In his view, planning procedures, for Europe as a whole, were as compatible with private enterprise in large markets as they were at the national level. He pointed to examples of national planning procedures in continental Europe and the United Kingdom. It seems clear that he saw a strong need for policy action at the European level in a wide range of sectors. His position does bear some similarities to Alexander Hamilton's views.

Jean Monnet was, of course, right. The Treaty of Rome did not exclude planning at the European level. However, the logic of Hayek's argument, given the fact of European diversity, prevented the necessary political agreement. The defeat of the Monnet model of European integration did not take place at the Treaty level (as Hamilton's did not happen at the Constitutional level). The reason pro-active policies have not been followed, at least up to now at the European level, is not

[26] Gillingham quotes W. R. Lewis, Rome or Brussels, An Economist's Comparative Analysis of the Development of the European Community and the aims of the Treaty of Rome, London, 1971, page 8.

[27] Jean Monnet, A Ferment of Change, Journal of Common Market Studies, 1/3, 1962, page 205.

that they are excluded by the Treaty. Instead, they have not been used because of difficulties achieving agreement at the European level.

Fortunately, in the United States, as well as in Europe, experience shows that pro-active policy actions are not necessary for proper functioning of markets. Clearly, the "invisible hand" does not operate in an institutional vacuum. It does have institutional prerequisites, for example, institutions to ensure open and competitive markets, right of contract, protection of property rights and, more generally, the rule of law. Indeed, it seems undisputed today that the security of property rights is fundamental to make investment in physical and human capital possible. Given these pre-conditions, further active interference by the public sector is not necessary for the functioning of the market mechanism. Difficulties to overcome before active policies can be pursued stem more from different interests and perspectives on the proper functioning of the economic system, rather than from the specific details of European decision-making (the parallel with the United States is striking).

It is worth revisiting Haberler's early view on the likelihood of European integration. His point has to do (like Hayek's) with the viability of policy decision-making at the European level. He wrote, in 1949, that "political or economic union in western Europe is utterly impossible".[28] He spelt the argument out in full:

"In our age of economic planning or, at least, of drastic government interference in the economic process, if a group of countries wishes to enjoy the benefits of economic unification, if they really want to create a free trade area such as exists within the boundaries of the United States, they must agree not only on a common tariff but also on all major phases of economic policy such as price policy and rationing, credit and investment policies, monetary and fiscal policies and several others."[29]

Haberler draws two fundamental (intermediate) conclusions: a) that economic unification is impossible without political unification; and b) that economic unification is politically impossible unless there is a return to a situation of relatively little government interference in economic affairs.

Therefore, he is able to reach his final judgement: "The inescapable conclusion, then, is this: In a democratic Europe there will be either planning and no economic or political unification, or, if there is unification there can be no comprehensive economic planning. Since I do not believe that there will be sufficiently widespread and far-reaching return to economic *laissez faire*, I do not expect economic or political unification. There will be no European union now or in our time".[30]

[28] Gottfried Haberler, Economic Aspects of a European Union, World Politics, 11(4) (July 1949), pp. 431-441.
[29] Haberler, op. cit., page 433.
[30] Haberler, op. cit., page 435.

Hayek and Haberler's arguments on the links between economic unification and politics seem well grounded in the history of US economic constitutionalism and in Europe's experience since World War II. Economic integration has progressed, pushed by market forces, not only despite of but because of the absence of comprehensive economic policy in the European Union. As Eichengreen points out, multilateral commitment to liberalisation and openness were key for the impressive economic performance in Europe in the post-war period (up to 1973).[31]

Conclusion

European integration has been one of the major evolutionary forces shaping world history in the second half of the 20th century. The canonical account of history looks at it from the viewpoint of politics. In its perspective, the main motivations for European integration have been, to use Adenauer's phrasing, first and foremost, political and not economic. Going to the extreme of simplicity the central driving force has been (and still is) the key priority both France and Germany assign to avoiding military conflict in the European continent. In this paper, we tried to emphasise the simultaneous, co-evolutionary character of politics and economics, following the fundamental insights from Friedrich Hayek.

How does this relate to the theme of the panel: "A single currency and a Union of 25 Member States"?

As we have already seen, the link is provided by Tommaso Padoa-Schioppa's phrase "from war to sweet commerce". The single currency leads to a deepening of the Single Market. There is ample evidence of a causal link from monetary unification to economic integration ("one money, one market"[32]). Otmar Issing, in a recent paper,[33] called political integration the unresolved side of the triangle ("economic integration, monetary integration, political integration"). He sees a pragmatic, step-by-step way forward, stressing Hayek's image of a "discovery process"[34] for an as yet unknown institutional solution. In this paper, we argued that such a path will be influenced by major evolutionary forces: market-driven integration and competition. Competition is the force driving Hayek's discovery process. Competition exercises its disciplinary and evolutionary powers, not only among economic agents, but also among institutional systems.

[31] Barry Eichengreen, Institutions and Economic Growth: Europe after WW II, in Nicholas Crafts and Gianni Toniolo (eds.), Economic Growth in Europe since 1945, Cambridge, Cambridge University Press, 1996.

[32] See, for example, Tamim Bayoumi, Michael Kumhof, Douglas Laxton and Kanda Naknoi, Exchange Rate Regimes, International Linkages and the Macroeconomic Performance of the New Member States, in Carsten Detken, Vítor Gaspar and Gilles Noblet (eds.), The New EU Member States: Convergence and Stability, Proceedings from the Third ECB Central Banking Conference, ECB, forthcoming. See the introduction to this volume for further references.

[33] Economic and Monetary Union in Europe: Political priority versus Economic Integration, in Ingo Bartens, Volker Gaspari and Bertram Schefold (eds.), Political Events and Economic Idea, 2004, Massachusetts, Edward Elgar.

[34] F. A. Hayek, Competition as a Discovery Procedure, in F. A. Hayek, New Studies in Philosophy, Politics, Economics and the History of Ideas, London, Routledge, 1978, pp. 179-90.

It is important to repeat that the single currency leads gradually, but significantly, to a deepening of the Single Market. The pioneering contribution was made by Andrew Rose.[35] He explored systematically the link between currency unification and trade integration. In a recent survey of different empirical studies, he considers the impact of a bilateral currency union on trade to range between 30% and 90%. Studies on the euro suggest slow adjustment with estimates of increased trade after five years of about 10%.[36] Moreover, recent evidence suggests that financial integration proceeds even faster after monetary unification.[37] With the single currency the spontaneous market push towards integration has been significantly magnified.

It is trivial to say that enlargement of the European Union to encompass 25 Member States has increased its diversity. With diversity the likelihood of agreeing on policies at the European level to promote particular interests or to tackle the policy challenges associated with the circumstances of the day diminishes. Thus, barring major disruptions, the conditions are propitious to produce a framework of stable rules leading to stable expectations. Such an environment supports private sector agents' ability to plan for the future, to innovate and to invest. This should be expected to lay the groundwork for European progress and prosperity. The point is reinforced by the specific characteristics of the new Member States. The new Member States are, in general, small fast-growing economies, catching-up economies with strong competitive positions relative to other EU Member States and the rest of the world. Thus, they are likely to oppose any initiatives that would weaken competitiveness and to favour strengthening the unopposed play of market forces. Moreover, characterised by a highly qualified labour force and relatively low wage costs and, in some cases, low and transparent tax systems, these countries will strengthen the play of competition pressures among the Member States of the European Union.

It is as if the current environment is calling on Benjamin Constant[38] to complete Montesquieu.[39]

[35] See Andrew Rose, One Money, One Market: Estimating the Effects of Common Currencies on Trade, Economic Policy, 30, pp. 9-45 and A Meta-analysis of the Effects of Common Currencies on International Trade, NBER Working Paper, 10373, March, 2004.

[36] See H. Faruquee, Measuring the Trade Effects of EMU, IMF Working Paper, 04/154, 2004 and A. Micco, E. Stein and G. Ordonez, The Currency Union Effects on Trade: Early Evidence from EMU, Economic Policy, October 2003, pp. 315-343, 348-356.

[37] See L. Baele, A. Ferrando, P. Hördahl, E. Krylova and C. Monnet, Measuring Financial Integration in the Euro Area, ECB Occasional Paper, 14, 2004.

[38] Benjamin Constant, The Liberty of the Ancients Compared With That of the Moderns, in Biancamaria Fontana (ed.), Constant: Political Writings, Cambridge, Cambridge University Press, 1988.

[39] "War precedes commerce. (...) War is all impulse, commerce, calculation. Hence, it follows that an age must come in which commerce replaces war. We have reached this age. (...) Commerce inspires in men a vivid love of individual independence. Commerce supplies their needs, satisfies their desires, without the intervention of the authorities. This intervention is almost always – and I do not know why I say almost – this intervention is always a trouble and an embarrassment. Every time collective power wishes to meddle with private speculations it harasses the speculators. Every time governments pretend to do our own business they do it more incompetently and expensively than we would."

A European Union with 25 Member States reminds us that transformation is pervasive in economic life. An economic constitution can only be successful, in a lasting way, if it provides a framework that facilitates change. Economic constitutions that create obstacles to economic change are likely to be costly in the short run and unsustainable in the long run. A European Union of 25 shows again that the European way to prosperity and innovation lies in its diversity.

STATEMENT BY DANIEL GROS

DIRECTOR OF THE CENTRE FOR EUROPEAN POLICY STUDIES

In my intervention, I will try to add some nuances to the arguments just put forward by Vítor Gaspar. One way to summarise my point of view might be the following: We have just heard why for objective, positive reasons it might be difficult in a more diverse Union to pursue an active policy management from the centre. I want to offer you a slightly different view, namely why active demand management might not be desirable, even if you could implement it. I think this is one of the core issues one should address when one thinks about the implications of a single currency for the governance of the EU, especially, of course, for economic governance.

Let me start with a proposition which has very wide implications. It is a proposition that is almost always just assumed. What is this proposition? If you want to put it in economic terms, it is quite simple. It says: if you are in a monetary union national fiscal policies have spillover effects. Any increase in demand in one country has an impact on other countries. This means that without fiscal policy coordination the Nash-equilibrium of uncoordinated fiscal policy is suboptimal. The conclusion is simple: we need coordination of fiscal policies. For most experts, this is an open/shut case; we don't need to discuss it any further.

I would like to open the case again and to give you one big and one smaller reason why this case should be re-opened and why perhaps the desirability of fiscal policy coordination is much less strong than many people believe.

Before I do that, let me make two quick parentheses. First, I was tempted to attribute the simplistic view that "of course" fiscal policy coordination is required in EMU to Tommaso, but he told me that this would not be correct. He has different views (plural) on the subject. One of these is contained in his book, in the last section of the last chapter, where he writes about the lack of political union being a challenge for Monetary Union. The sense of my intervention is: maybe it is not only a challenge, it is also an opportunity!

And, as a second part of the parentheses, I wish to emphasise that I will be speaking technically about fiscal policy, but as already discussed up to now, similar arguments apply also to other policy areas like all these structural policies subsumed under the Lisbon process. The key question is: as long as these policies remain in the national domain, do we need a strong coordination mechanism at the EU or euro area level?

As I said, initially the theoretical case for fiscal policy coordination in the euro area seems open and shut: There are spillover effects, which implies that we need coordination. But I would like to have reality encroach a bit on these general considerations in two forms.

The first point is technical, but very important. Just consider the following: if you have a fiscal expansion in one particular member country of the monetary union, do we actually know what the signs and the size of these spillover effects are? The

true answer is: we do not. Because, as we all know from basic economics, fiscal expansion in one country, if it works, increases demand at home. This in turn increases imports from partner countries, so other countries gain in that respect. Gain means in this case that more exports should mean higher employment (and not higher prices). But a fiscal expansion in any one EMU country also puts pressure on the area-wide interest rates, which has another effect which goes in the opposite direction. The net effect is unclear ex ante. It will vary from country to country, from circumstance to circumstance, depending on how strong these effects are.

To make a crude example, start with a fiscal expansion in Germany. Presumably, the direct demand effect is stronger for Belgium than, let's say, for Greece, which has less trade with Germany than Belgium. But, of course, there are other things which are different, the structure of the Greek economy might be different, the impact of a higher interest rate on the Greek economy might be different and so on. Hence it is even difficult to say ex ante whether Greece or Belgium would gain or lose more from a fiscal expansion in Germany.

So, once we know that the two effects go in opposite directions, we might be tempted to turn to our macroeconomic models and get a precise answer. However, this does not work because when you turn to models you get as many answers as you have models, and not just in terms of the size of the spillover effects, but also their signs. And also in the way the signs evolve over time; in some models the spillover effects are first negative, then positive, in others the other way around. So that is the first problem: if you really want coordination, which model do you take? And as we all know, coordination based on the wrong model might not exactly be a recipe to achieve a superior outcome.

But let me emphasise much more a second reason to be sceptical about the benefits of coordination which I think is insufficiently recognised, although Alexandre Lamfalussy this morning actually mentioned it. This line of thinking starts from the observation that it is easier to define fiscal policy in theory than in practice. In theory, in our models, we can execute an optimal fiscal policy, in other words we always do exactly the right thing at the right moment. In reality, however, we know that fiscal policy does not work that way. There are a variety of reasons why actually there is a large error or disturbance element in all fiscal policy actions.

For example, if the French or German government were to increase their deficits today, are we certain that this will lead to more demand? Or does it rather lead to some non-Keynesian effects decreasing demand, because people are afraid of future deficits? At present, we cannot be totally sure either way. The assumption is generally that Keynesian effects are stronger, but we do not really know. A second consideration is that many actions affect the structure of our fiscal systems. Many countries have recently reduced corporate income taxation – what will be the net effect on revenues? Will the expansion of activity and the repatriation of profits actually lead to higher revenues or lower revenues? What will be the impact on investment demand and so on? We do not really know.

So there will always be an error term. Politicians and parliaments can pass certain laws and regulations, but we do not really know for sure beforehand what the outcome will be in terms of demand and output. So when we write down our models, we should keep in mind that in reality we always have a large error term at the very end, and this applies to all countries. And then the question for a monetary area is: what is the overall effect of these national error terms? In principle one would expect them to average zero if governments do not make systematic mistakes. But a more interesting question concerns the variability of the sum of these national disturbance terms. The variance of the area-wide sum is equal to the sum of the variances of the national error terms plus the co-variance term. At this point a general proposition becomes straightforward: the larger this co-variance term, the higher the overall variance in the monetary union. In this sense no coordination might be better than none at all.

Let us first consider the case where there are no spillover effects. In this case you have only pure diversification effects. The more different sources of errors we have, hopefully with little correlation, the better off we are; the more we impose coordination – for instance if you tell everybody "Yes, reducing corporate income taxation is good", or "Yes, now we are in a recession in Europe, full speed ahead with fiscal policy" – the more we actually increase the co-variance in error terms. And that means the overall variance of the economy will increase, which will make the management of the monetary union more difficult.

If the spillover effects are actually positive, the proposition becomes even stronger. The more coordination you have, the higher the probability that you also coordinate an error. And with positive spillover effects these errors would reinforce each other. So the stronger the spillover effects, the better it is not to have coordination because otherwise you are driving yourself in the wrong direction. Only in the case that many people consider unlikely, namely that fiscal policy in one country actually has a negative effect on demand and output in other countries, only in that case can you say that if you coordinate more, you are more likely to make the same mistake, but those neutralise each other.

In conclusion, one should keep in mind that with coordination it becomes more likely that countries follow the same approach and, therefore, are more likely to go in the same direction in their errors as well. This implies that one cannot maintain that more coordination is always better. It may destabilise a monetary union and it may make it less easy to govern and less easy to maintain price stability.

Many people argue that it is more difficult in a diverse union to agree on policy coordination. Maybe this is desirable; maybe we should conserve a very large degree of national diversity because that diversifies also the sources of error. Let me close with that remark.

Giuliano Amato

I thought that Vítor was already taking an extreme position, but you demonstrate that Vítor was moderate somehow and you go far beyond him. According to you,

we may have been working on a false issue for years and even central bankers could ask themselves whether there is anything at all to be done by a central bank. Happily for them they at least have to ensure price stability, so if prices go up they are supposed to do something. But, based on your assumption, this might also be wrong. Somehow you remind me of an old and wise Italian politician who told me once when I was in my first years in government: “Remember, Giuliano, that when we hold these positions we have to minimise the damage that we do in being here”.

STATEMENT BY KARL LAMERS

FORMER FOREIGN AFFAIRS SPOKESPERSON OF THE CDU/CSU PARLIAMENTARY GROUP IN THE DEUTSCHER BUNDESTAG

Mr Chairman, dear friends, I am of course also an outsider in this distinguished community of bankers, central bankers and economists. As an outsider, I do not have the other panellists' wealth of practical experience in the field of European economic policy or their extensive theoretical knowledge, so I will simply attempt to contribute some thoughts on basic policy principles. I do so as someone who fully endorses Tommaso's conviction that Europe's economic unification is an indispensable component, although of course not the only component, of our continent's full political union.

First, a definition. We have coined the term "European model" to sum up the essence of Economic and Monetary Union. This model tends to be defined solely in terms of its objective, which is to combine a liberal economic system with the principle of solidarity – in other words, to establish a new and positive balance between freedom and justice, competition and solidarity under the conditions of globalisation. But the European model is also a unique method of institutionalised cooperation among Europe's 25 nations. In pursuit of this economic goal, these nations have removed the borders within Europe to form the Single Market and have transferred the responsibility for competition law to the European level. Monetary policy competencies in respect of the single currency, albeit still confined to 12 Member States, have also been handed over to Europe. A rather limited transfer of resources based on solidarity is also taking place between the stronger and the weaker Member States.

By dismantling its borders, Europe has thus become part of, but is also a response to, what we call globalisation. The economic tenets enshrined in the provisions of the Maastricht Treaty and the Stability and Growth Pact are based on an acceptance of the globalisation process and the recognition of the ensuing need for structural adjustments. They map out a programme for the modernisation and recovery of the European economies, although the responsibility for achieving these goals, in line with the principles and objectives established by the EU, still rests with the Member States.

Second, an analysis. How has this system functioned to date, and how will it function in future with ten new Member States which differ considerably from the EU15? Let me make it clear from the outset that the European level has fulfilled its responsibilities. This can, however, not be said of the national level to the same extent. I am neither willing nor able to pass a judgement on all aspects involved, but what I can say with certainty is that the measures adopted by the European Commission to complete the internal market and enforce fair competition have been both appropriate and necessary. Certainly, one would sometimes have wished for the Commission to state its overall position with greater clarity, but this certainly does not apply for individual Commissioners, such as Mario Monti, who is here today. It is still too early to judge the effectiveness of the new Commission, but it is clear that it will face additional difficulties owing to the

increased number of Commissioners and the specific conditions pertaining in the new Member States. What is unclear at this stage is whether the new Constitution will make the Commission's work any easier, for it is uncertain whether this Constitution will be adopted at all.

Let me now turn to the ECB. The ECB, in my view, has fully fulfilled its mandate. It has lived up to its responsibilities and has managed in a short space of time to acquire the single most important capital asset, namely trust and confidence. I myself am particularly grateful for this. Like everyone else in Germany who campaigned for Economic and Monetary Union, I was faced not only with the public's rational doubts but also with its irrational fears and even the accusation that EMU violated the German people's sense of identity. Forging the ECB's two governing bodies, the profiles of which were highly disparate since their members were drawn from many different countries, into a unified and well functioning entity so swiftly, was a substantial achievement. There are many people whose services deserve to be recognised in this context, but I am sure you will understand if I only mention Tommaso, who lobbied very successfully all over the world for the euro, which is now a key element of the global economy and enjoys the confidence of the market. What is remarkable from my perspective, although my lack of expertise prevents me from explaining it satisfactorily, is that the ECB's decisions have had no adverse impact on any euro area or other country despite the wide variation in basic economic conditions. With the accession of the ten new Member States, these disparities have increased significantly within the EU. As the ECB's decisions also affect these new Member States, even though they do not belong to the euro area, it remains to be seen how the situation will develop in the future. In my view, almost everything depends on the maintenance of political stability in these countries.

At the national level, the track record is far less positive. Despite the frequent criticism, we must acknowledge that all the Member States have embarked on reforms and I am confident that they will be successful over the medium term, but unfortunately, it is also true that the major countries – notably Italy, France and Germany – did much "too little, too late" to put their houses in order. The fact that Germany and France in particular are attempting to water down the Stability and Growth Pact is a cause for concern.

The reasons for the difficulties are well known. No matter how we look at it, the necessary adjustments to globalisation will entail a downward adjustment for workers, at least for the foreseeable future. The desired balance between liberalisation and solidarity appears to be drifting further and further out of reach. The need for adjustments is constantly being questioned. Where it is accepted, citizens' attitudes not only to politics but to the state itself shift, because people see that the state's claim to full, ultimate and sole responsibility within its borders is being undermined by a globalisation process as a result of which borders are becoming more and more meaningless. The state itself is facing competition as an economic location and therefore also as a guarantor of the citizens' welfare.

One example of this is tax competition, which is now intensifying in the EU too with the accession of the new Member States. This places a strain on solidarity, especially between the new Member States and the net contributors, as is only too apparent from the German Chancellor's comments about the flat corporate tax rate in Slovakia. This is a short-sighted view, but it is a natural response as well and these tensions are, therefore, likely to increase.

The reform efforts being undertaken by the EU Member States impact on social cohesion and the relationship between the citizen and the state. These are indeed fundamental issues, hence the vigorous opposition in the reform process. This opposition is also targeted against Europe, since it is the Union which sets the parameters, defines the criteria and makes demands. The stronger the adherence to, or rather the illusion of, national self-determination, the more opposition there is. And yet, the pressure emanating from Europe has been generated by the European nations themselves, and it is urgently needed. What would have happened without it? Without this pressure, how much progress would have been achieved in modernising the European economies? At the same time, however, do we really believe that the flaws in the European social model could be removed by means of a "Europeanisation"? I find this rather doubtful. The case of the Bolkestein Directive provides interesting lessons in this respect.

In my view, it is therefore in the area of the Common Foreign and Security Policy that more Europe is needed. Only by adopting a wide-ranging global approach towards the rest of the world will Europe be able to develop a comprehensive strategy in response to its domestic problems resulting from globalisation.

Giuliano Amato

So at least we have the case now for a comprehensive European strategy, which conflicts quite a lot with what has been said by the previous panellists. I hope they will react.

Let me say though that the case of the Bolkestein Directive was not a case of more competences for Europe, but just Europe exercising its competence in removing obstacles to the internal market, which also Hayek and his supporters would accept. The problem here was that it was not understood as such and thus not accepted. In my frank opinion, before releasing this proposal into the French arena, the Commission should perhaps have formulated a proposal on the principles and conditions for the management of public services, which is only a slight part of that Directive but one for which a particular French sensitivity exists that has been ignored. Thus, something more and not something less would have been helpful to create a more favourable environment for that Directive.

STATEMENT BY MARIO MONTI

FORMER MEMBER OF THE EUROPEAN COMMISSION AND PRESIDENT OF BOCCONI UNIVERSITY

Thank you, Mr Chairman. One of the many areas where Tommaso Padoa-Schioppa has provided key contributions in terms of both vision and action is the relationship between money and markets, between monetary policy and the structural policies needed to achieve efficient markets. This is a crucial link in any national economy, and even more so in building an integrated system like the European Union.

Like many of us here, I have found Tommaso's work inspiring in my own academic, and then policy, activity. I had the privilege of cooperating closely with him on a number of occasions and I hope that there might be more such occasions now that Tommaso and I have reached almost simultaneously what you, Mr Chairman, so nicely described as the "third age". I recall in particular two occasions of cooperation. In the mid-1970s, with the encouragement of Guido Carli and Paolo Baffi, we steered together a small Banca d'Italia-Bocconi University group, in order to outline a realistic liberalisation policy for Italy's then almost totally administered banking system. And then in the late 1980s we were both members of the committee which drafted Italy's first competition law.

Over the last few years, the duet "money and market" has kept us both rather busy at the EU level, with Tommaso's key role in shaping and then managing in particular the "M" in EMU, Monetary Union, and my efforts to give some realism to the "E" in EMU, Economic Union, i.e. to achieve a Single Market in fact, and not only in theory, and to make it a competitive market.

This leads me to submit a few reflections on monetary policy and competition policy in the European Union, which is one of the relevant inter-policy links under the headline of this session, "A single currency and a Union of 25 Member States". I will briefly outline certain similarities between monetary policy and competition policy as well as certain complementarities.

I see four main similarities: genetic, institutional, organisational and political.

First, the genetic or historical similarity. Within the EU, monetary policy and competition policy have a common historical lineage, that is post-war Germany, or indeed the pre-war Freiburg School. There the foundations were laid for the social market economy. Two of the key features of these foundations were in particular an independent central bank, devoted to pursuing price stability, and competition policy. That came to be embodied in two institutions of this country: the Bundesbank and the Bundeskartellamt. Both were transplanted into the European Union model, with the Treaty of Rome for competition policy, then with the Maastricht Treaty for monetary policy.

This happened with the consent of the other Member States, above all France. I note this not to be historically pedantic, but because in recent times one hears in France and Germany sceptical, resentful, and sometimes outraged references to the market

as a product of some alien "Anglo-Saxon" and "ultra-liberal" influence. In the 1960s and 1970s, Germany and France were in fact a lot closer to a market economy model than was the United Kingdom, which was still in the pre-Thatcher era. Germany and France, in my view, should be much more proud about this fact, rather than being on the defensive so much. After all, they, not the Anglo-Saxons, brought the market economy into the European construction.

The second similarity between monetary policy and competition policy is institutional. There are in fact not many policy areas where the EU decides in a unitary way and speaks with one voice. As a matter of fact, I see only three such areas. Two of them were born in 1958: competition policy and trade policy. The third, monetary policy, was born in 1999. This unitary feature of these three areas of policy-making is a key prerequisite for the EU to have a global role, which indeed it has in these areas.

Looking, for instance, at the area with which I have some familiarity, i.e. the area of competition policy, we have in fact had trans-Atlantic cooperation for a few years now, what was advocated as the "G2 proposal" by Fred Bergsten and Caio Koch-Weser. There is a G2 effectively in place, with the European Commission on one side of the Atlantic and the antitrust authorities in Washington (the Justice Department and the Federal Trade Commission) on the other. This is leading to a very high degree of convergence in actual decisions in this policy area. Trans-Atlantic cooperation has also been the basis for the beginning of multilateral coordination, which has existed for three years now and is known as the International Competition Network (ICN). Now we see that the Constitutional Treaty aims to make a partial, limited, gradualist move in the direction of creating also for the crucial area of foreign policy a more unitary identity and decision-making process, which has proved so helpful in trade, competition and monetary policy.

The third similarity between monetary policy and competition policy is organisational. It is rather interesting to observe the respective evolutions in this respect. In both cases we have, as described vividly by President Trichet this morning, a "centre" and a "team". As far as the Eurosystem is concerned, you are all familiar with the situation and I do not need to spend time on this. In the less known, and less glamorous, world of competition policy, the European Competition Network has now been in place for one year. This network, which is the result of a regulation which came into effect on 1 May 2004, introduces – in line with the spirit of subsidiarity – a substantial decentralisation in the way in which competition policy is implemented in the European Union. As regards the fight against restrictive agreements and abuses of dominant positions, the European Commission certainly remains at the centre, but there are now 25 national competition authorities on the field, applying not only their own national competition law, but also EU competition law in all cases where there is a cross-border effect.

There are, however, also interesting differences between the two arrangements. As regards competition policy, for those decisions which are taken at the centre by the European Commission, there is no participation by the national competition

authorities. They are involved in a consultative process before the proposal is put on the table of the Commission by the competition Commissioner, but they do not have a decision-making role. For monetary policy, on the other hand, the governors of the national central banks do participate in the decisions in the Governing Council. In fact, were there to be a vote in the Governing Council – we understand that this is only a possibility – they would together have more votes than the members of the Executive Board.

Perhaps it is interesting also to look at the other side of the Atlantic and compare the institutional arrangements between centre and team in these two policy areas. For monetary policy, perhaps the US arrangement is even more perfect, I would venture to say, than the European one, at least in terms of the sense of identity. The staff working at the Federal Reserve Bank of San Francisco, as Wim Duisenberg said this morning, would say "I work at the Fed". For competition policy, in the United States they are perhaps less perfect. They have, as I have mentioned, two federal authorities – not always with a crystal clear division of roles between the two – and they have 50 state attorneys general who do have antitrust competence, but without a clear framework for coordination or a clear division of roles between the federal and the state levels.

The fourth similarity is a crucial one – independence. In both cases there is independence. For both monetary policy and competition policy, there is real and perceived independence (and I think both aspects are equally important). Of course both institutions are submitted to pressures. Independence here is again ensured in two very different ways. I will not venture to explain how independence is maintained in fact, and not only in theory, at the ECB. I can only pay tribute to how the ECB has achieved and demonstrated its independence. In the case of competition policy, the pressures are of course also there. Maybe they are even more articulated and ramified because there are pressures on the general policy trust and there are sometimes quite strong pressures in individual cases.

There is an additional dimension which is perhaps worth noting: the judiciary. Decisions by a competition authority can be, and often are, challenged, with two levels of appeal before the European Courts. I am not aware – and I am not suggesting that this should be the case – that monetary policy decisions may be challenged before a court, for instance because the interest rate is considered to be either too low or too high. The ECB is confronted with other sorts of challenges, which it handles admirably. But at least in the case of a competition authority, I would submit that the fact of having to face potential challenges in the courts adds to its independence, because it provides additional motivation for the ability and indeed the need to withstand pressures. So I believe there is the same posture there between the two authorities, though I would perhaps phrase it slightly differently from what Mr Duisenberg said this morning. After a meeting with the prime minister of an unnamed Member State, Wim commented: "We listened, but didn't hear". In similar circumstances, I remember having often commented: "We heard, but did not listen".

Having discussed the four similarities between monetary and competition policy, I should now move to the complementarities between the two policies. In fact, they have already been largely outlined by the Chairman in his introductory remarks.

I would merely like to add that, with regard to the structural policies concerning the Single Market and competition, the Constitutional Treaty – thanks also to the awareness of the Chairman of this panel in his capacity as Vice-President of the European Convention – keeps intact the powers and possibilities to act and therefore to effectively complement the single monetary policy. But I agree very much with Karl Lamers: pressures are mounting and I believe there will be a greater and greater need to articulate persuasive public explanations if these pressures are not to undermine the full effectiveness of these policies.

GENERAL DISCUSSION – SESSION II

Before opening the floor to the audience, **Giuliano Amato** asked Daniel Gros and Vítor Gaspar whether the Stability and Growth Pact made any sense within their respective conceptual frameworks. **Daniel Gros** explained that the purpose of the Stability Pact was to reduce the variance of errors one can make at the national level (i.e. having excessive deficits), which he considered a valuable and necessary kind of coordination. **Vítor Gaspar** agreed with Daniel Gros that the Stability and Growth Pact made a lot of sense. He stressed in particular the fact that in a monetary union the bond market becomes a common pool, in which case overall discipline becomes a common concern that has to be tackled by common rules.

Jacob A. Frenkel elaborated further on the interaction between monetary policy, fiscal policy, competition policy and structural reforms. He pointed out that the efficacy of monetary policy is significantly enhanced if the economy is flexible. In order for a single currency to be sustainable in the context of 25 Member States, he considered it of paramount importance that a credible framework for fiscal policy be in place and that there be a framework for enhancing competition and flexibility, which he considered the *sine qua non* for an effective monetary policy.

In response to the suggestion that the Stability and Growth Pact be cyclically adjusted, **Daniel Gros** pointed out that this was, in fact, already the case. The problem was, however, that Member States did not abide by these self-imposed rules. The real issue at stake was, therefore, not the rules themselves, but rather their implementation. He added that the violation of the self-imposed rules regarding the correction of cyclically adjusted balances also showed that increasing national ownership would not be a way forward.

Nigel Wicks followed up on Mario Monti's comparison of monetary policy and competition policy in the European Union. He wondered whether the Commission's independence was complete, given the political environment in which it has to work. In addition, he doubted that each member of the Commission could be considered an expert in competition policy. Thus, he asked Mario Monti whether it would not be better to transfer this competence to an independent European system of competition commissioners, along the lines of the Bundeskartellamt. **Mario Monti** explained that, upon arrival at the Commission, he shared this view, but that he changed his mind later on. He explained that the Commission's independence was ensured by the fact that every member of the European Commission was acting in the general interest of the Community. Moreover, he argued that two important aspects would be lost if there were to be a separate competition agency. First, the synergy between antitrust and state aid policy would be lost, as this new agency would most probably not be dealing with the latter policy. Second, a separate competition agency outside the Commission would not be able to ensure that decisions in other areas of the Commission's competence did not produce anti-competitive side-effects. **Giuliano Amato** agreed with Mario Monti that the input of the

competition authority in shaping the other Commission decisions was very important. However, he did not share the view that the Commission could be considered a fully independent body.

Martin Wolf came back to the issue of the Stability and Growth Pact. He believed that what we had witnessed was a straight clash between European obligations and domestic politics in the most powerful Member States in the EU, with the latter adjusting their European obligations accordingly. The Stability and Growth Pact was dead. In his reply to Martin Wolf, **Daniel Gros** expressed his belief that the Stability and Growth Pact had nine lives – and that the Pact still had some lives left. The reason for this was that it served a purpose for finance ministers in their own dealings with their colleagues, as well as for those who wanted to keep the euro area as small as possible. The spectre of the accession to the euro area of ten Member States from the east which were quite different and which might need a different monetary policy could lead some politicians in the west to think that a small degree of domestic fiscal adjustment might be a worthwhile price to pay in order to be able to apply the Pact afterwards in a much stronger way. He, therefore, expected a different policy stance from the ECOFIN Council as soon as the business cycle picked up. **Vítor Gaspar** also felt that the Stability and Growth Pact was not dead. The concern with fiscal discipline and many of the relevant rules were contained in the Treaty on European Union itself. The key issues remained the same as before: implementation and enforcement. **Karl Lamers** believed that the problems with the Pact were, in fact, of a more psychological nature. The question was not what kind of rulebook you had in place, but rather, who worked with it. In this respect, he was rather sceptical regarding the motivations of some governments. **Mario Monti** agreed with the other panellists that the Stability and Growth Pact was not dead, although it had been seriously injured and had undergone intensive surgery, plus some plastic surgery, which had made it somewhat more satisfactory from a logical point of view, but less credible from a political point of view. Recent events had, however, been costly for the European Union. The real cost was the undermining of the principle of equality of treatment between Member States. In addition, there was an opportunity cost, since these wrangles about fiscal policy had deflected political attention away from the real problem facing the European economy: how to give teeth to the Lisbon strategy for competitiveness.

In his final remarks, **Giuliano Amato** elaborated on the issue of a federal finance minister, who he felt would not play a role similar to national finance ministers, but would, rather, play more of a coordinating role. His conclusion with regard to the European Constitution and the euro was that, whatever happened to the European Constitution, the current legal and institutional framework of EMU would remain intact.

4 SESSION III:

THE SINGLE CURRENCY AND THE WORLD

INTRODUCTION BY JEAN-CLAUDE TRICHET

PRESIDENT OF THE EUROPEAN CENTRAL BANK

I will open this session with a few introductory remarks on the international aspects of the euro, the Eurosystem, the euro area, and Europe more broadly. First of all, the start of Economic and Monetary Union (EMU) constituted a major transformation in Europe, a transformation that has no role model, a transformation that is extremely bold from a historical and conceptual point of view. While EMU was not designed with the purpose of transforming the international monetary system, it is having a major impact on the functioning of the global economy. Indeed, as I have very frequently underlined myself, we did not create the euro to compete with other currencies, nor did we design it to engage in a kind of global quarrelling. We have the best possible relationship with the Federal Reserve. One example is the cooperation in the aftermath of the terrorist attacks on 11 September 2001, when the intimacy and confidence of our relationship with the Federal Reserve was such that, in the afternoon of the event, we organised teleconferences across the Atlantic and of course across Europe, deciding together what we would do in Europe in order to avoid potential liquidity shortages the next day. We negotiated with the Federal Reserve a swap of USD 50 billion in order to be able to provide US dollar liquidity to European banks in the event that their US counterparts would have to interrupt their services. As a result of this intensive and effective cooperation, there were no liquidity problems on either side of the Atlantic after the most dramatic event you can imagine. All this demonstrates that in the event of exceptional stress, we as central banks have such intimate relations that we can act in real time and effectively cope with dramatic circumstances.

The second remark I would like to make concerns the role of the ECB, the Eurosystem and the euro area on the world stage. While we are still in the process of improvement, it seems to me that we have advanced a lot over the past few years within informal groupings that allow for intimate global cooperation, such as the G7 and the G10, including the G10 Governors, which I have the privilege to chair. To this list, I can add the Financial Stability Forum, chaired by Roger Ferguson, which is a very important grouping that aims to promote financial stability at the global level. The ECB also participates in the G20, another recently created informal forum of extreme importance. The work of these groups is very encouraging, even though we certainly have to improve a lot at the global level, particularly in terms of the participation of the Eurosystem and the ECB. Specifically, representation of the euro area is still not satisfactory in official institutions such as the IMF, where the ECB has observer status. To sum up, while euro area representation is well organised in informal groupings, it is still relatively scattered in more formal institutions.

My third and last remark concerns the bilateral relationships between the ECB/Eurosystem and other central banks. We have established bilateral relationships with central banks in Asia, Latin America, Africa and the Mediterranean region. Discussions with these central banks often focus on

regional integration issues, as we are at the forefront in Europe in terms of monetary integration. The originality of the European experience is certainly observed closely by our colleagues on the other continents. Moreover, our experience confirms that regional integration does not stand in the way of global integration. On the contrary, both processes are very much complementary. For instance, I am struck by the fact that, while trade within the euro area rose by 40.1 per cent from 1998 to 2004, euro area trade with third countries increased even further, by 47.4 per cent. Therefore, the Single Market with a single currency in the euro area has not only accelerated trade integration within the region, as was widely expected, but has also deepened trade linkages with the rest of the world.

Now, let me introduce the various speakers in alphabetical order, starting with Fred Bergsten. As he is known to all of us, I do not need to introduce Fred in detail. It is sufficient to remind you that he is not only the Director of the Institute for International Economics, but also the Chairman of the Shadow G8, an advisory body that supports G8 countries in the preparation of the annual summit meetings. Fred has also held eminent responsibilities at the US Treasury and has written many books, including the recently published “The United States and the World Economy: Foreign Economic Policy for the Next Decade”, which makes remarkably stimulating reading. A final remark is that Fred has also fully grasped the nature of the euro and has been very supportive of the single currency since its early stages, differentiating himself from any other observer across the Atlantic.

As our second speaker, I have the honour of introducing Toyoo Gyohten. In the past, we have often had the chance to meet and work with you in your former capacity as Vice Minister of International Affairs in Japan. I would dare to say that, among all those that have held this position, you were exceptionally efficient, underpinned by a fantastic mastering of English. It was a great privilege to work with you. You have been Chairman of the Bank of Tokyo and are President of the Institute for International Monetary Affairs.

The third speaker, Fabrizio Saccomanni, is also known to all of us. He is Vice President of the European Bank for Reconstruction and Development, and has in the past held many important positions at the Banca d’Italia. He has published many books, in which he demonstrates his unique talent of merging very profound concepts and ideas with remarkable Italian eloquence and British humour.

The last speaker on this panel will be Martin Wolf, associate editor at the Financial Times. He has a fantastic reputation, and I believe that we all read his articles, which are so remarkable with their extreme acuteness of analysis, sharpness of views, and extreme incisiveness. We all witnessed your sharpness recently when you told someone: “Sir, in what you just said there are things that are true and things that are new”. At first glance, this sounded extremely nice and flattering. But then you added: “but unfortunately what is new is not true, and what is true is not new”. Now too, we hope very much to hear your nicely provocative propositions.

STATEMENT BY C. FRED BERGSTEN

DIRECTOR, INSTITUTE FOR INTERNATIONAL ECONOMICS

THE EURO AND THE WORLD ECONOMY?*

THE EURO AND THE INTERNATIONAL FINANCIAL ARCHITECTURE

The dollar has been the dominant currency of the world economy for almost a century for a single overwhelming reason: it had no competition. No other economy came close to the size of the United States. Hence no currency could acquire the network externalities, economies of scale and scope, and public goods benefits necessary to rival the dollar at the global level.[1] A similar situation for the United Kingdom explains sterling's dominance in the 19th century.

The clearest historical evidence for this conclusion is the fact that the dollar continued to reign supreme during prolonged periods of very poor economic performance by the United States:

- Its economy grew very slowly for two full decades, from the early 1970s to the early 1990s, with productivity growth that was especially mediocre (at 1.5 per cent or less per year).
- It experienced high inflation for almost a decade, from 1973 to 1981, including three years of double digit price increases.
- It has run large external deficits for most of the past 30 years, including two periods when those deficits were rising at clearly unsustainable rates (1982-87 and 1998-present), and had become a debtor country by the late 1980s.

Econometric evidence also verifies the central importance of size for international currency purposes. Eichengreen and Frankel (1996) concluded that a rise of 1 percentage point in a key currency country's share of world product (measured at purchasing power parities) is associated with a rise of 1.33 percentage points in that currency's share of central bank reserves. In a more sophisticated version of those estimates, which attempted to account for historical inertia (see below) as well as economic size, Eichengreen (1997) found consistent if modestly smaller effects: the rise of a currency's share in global reserves that derived from a rise of 1 percentage point in its country's share of global output (at PPP) is 0.9 percentage point. The central importance of size was clearly validated.

The creation and clear success of the euro over its first five years dramatically and fundamentally alters the global currency situation. The present Euroland is

* The first part of this paper is adapted from the author's "The Euro and the Dollar: Toward a 'Finance G-2'?" in Adam Posen, ed., The Euro at Five: Ready for a Global Role? (Washington, Institute for International Economics, April 2005).

[1] Helmut Schmidt frequently reminded us that West Germany was the size of Oregon. Hence the Deutsche Mark, the second key currency through most of the post-war period, never attained a global currency share more than one-quarter of that of the dollar, in keeping with its GDP never exceeding about one-quarter of that of the United States.

20 per cent smaller than the United States in terms of total output and 18 per cent higher in its share of world trade. Expansion of the euro area to include all 15 "old" members of the current European Union would take the numbers modestly (3 per cent) above the United States in output terms as well. Inclusion of the ten "new" EU members would add another 5 per cent to Euroland's output superiority (as well as bringing its population to about two-thirds greater than that of the United States). For all practical purposes, the two currency areas are already close enough on all key variables to be regarded as rough equivalents.

It is thus clear that the euro provides the first real competition for the dollar since the latter's ascent to global currency dominance. The key question is whether (and when) the euro will realise this potential sufficiently that a bipolar monetary system will replace the dollar hegemony of the past century. The outcome, and especially its timing, are likely to turn on four key variables (Bergsten, 1996).

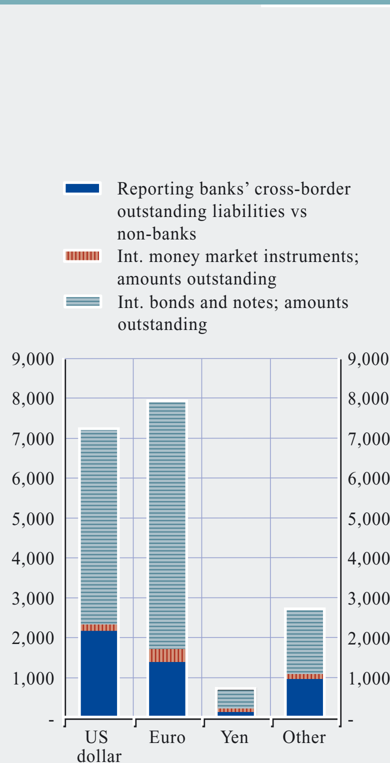
First, Euroland will need to further integrate its money and capital markets to realise the full international potential of the new currency (Portes and Rey, 1998). The superiority of the American financial markets, and those of the United Kingdom during the period of sterling's dominance, were key elements in their global monetary leadership. The negative case of Japan is also instructive: its failure to modernise its financial markets undercut any possibility that the yen, despite Japan's dynamic growth and huge international creditor position (before its lost decade of the 1990s), might have come to play a major international role.

The European financial markets, galvanised both directly and indirectly by the euro itself, have already made impressive strides. Indeed, the euro's share already exceeds that of the dollar in the denomination of global financial assets excluding derivatives (Chart 1) and approximates the dollar's share when derivatives are included (Chart 2). However, national rivalries still impede cross-border mergers of both banks and equity markets. No single benchmark security, or yield curve, has developed to rival the US Treasury bill and other US government assets. The pace at which Euroland overcomes these shortcomings will play a major role in the timing of the euro's further rise in international asset allocation (Mann and Meade, 2002).

Second, Europe will need to get its act together institutionally. The European Union has been a fully equal partner to the United States in the management of the global trading system for four decades. Cooperation between this "trade G2" was in fact a necessary condition for the successful launch and completion of each of the three major multilateral trade agreements of the post-war period (and again for the launch of the Doha round in November 2001).

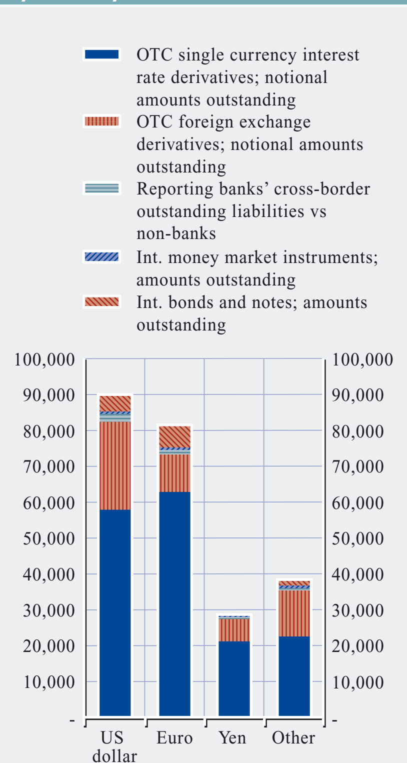
Europe was able to successfully challenge the previous dominance of the United States in the trading system for two reasons. One, as with finance, was the rough equivalence of its trade volume with the United States. Second, and of crucial importance, was its early decision to centralise virtually all trade policy decisions and negotiations in a single entity (the European Commission in Brussels). But Europe still speaks with a multiplicity, even a cacophony, of voices on the

Chart I Global financial assets, fourth quarter 2004, by currency



Source: BIS Quarterly Review, March 2005, Tables 5B, 13A and 13B.

Chart II Global financial assets, incl. derivatives, fourth quarter 2004, by currency



Source: BIS Quarterly Review, March 2005, Tables 5B, 13A, 13B, 20B and 21B.

monetary and macroeconomic front. Hence it dissipates much of its potential for realising a key international role for the euro.

Third, the international role of the euro would obviously be strengthened if Europe were to improve its economic performance. Euroland has already achieved convincing price stability. Its growth has badly lagged behind that of the United States, however, and (along with Japan) has been one of the weakest components of the buoyant world economy of the recent past. International interest in the euro would surely rise if Euroland countries were able to overcome their continuing structural impediments and the Eurozone were to employ more expansionary macroeconomic (mainly monetary) policies.

Fourth, and perhaps most important, the United States will probably have to foul up for the euro to realise its potential to achieve comparable status with the dollar at the core of the international monetary system. Inertia is so strong in financial affairs that it may be impossible to dislodge an incumbent, even in the presence of a fully qualified rival, unless the incumbent opens the door for that rival (Bergsten, 1996). Sterling maintained a central international role for at least half

a century after the United States had surpassed Britain's level of GDP and faded only as a result of the shock of World War I (during which its trade and investment were disrupted and it had to sell off many of its foreign assets) and its own major economic mismanagement in the 1920s (a persistent macroeconomic slump, sterling overvaluation, creeping protectionism and a variety of capital controls) (Eichengreen, 1997).

An interesting thought experiment is to ask what would have happened to the international role of the dollar in the late 1970s and early 1980s if the euro had existed when US inflation hit double digits, interest rates rose to 15-20 per cent, the economy suffered its worst recession since the 1930s and the country started running external deficits that transformed it in short order from the world's largest creditor to the largest debtor country. Even without such a competitor, the global market share of the dollar dropped substantially. The process of European monetary integration that eventually led to the creation of the euro was galvanised.

Are there any foreseeable developments that could represent such a repetition of recent history? As Robert Mundell (1998) indicated prophetically on the eve of euro creation:

"It would be a mistake to ignore [the fact that] in the last 15 years US current account deficits have turned the US from the world's biggest creditor to its biggest debtor (…) The low-saving high-debt problems will one day come home to roost (…) There will come a time when the pileup of international indebtedness makes reliance on the dollar as the world's only main currency untenable (…) The fact that the bulk of international reserves is held in dollars makes the currency a sitting duck in a currency crisis (…) Sole reliance on the dollar as the main reserve, invoice and intervention currency presents risks that are no longer necessary."

The quadruple prospect for euro appreciation

There are four reasons, combining these structural systemic considerations with present market prospects, that should lead us to expect considerable further appreciation of the exchange rate of the euro against the dollar over the short to medium term. This appreciation may in turn hasten the expansion of the euro's systemic role.

First, the international debt and deficit problems of the United States are accelerating at a rapid pace and are clearly unsustainable. The current account deficit reached annual rates in excess of USD 750 billion, more than 6 per cent of GDP, in late 2004 and early 2005. It has risen by an annual average of about half a per cent of GDP for the past decade and is likely to continue climbing rapidly (Mann, 2004b; Cline, 2005). As a result, the United States must import USD 5 billion of foreign capital every working day (to finance its own foreign investments along with the current account deficit). The net international investment position of the United States would hit 50 per cent of GDP, on present trends, within the next few years and rise to 100 per cent of GDP – totally uncharted terrain – in a decade or so (Mussa, 2005). The dollar has experienced modest depreciation over the past three years but is thus likely

to fall much farther.[2] The euro, as the main counterpart currency in the system, will undergo further appreciation against the dollar simply as a result thereof.[3]

Second, the major surplus countries in East Asia continue to resist significant – or, in the central case of China, any – appreciation to mirror the dollar decline. If China and the other Asians continue to block adjustment, and the rest of the world permits these practices to continue,[4] the euro (and the other truly floating currencies) will experience a further disproportionate share of the counterpart appreciation to further dollar decline.

Third, the current dollar depreciation is taking place in a very different world from the substantial dollar falls of 1971-73, 1978-79, 1985-87 and 1994-95: one that includes the euro, which as noted is the first competitor for global status that the dollar has faced throughout its entire period of currency hegemony. This fall of the dollar could thus trigger important, indeed historic, systemic as well as market and macroeconomic effects. The substantial and prolonged strengthening of the euro, arising from the global adjustment of the current account imbalances, is at some point likely to trigger structural portfolio diversification into euro by both private and official holders that is an inevitable result of the transition toward a bipolar monetary regime. This shift would reflect the failure of the United States to get its own house in order, thus jeopardising the global role of the dollar and opening the door for the euro to accede to a major position in world finance. I and others estimated the magnitude of that shift at USD 500 billion-1 trillion on the basis of the magnitude of global currency portfolios in the mid-1990s (Bergsten, 1997a; Portes and Rey, 1998), which would be at least twice as great today and would clearly mark the arrival of the euro as a major competitor to the dollar.

Fourth, and more conjecturally, the next few years could witness a substantial alteration in relative economic performance in the United States and Europe – owing mainly to poorer results in the United States. A rapid fall of the dollar, combined with the precipitous rise of world energy prices that is likely to continue and indeed escalate further, could produce a series of major setbacks to a US economy that is now approaching full employment: much higher inflation and interest rates,[5] a renewed drop in both the equity and housing markets with large negative wealth effects, and a consequent sharp decline in economic growth. The economic attractiveness of Europe relative to the United States would then rise considerably and further accelerate the appreciation of the single

[2] In addition to this international financial unsustainability, there is the domestic political unsustainability of the large and rapidly growing current account deficit (and continued large dollar overvaluation): trade protectionism. The current escalation of US trade controls and Congressional actions, mainly against China (apparel, textiles, colour televisions, semiconductors, shrimp) and frequently linked directly to the currency misalignment, are the latest cases in point.

[3] Although the real effective exchange rate of the euro might not appreciate at all, or might even depreciate, if the Asian countries (contrary to the next paragraphs in my text) were to permit their currencies to appreciate significantly against the dollar, since they would probably rise more than the euro in the next phase of dollar correction.

[4] See Bergsten (2005a) for an elaboration of the currency manipulation problem and what to do about it.

[5] Baily (2002) projects US interest rates rising to double digits under plausible combinations of these variables.

currency. This effect would of course be multiplied if Europe were at some early point to enjoy the same unexpected jump in productivity growth that the United States experienced in the mid-1990s, perhaps related to enlargement or a serious new effort to implement the Lisbon agenda.[6]

Policy implications

Thus a series of three or four events – generalised further dollar depreciation, disproportionate euro appreciation owing to continued Asian resistance to participation in the adjustment process, subsequent acceleration of the inevitable portfolio diversification from dollars to euro and perhaps a positive shift in the relative economic appeal of Euroland vis-à-vis the United States – could produce a very large further rise in the euro. Such a scenario would be extremely uncomfortable for Euroland and extremely destabilising for the world economy, perhaps even triggering a global recession. Four steps are required to produce an orderly correction of the global payments imbalances and an orderly further depreciation of the dollar, rather than a hard landing, and hence to prevent the realisation of such events:

- The United States must launch a serious programme to cut its budget deficit, the only policy available to substantially increase national saving in the deficit country and thus reduce its dependence on foreign capital.
- The G7 (especially Euroland) must insist that the IMF implement its rules against currency manipulation and require China, in particular, to cease the competitive undervaluation of its currency that is blocking the participation of all of East Asia in the international adjustment process (Goldstein, 2005).
- Japan and (especially) Europe must stimulate domestic demand to affect the decline in their external surpluses, by adopting the needed structural reforms (Baily and Kirkegaard, 2004) but also through a lowering of interest rates by the ECB (which the euro appreciation will help to permit).
- Euroland and the United States, as the issuers of the world's two key currencies, must create a new "finance G2" to manage both the sizable currency swings that have already come to dominate their bilateral monetary relationship and their joint responsibility for global financial instability (Bergsten, 2005b). The next big problem facing the "international financial architecture" may otherwise centre on the countries and currencies at its core, the United States and Euroland, as was the case in the 1960s and 1970s, rather than the emerging market economies and their currencies as in the last two decades.

Tommaso Padoa-Schioppa has been the "Foreign Minister of the Euro" since (and indeed even before) the creation of the single currency. There could be no more fitting tribute to his historic contribution to the evolution of the international monetary system than if this conference in his honour were to both recognise the advent of the euro as the world's second key currency and initiate a process to ensure that its new role was stabilising rather than destabilising for the global economy. I deeply appreciate the honour of addressing this esteemed group and hope that its members will do everything they can to initiate the actions necessary to realise both of these outcomes.

[6] As recommended in Baily and Kirkegaard (2004).

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STATEMENT BY TOYOO GYOHTEN

PRESIDENT OF THE INSTITUTE FOR INTERNATIONAL MONETARY AFFAIRS

The creation of the European Single Market and the single currency has indeed served as a wake-up call for Asia. Asia as a whole has demonstrated a remarkable record of economic development throughout the post-war period and its presence in the world has been enhanced steadily. In the 1960s Japan made a remarkable recovery from the destruction of the war. Implementing ambitious and successful programmes such as the "Income Doubling Plan", Japan rebuilt its economy and made it the second largest in the world with highly competitive manufacturing industry. In the 1970s, so-called NIES, or newly industrialised economies, including Taiwan, Korea, Singapore and Hong Kong, started to grow rapidly by establishing and strengthening export-oriented light manufacturing industries. They were often dubbed the four tigers of Asia. In the 1980s other South-East Asian countries in the group of ASEAN started to take off. In fact ASEAN was formed as early as 1967. However, its economic development as a sub-regional bloc was less than remarkable owing to the conflict of national interest. Since the 1980s, encouraged by the roaring four tigers and supported by surging foreign direct investment, particularly from Japan, ASEAN countries embarked upon a rapid export-oriented and government-led process of industrialisation. Then, in the 1990s, China joined the Asian surge. The combined force of a 1.3 billion population, strong leadership and dynamic entrepreneurship has propelled China up to the position of a world centre of production, consumption and trade in a matter of just 20 years. Now, in the 2000s, we see India is looming up over the horizon as the leader of the West Asian economy. These dynamic developments tell us that in coming decades the presence of the Asian economy and the role of Asia in the world will most likely be greater than they are today.

In spite of all these achievements, however, Asia was compelled to recognise that its development in the past was not built upon a solid and enduring foundation. The experience of the 1997 crisis was a thunderclap out of the blue. It told Asia that its financial system was badly flawed and that Asia did not possess effective mechanisms to prevent and manage such a crisis in its own region. Uncontrollable exchange rate volatility, inadequate hard currency finance and vulnerability to foreign speculators seriously damaged Asia's confidence in the management of its own economy. It was quite natural that interest in regional economic and financial integration was given a strong boost.

The idea of integration was not new in Asia. However, the Asian financial crisis, the successful launching of the ECB and the single currency the euro were the events which made the issue serious and urgent. In a broad context there are four motives behind the Asian aspiration toward integration. The first is to fortify the region's growth potential so that the region can play a leading role in global economic development as one of the three pillars, together with the western hemisphere and the EU. There is a strong sense of concern in Asia that the steady progress of integration in the western hemisphere and the EU may, before long,

create a situation where the two giant blocs dominate the world economy while Asia is either swallowed up or marginalised by them. Therefore, if Asia wants to play an independent and meaningful role in the global economy, Asia must step up its own process of integration so that it can make its voice heard in the global scene. The second motive is to strengthen the financial system in the region. It is well known by now that the Asian crisis of 1997 was prompted by the weakness of the financial system, i.e. the unhealthy balance sheet and poor governance of banks, ineffective and corrupt regulatory apparatus, and underdeveloped market infrastructure. It is deemed imperative to develop and strengthen the financial system of the region in order to avoid a recurrence of the crisis. The third motive is to make better use of the region's own savings. Asia is known for its high savings ratio, over 30% of GDP. So far, however, Asians are investing the bulk of their savings in dollar or euro-denominated instruments of various kinds. Then, the money is recycled back to Asia by American and European corporations and institutional investors in the form of direct investment and portfolio investment. In other words, although Asia saves a lot, Asia is not the master of its own savings. So far, the Asian savings have had to make a detour because of the lack of efficient and effective instruments, players and markets. It is natural to see a growing aspiration in Asia to make better and more direct use of its savings for the development of the region. The fourth motive is the concern about the dollar. The US current account deficit is growing ominously. It has exceeded 5% of GDP and is still growing. The deficit is creating an increasing dependence on foreign financing and mounting external indebtedness. The net external deficit of the United States is now well over USD 2.5 trillion. It will incur a ballooning debt service burden. As a result, the future of the dollar is increasingly uncertain. Yet, Asia's dependence on the dollar is dangerously high. Today, Asian countries are investing well over USD 1.5 trillion of their official reserves in US Treasury bonds. This situation needs to be rectified, and the ultimate solution will be to have Asia's own international reserve asset, a common Asian currency.

Prompted by these motives, there are four major areas where we see active studies, negotiations and concrete arrangements being made towards regional integration. First, the FTA (Free Trade Agreement) in the region, both bilateral and multilateral, is proliferating, with the hope of preparing a basic building block for a pan-Asian common market. Second, the network of bilateral currency-swap arrangements between central banks in the region has almost been completed, with 16 such arrangements amounting to USD 40 billion. The next stage will be to consider how we can centralise the functioning of bilateral arrangements. We will need a central body to manage the operations, we will need facilities to earmark or pool a certain portion of official reserves. The ultimate goal in this area will be the creation of an AMF (Asian Monetary Fund). Third, the idea of creating and developing regional bond markets (the Asian Bond Market Initiative) is being expeditiously studied and negotiated. The group of central banks in the region (EMEAP) has successfully launched a pilot project for an Asian Bond Fund. Fourth, the idea of creating an Asian common currency is actively being studied at various fora among academics and official circles. Admittedly, the common currency is a long-term goal. At this point, it seems that the mainstream of these studies is aiming to start the process by creating a basket currency consisting of three major currencies, i.e. the dollar, the yen and the euro,

structured to suit the actual conditions of each Asian country. It will develop into a common basket currency as the degree of economic convergence evolves. Then, when each Asian currency has achieved the adequate degree of international convertibility, the basket will be restructured to be composed of Asian currencies. It will then become the embryo of an Asian single currency.

However, during the long period of transition, which will last for several decades, before Asia can achieve any sort of currency conversion, the Asian economy will continue to use the major national currencies it uses now, i.e. the dollar, the yen and the euro. Today, Asian economies, on average, for their international activities, depend 60% on the dollar, and 20% each on the yen and the euro. It is indeed an awkward situation because already the share of intra-regional trade in Asia is almost 60%. The relative share of the three currencies will certainly change over time depending on the performance of each currency country. If the Chinese economy continues to develop as it does now and the renminbi becomes a fully convertible and usable currency internationally, it will become another major regional currency. I guess it will take 10-15 years. Under the circumstances, it is crucially important for the Asian economy to have a reasonable degree of stability and predictability in the exchange rates among these major currencies. In this respect, it is much hoped that major currency countries can agree upon some international arrangement to promote their economic policy coordination so that more stability and predictability in the exchange rates can be secured.

All in all, in spite of the mounting interest and enthusiasm among Asian countries, Asian economic and financial integration, let alone political integration, is a daunting task. If one considers the vast disparity among countries, inadequate political leadership and the risk of geo-political instability, one has to conclude that it ought to be a gradual and time-consuming process. I would argue that it is neither realistic nor appropriate to try to measure the success of Asian integration using the same rigid scale applied in the case of Europe. The structure of Asian integration will inevitably be a soft and open one, more operational than institutional. At the same time, I believe that, because of that very nature, Asian integration can certainly become resilient and viable as it develops.

At the outset, I mentioned that the creation of the European Single Market and single currency served as a wake-up call for Asians. Asia was alarmed but at the same time encouraged by the vigorous and tenacious efforts which brought about this achievement of historic importance in Europe. The enhanced interest in Asian integration was indeed a by-product of the European integration. During this process Asians have always used the European experience as a point of reference. European integration, particularly the euro, has served as a role model for Asian integration. In the coming years Asia will surely come back many times to learn from European experience.

Of course, one has to discover many nuances in such a plain and straight statement. I would like to identify three points. First, the performance of the EU economy after the introduction of the euro has not been as spectacular as some

might have expected. In terms of growth, structural reform, productivity and competitiveness, and fiscal discipline, what Asia hears more these days is not a triumphant account of success, but rather a lament on why things are not doing well. As a result, Asia is not viewing the European experience with a sense of naïve admiration. Second, Asia is now more aware than before of the huge difference between Europe and Asia with respect to integration. As studies, discussions and negotiations are conducted on the integration in Asia, Asia has discovered that it lacks a great deal if it wants to emulate the success of Europe. This discovery has made Asia less optimistic and has also convinced Asia that it has to devise and develop its own model of integration. Third, for a good historical reason, Asia's closest neighbour has been the United States. The emergence of Europe as a unified and powerful economic bloc has certainly modified the Asian view of the world. The creation of fora such as ASEM (Asia-Europe Meeting) was a good example of this. Nevertheless, for Asia, Europe is still perceived as a substitute for the United States. Therefore, the importance of Europe waxes and wanes in parallel with the waning and waxing of US influence. The increased interest in the euro today precisely reflects the increased concern about the future of the dollar.

As I mentioned earlier, Asia's global importance will be enhanced further in the coming decades, although the power of Asia as an integrated bloc may not come soon. The dynamics among the United States, the EU and Asia will remain, for many years, characterised by a considerable amount of uncertainty and fluidity. However, there is one thing Asia never doubts about Europe: that the European integration and the euro will not collapse, and there will be no more war in Europe.

STATEMENT BY FABRIZIO SACCOMANNI

VICE PRESIDENT, RISK MANAGEMENT, EUROPEAN BANK FOR RECONSTRUCTION AND DEVELOPMENT

MANAGING MONETARY AND FINANCIAL INSTABILITY IN AN INTERNATIONAL CONTEXT

In 1994, the 50th anniversary of the Bretton Woods Conference, Fred Bergsten organised a seminar at his Institute for International Economics to review the functioning of the international monetary system. A feeling of satisfaction and complacency permeated the debates. Long gone were the complaints which characterised the 1970s about the monetary anarchy created by the collapse of the par-value regime for exchange rates and the calls for the International Monetary Fund (IMF) to regulate world liquidity through its multilateral new currency, the SDR. Following the wave of deregulation and liberalisation promoted by Margaret Thatcher and Ronald Reagan, the very concept of an international monetary system seemed increasingly irrelevant: indeed there was a broad consensus among economists and officials that, if every country kept its house in order, floating exchange rates and free capital movement would cushion and adjust international payment imbalances; hence there would no longer be a need to actively manage "systemic" issues. It was the heyday of the "house in order approach", which subsequent events would demonstrate to be totally inadequate and fallacious both as an analytical tool and as a policy prescription.[1] Very few were the voices – and not always well argued – of those complaining about the current non-system and calling for a "new Bretton Woods" to reinvent the monetary system for the new millennium.

Tommaso Padoa-Schioppa and I contributed to the seminar by proposing a different approach. We asked ourselves what kind of institutional underpinning was required to ensure the smooth functioning of the "market-led international monetary system" (M-IMS) that had emerged from the demise of the old "government-led international monetary system" (G-IMS) created in 1944. We argued that under such a new system, with freely floating exchange rates and full capital mobility, global financial markets would determine the creation and distribution of international liquidity and the level of exchange rates (Padoa-Schioppa and Saccomanni, 1994). Therefore, we thought that a first priority for monetary authorities was to achieve a better understanding of the unwritten rules and conventions of the M-IMS and their implications for the world economy. Indeed, we feared that in the likely context of further expansion and increased globalisation of financial markets, there was the risk of "disturbances that may have an impact on the stability of the financial system or lead to a revival of inflation".

Since we wrote that paper the global financial system has indeed witnessed an intensification of episodes of instability, with significant international

[1] A fatal blow to this approach was dealt by Padoa-Schioppa in a series of lectures at the European University Institute in Florence in early 2005, which I hope will soon be published.

repercussions. These episodes have been associated with large unidirectional movements in the price of assets, such as bonds, shares, currencies and real estate, followed by sharp reversals, leading to disruptions in the orderly functioning of financial markets, the bankruptcy of intermediaries and corporations or, in some cases, to the suspension of the debt servicing obligations of major sovereign borrowers. These episodes have not only occurred in emerging or transition countries, but have also involved mature economies, like Japan, or affected efficient markets like the New York Stock Exchange or the international bond market. Currency misalignments have not been concentrated in Latin America or South-East Asia, but have at one time or another affected the three key currencies of the world monetary system: the dollar, the euro and the yen. Contrary to our expectations, however, such financial tensions and imbalances have materialised in a context of generally low or declining inflation. This unexpected development raises important policy issues which deserve to be carefully examined.

Although the triggering factors for the outbreak of crises have been closely connected with specific imbalances in individual countries or markets, the alternation of situations of excessive credit expansion with phases of sudden credit contraction, typical of such crises, has been increasingly linked to "systemic" shortcomings of global financial markets. These include the tendency by global players to underestimate (and therefore to "underprice") the risk of financial operations and to overestimate the degree of liquidity in markets; moreover, competitive pressures lead to "herd behaviour" by intermediaries, which may result in the phenomenon of financial contagion. In turn, the tendency of markets to generate "boom and bust" cycles has been associated with the monetary policy stances adopted by the major key currency countries (i.e. the United States, the euro area and Japan), whose influence has been amplified and propagated by financial intermediaries, thus affecting the allocation of international capital flows (see Saccomanni (2002) and the literature quoted therein). Excessive credit expansion induced by international capital flows could result in considerable divergence from "equilibrium" levels of crucial variables like the exchange rate, the money supply, the price-earning ratio on stocks, or property prices. In such circumstances the likelihood of overshooting and bandwagons increases, with the risk of generating a speculative bubble. Nor should much reliance be placed on the capacity of financial markets to exert discipline on intermediaries and borrowers, as the "disciplinary" actions imparted have often turned out to be "too much, too late".

The potential for instability has increased since the 1990s in particular as regards exchange rate relationships, because of two main developments. The first one is the global polarisation of currency flows around a limited number of currency "poles". The creation of the euro has clearly provided an alternative to the US dollar as a main reserve currency. Similarly in Asia we are witnessing the emergence of a new currency pole in the "ASEAN+3" group of countries, which includes the yen but also the renminbi.[2] The emergence of a multi-polar exchange

[2] Developments in foreign exchange policies in the ASEAN+3 countries have been thoroughly reviewed by Padoa-Schioppa (2003).

rate regime enhances the scope for frequent reallocation of foreign exchange flows among currency poles in line with changes in their economic and financial conditions. The second development is the growing tendency – clearly identified by the Bank for International Settlements (BIS) in its periodic survey of the turnover of the global foreign exchange market – for global financial players to treat foreign exchange as an asset *per se* and not just as a vehicle for foreign commercial and financial transactions.[3] Both developments have led to greater volatility in exchange rates and have enhanced the role played by liquidity conditions in international markets, as a determinant of exchange rate levels. This in turn increases the risk of exchange rate misalignments.

If having a sound and well managed financial system and keeping inflation under control is no guarantee of financial stability, then what are the policy options available to the monetary and financial authorities of individual countries to counter emerging financial imbalances at an early stage?[4] Until recently the answer to this question coming from both academic economists and policy-makers was rather disappointing, for a variety of reasons. A broad consensus supported the thesis that monetary policy cannot be used to pursue financial stability as it is already assigned to pursue price stability: if you have two objectives, you need two instruments. This view has received strong support from such an authority in the field as Alan Greenspan (2002), who has reiterated the arguments against the recourse to interest rate hikes to counter the formation of bubbles. Rather – Greenspan maintains – monetary policy should be used promptly and aggressively to limit the deflationary impact of the bursting of the bubble, after it has occurred.

If an instrument other than monetary policy is required to pursue financial stability, it is widely recognised that the tools available to the regulatory authorities of financial markets are not really suitable to cope with situations of systemic instability of the type generated by excessive credit creation. Typically these authorities are equipped to deal with the instability of individual market participants, be they banks or other financial intermediaries, and their primary concern is to ensure that market participants have a capital base which is adequate with respect to the risks they incur and that their operations are transparent. The approach followed by supervisory authorities is, in other words, "microprudential", while the problem they have to deal with is of a "macroprudential" nature.

In these circumstances, one would have to conclude that there is not much that the authorities can do to prevent systemic financial instability or the emergence of bubbles. To take such a resigned attitude, however, could be seriously counterproductive as it might convince citizens and their elected representatives that the only way to cope with financial instability is to introduce restrictions on capital movements or to "throw sand in the wheels" of international financial markets. Protectionism is not a viable strategy to deal with international financial instability, as it would distort the flow of international trade and investment with negative repercussions for growth and employment on a global scale. Fortunately, the

[3] See Galati and Melvin (2004).

[4] I have addressed this question in Saccomanni (2003), from which the ensuing considerations are drawn.

importance of devising a policy framework that would allow the normal operation of global financial markets while promoting conditions of financial stability is increasingly being recognised, mostly within the central banking community.

A first call for a thorough re-examination of the issues raised for monetary authorities by financial instability came from Andrew Crockett with his seminal paper for the 22nd SUERF Colloquium (Crockett, 2000), in which he identified two areas for further research and analysis: firstly, how to deal with the systemic risks associated with the financial cycle; and secondly, the relationship between monetary and financial stability. This latter question, Crockett advised, should be explored with a "critical but open mind".

Not surprisingly, Crockett's suggestion has been heeded primarily within the BIS, where a number of very stimulating papers have been produced in recent years. In a first paper (Borio and Lowe, 2002), empirical evidence is presented demonstrating that it is possible to identify financial imbalances *ex ante* and that sustained credit growth, combined with large upward movements in asset prices, increases the probability of an episode of financial instability. The paper also argues that while low inflation promotes financial stability, it also increases the likelihood that excess demand pressures will show up first in credit aggregates and asset prices rather than in goods and services prices. In subsequent papers (Borio, 2002; Borio, English and Filardo, 2002) the policy implications of these empirical findings are analysed. As regards the framework for monetary policy, it is argued that change would be required not in the objectives of monetary policy, but in the way they are pursued: basically, greater weight should be given "to signs of the build up of financial imbalances in deciding when and how far to tighten policy". As regards the framework for financial supervision and regulation, it is argued that a macro-prudential approach would be required, in which the main concern would be "the disruption of economic life (…) brought about by generalised financial distress" rather than "the pursuit of narrowly interpreted depositor protection objectives". In practice, the macro-prudential approach would rely to a large extent on the cooperation among central banks and supervisory authorities.

In a more recent paper, Borio and White (2004) call for "subtle modifications in current policy frameworks in both the financial and monetary spheres" with the aim of limiting "the potential excessive procyclicality of the financial system". In the monetary sphere, in particular, they draw attention to the risk that financial imbalances may materialise also when inflation is low and to the need to lean against those imbalances by lengthening the time horizon and giving greater weight to financial risks in the monetary policy formulation.

I believe these conclusions are broadly shared within the European Central Bank. As noted by Tommaso Padoa-Schioppa (2002) the authorities have to explore "the land in between" monetary policy and prudential supervision; that land does indeed exist and in it there are instruments that can be used to pursue monetary and financial stability at the Eurosystem level: management of the payment system, emergency liquidity support, crisis management coordination, and public and private comments (sometimes defined by market participants as

"oral interventions"). As these instruments are available to central banks or to supervisory authorities or to both, it follows that their efficient use depends crucially on the coordination of interventions by the authorities involved. Moreover, Otmar Issing (2004) recognises that central banks can "fight excessive asset price developments" through the control of the creation of money or the multiplication of credit.

I have briefly summarised these analytical contributions simply to underline the point that the pursuit of financial stability does indeed mean going beyond the purely structural measures necessary to strengthen the foundations of the banking and financial sectors. No doubt further analytical work would be required to identify the appropriate policy strategy to tackle at an early stage emerging threats to financial stability. I would venture, however, to make a few general comments of a preliminary nature.

Irrespective of the precise content of the strategy, it is quite likely that a certain degree of policy activism would be required on the part of monetary and financial authorities. In a regime of global finance, there are no "automatic pilot" devices in the framework for monetary and exchange rate policies or in the prudential regulatory system to which one can safely relinquish the responsibility of ensuring financial stability. Nor is it advisable to adopt a policy of benign neglect and rely on market discipline. Policy activism does not necessarily mean to adopt new measures or to change policy at every sign of turbulence; it means to be ready to broadcast appropriate policy signals whenever there appears to be evidence of unsustainable trends in relevant financial variables such as credit aggregates, asset prices or exchange rates. The "signal" should make clear to market participants that the authorities consider current trends unsustainable and likely to lead to severe financial imbalances. The nature of the signal may be appropriately differentiated in light of particular circumstances: it may take the form of an oral warning, or might involve monetary policy measures, exchange market interventions, tax or regulatory changes.

It may be argued that such policy activism may in itself be destabilising and give rise to greater market volatility. Moreover, if the activism included a pre-emptive monetary tightening by the central bank, without clear evidence of an inflationary threat, this may be criticised as damaging to the economy and the legitimate interests of, say, private investors in the stock market. These arguments are understandable, but are not really convincing. Any policy action is bound to change financial market expectations and the evaluation of risks and return by intermediaries and investors. The volatility in financial markets that normally accompanies policy changes reflects precisely the adjustment process carried out by the market as intermediaries re-arrange their positions in light of the new expectations about risks and return on their investment. In this process, inevitably, some people gain and some people lose. But what matters is that the volatility entails an enhanced perception of risk by market participants, which may be the crucial ingredient for deflating a potential financial bubble. Indeed bubbles are generated when markets lose the perception of a two-way risk; it is one-way markets that generate overshootings, bandwagons and bubbles. In the end, investors should be grateful that a bubble has been deflated sooner rather than later.

Thus, in my view, the key question is not if policy activism is justifiable or not; the key question is whether a potential financial imbalance can be unmistakably identified at an early stage. Here again, I would tend to discount the usual arguments that monetary authorities are not endowed with perfect foresight, that they should not presume to know better than the collective wisdom of millions of market participants, etc. What is required in this case is not the crystal ball, but a considerate judgement on the sustainability of economic trends that are relevant for financial stability. I believe that economic theory, empirical analysis of historical data, careful monitoring of market dynamics and plain common sense are in most cases quite sufficient for passing such a judgement. In fact, experience gained in the management of unsustainable trends in exchange rates shows that when the authorities have been explicit in advocating a reversal of the trend and have supported their words with consistent policy actions, the market sentiment has generally been reversed, in many cases quite rapidly.

In a regime of globalisation, however, it may be difficult for the monetary authorities of any individual country, large or small, to have all the information needed to assess the impact on financial conditions of international capital flows and of the operation of global financial markets. It is only in the fora of international consultation and cooperation that the full picture of the trends and the vulnerabilities of the international financial system can be seen. Indeed, also at the international level, there is a need to reconsider how best to implement a macro-prudential approach to financial instability, bringing together the expertise of national finance ministries, central banks and supervisory agencies. This is where the Eurogroup of finance ministers and the Eurosystem of central banks could play a fundamental role[5] by promoting such a new approach within the G7 and the Financial Stability Forum, whose establishment has already allowed the development of important synergies in analysis and in the policy debate. Still, more formal and explicit procedures could be devised to link the review of macroeconomic policies with the analysis of financial market trends and of financial vulnerabilities. A more central role could be envisaged in these procedures for international institutions like the IMF and the BIS, which have accumulated invaluable expertise in the identification of unsustainable financial trends. To call for strengthened international cooperation in this tense moment for international relations may sound naïve and unrealistic, but the fact remains that international financial stability is a public good that can only be produced by international institutions.

Clearly what is at stake here is that, in the absence of a systemic approach to monetary and financial stability on a global scale, there may be a bias in favour of excessive credit creation, as monetary authorities remain passive in the face of sustained upward movements in asset prices and stand ready to aggressively relax monetary policies to counter the deflationary impact of the bursting of the bubbles.

As a risk manager, I must say I am worried by the current situation of very abundant international liquidity and very low spreads prevailing in credit

[5] On the international role of the Eurosystem in the field of financial stability, see Padoa-Schioppa (2004), pp. 157-163, and Padoa-Schioppa (2004 b), Chapter 8.

markets. Nor am I reassured by the resilience shown so far by global financial markets, which seems to be based entirely on their remarkable ability to spread risks over an ever larger spectrum of investors and intermediaries, through highly sophisticated financial instruments, such as credit default swaps (CDS) or asset-backed securities (ABS), whose performance under stress has not been tested as yet. No one knows where and when tensions or crises are going to materialise in the future, when credit spreads are going to increase and credit is going to be contracted, as would inevitably happen. Is it going to be in the field of collateralised debt obligations? In the housing market? In China? One can only guess.

In conclusion, securing monetary *and* financial stability in a globalised international economy is going to be quite challenging for national monetary authorities and for the institutions of international cooperation. As a former central banker, I think the chances of success in this endeavour will depend crucially on the role that central banking will be allowed to play in this difficult game. To confine central banks to the role of guardians of price stability, without fully using their expertise in dealing with banking systems and financial markets, would be a serious misallocation of resources. At the same time central bankers should not be overcautious and refrain from giving stability-oriented policy signals to the markets for fear of criticism. As a great American central banker, William McChesney Martin, famously said: "the central banker is the guy that takes away the punch bowl when the party gets going". This exhortation seems to be just as valid today as when it was first issued more than 50 years ago. I would just add that today the "guy" needs to make sure that no one – particularly global financial markets – is refilling the bowl while he is looking at other things.

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STATEMENT BY MARTIN WOLF

ASSOCIATE EDITOR AND CHIEF ECONOMICS COMMENTATOR, FINANCIAL TIMES

It is both a great pleasure and a great honour to have been invited, as a mere journalist, to participate in this colloquium in honour of Tommaso Padoa-Schioppa. As a citizen of the United Kingdom, I am still more surprised, given the notorious reluctance of my fellow countrymen to share the enthusiasm of Tommaso himself for the European project, in general, and Monetary Union, in particular. Indeed, I myself have been known to share some of the scepticism. It was with some pleasure, therefore, that I learned of Tommaso's own appreciation of the roots of the difficulty when I asked him, some years ago, when here in Frankfurt, whether he thought the United Kingdom should attempt to join the Eurosystem. Understanding perhaps what a large and ungainly cuckoo would, thereby, be brought into his elegant nest, he replied promptly, "not before the United Kingdom decides it is a European country". That, on present trends, may take a while. Your deliberations here at the ECB are, I agree, unlikely to be troubled by British obstructionism for some years, if not decades, to come.

I have been asked to address the role of the single currency and the world at the end of a long list of hugely distinguished speakers. By now, every point that could be made has been made. Tant pis, as our French friends would say. Yet if I cannot avoid saying something, I will at least attempt to be brief. In what follows, I will cover four issues: the euro as a rival to the US dollar; the euro area as an area that contributes to global economic stability; the euro as a model for the world; and, finally, the euro area in global economic governance.

The euro as a rival to the dollar

The euro was established, in part, to create a European alternative to, in the words of Charles de Gaulle, the "exorbitant privileges" of the US dollar. Since the founder of the Fifth Republic made this remark towards the much-desired end of the Bretton Woods exchange rate arrangement, while we now live in what some call a new or second Bretton Woods, the ambition seems both timely and understandable. The US dollar remains today the world's dominant currency, as a unit of account, means of payment and store of value. Backed by the world's most dynamic large economy, its position appears unchallengeable. At the end of 2003, the US dollar accounted for 64 per cent of global currency reserves, which was even up from the 53 per cent in 1994. The euro has also made some progress, with its rise from 13.5 per cent in 1999 to 19.7 per cent in 2003. This upward movement does, however, reflect its appreciation, rather than increased holdings of the currency.

In the last few years, the United States has exercised its "exorbitant privilege" to a quite extraordinary extent. 45 per cent of the USD 3,700 billion in global foreign currency reserves held at the end of last year had been accumulated in the previous three years, much of it in dollars. Japan alone had accumulated USD 437 billion, China USD 400 billion and the whole of Asia USD 1,244 billion.

This accumulation has permitted the United States to run enormous current account deficits unscathed: according to US balance of payments statistics, 43 per cent of the financing of the US current account between 2002 and 2004, inclusive, came from foreign official sources. At the end of 2003, moreover, close to half of the net claims on the United States were held by foreign governments: "exorbitant privilege" indeed.

Can and should the euro aspire to replace the dollar as the world's official store of value? To these questions, I suggest, the answer is no. First, let us look at the "can". The world now clearly holds excessive reserves. This suggests, at least to me, that the future will not consist of further accumulations on this scale. There will, therefore, be little new in the way of exorbitant privileges to enjoy.

Now let us turn to the "should". Here I suggest one remembers the old line: being careful what one wishes for. Consider a world in which the ties with the dollar are broken. The world will then be awash with dollar reserves. The natural desire of its holders will be to switch into other currencies, the euro foremost among them. The effect is likely to be a prolonged period of dollar weakness and of euro strength. However pleasant that may be for holders of euro, it would be enormously unpleasant for euro-based producers.

On balance, therefore, I suggest we should look towards the ending of the dollar era, likely though it is, with some trepidation. It is likely to be a period of upheaval and currency instability, comparable perhaps to the 1970s. Nobody in Europe should welcome such an outcome. Nor should anybody in the euro area much welcome a global desire to hold the euro in place of the dollar if the strength of the currency comes at the expense of the vigour of the economy.

The euro area's contribution to global economic stability

Discussion of the role of the dollar in the world economy brings us naturally to my second issue – the role of the euro area in securing global economic stability. It is not, in my view, anything close to adequate. It is admirable to have in Europe a zone of monetary stability. But the euro area economy is insufficiently dynamic and, for this reason, incapable of making its proper contribution to the unwinding of today's global imbalances. There is a quite improper tendency in Europe to blame what is happening merely on US profligacy, without recognising the obvious point that for every lender there must be a borrower. Without such a borrower, the result can only be a global depression. That is the most important single lesson of the work of John Maynard Keynes. Today, the world is replete with would-be lenders and seriously short of would-be borrowers. This is why, in my view, the US current account deficit is created more by the rest of the world's reluctance to spend than by the Americans' determination to do so.

Where then does the euro area fit in? Not well, is the answer. Between 1997 and 2006, according to the IMF, real total domestic demand will have risen at 2 per cent a year in the euro area, against 3.8 per cent in the United States. In Germany's case the increase will be a mere 0.8 per cent a year. Over the same period, real output in the euro area will also have grown at 2 per cent a year. So

the zone has imparted no net stimulus to the rest of the world. Equally, the euro area's current account position has moved from plus USD 79 billion in 1996 to minus USD 72 billion in 2000 and back to USD 53 billion in 2004. The big driver here has been Germany, with a current account surplus last year of USD 104 billion, up from minus USD 29 billion just four years before.

The euro area has not been exacerbating global imbalances to a huge degree, but it is doing nothing to resolve them. While the biggest adjustments do need to be made elsewhere, an orderly reduction in the US current account deficit, which most people agree is desirable, depends on an expansion in deficits or reductions in surpluses elsewhere. Is the euro area in a position to help? Alas, I fear not.

The euro as a model for the world

My third question can be dealt with more quickly. I do not foresee another euro emerging elsewhere, particularly not in Asia. It is clear that the unresolved rivalries between Japan and China would not permit such a development for the foreseeable future. Should those rivalries be resolved, it is likely to be in the form of a Chinese economic "victory". In that case, the currency of an economically successful, but nationalistic, China is likely to become itself the dominant currency of the Asian region. The special political conditions of Europe – a civilisation of states desperate to put an end to the warring – do not apply elsewhere.

The euro area in global economic governance

Finally, let me turn to the role of the euro area in global economic governance. It is evident to any outside observer that the institutions we have at our disposal do not match our needs. The International Monetary Fund is too small to help its larger emerging market members effectively. More important, the Asians have decided to self-insure themselves, in a hugely inefficient and expensive way, rather than rely on the IMF in future. It would make far better sense, however, if reserves could again be pooled and so investment in them safely reduced. Again, the IMF is largely ineffective as an instrument for discussing global balance of payments adjustment.

There are many reasons for this state of affairs, but among the most important has been the insistence of the old western powers, but particularly the Europeans, on preserving their privileged position like so many ancien régime aristocrats. Today, if I remember correctly, Belgium's quota in the Fund is bigger than India's. Countries that will never borrow from the Fund again insist on appointing its Managing Director. It is evident to the least intelligent observer that this delegitimises the IMF as an institution. Europeans should, instead, agree enthusiastically to reforms of the quotas and changes in their approach to appointing the IMF's management. Needless to say, this should coincide with a comparable agreement by the Americans on the World Bank. Only by change can these institutions be renewed and made relevant to the very different world of the 21st century. Equally, the principal forum for discussion of the global economy will have to be the G20, rather than the increasingly outmoded G7, with its four

European members. Evidently, a part of this change must be an increasing ability by the euro area to speak collectively.

Conclusion

To bring these strands together, let me make four bold points. First, do not pray for the dethronement of the dollar. This could be agonising for us all. Second, do make a better effort to contribute to global economic stability by generating stronger demand in the euro area. Third, do not regard the euro as a model for the world. Finally, do embrace radical reform of the global economic institutions, even if this means a diminution of European privileges. This is a new world in which Europe has a smaller place. Europeans should recognise reality before reality overwhelms them.

GENERAL DISCUSSION – SESSION III

On the subject of global imbalances, **Roger Ferguson** remarked that, while it was easy to define a list of possible driving factors for global imbalances, it was more challenging to assign priorities to these factors – an important means of identifying the best way to reduce the imbalances. He presented his order of priority: (i) the dramatic increase in productivity in the United States, making the economy an attractive destination for global savings; (ii) a fall-off in domestic demand outside the United States, leading to a large glut of savings; (iii) improved efficiency in global financial markets that has allowed global savings to be channelled more smoothly into the United States; and (iv) the drop in US savings, reflecting declining government and household savings. Reacting to this, **Fred Bergsten** cautioned that pinpointing the causes of imbalances may not be of great significance in identifying the remedies. For instance, if one of the key causes of the imbalances were indeed the sharp pick-up in US productivity growth, it would seem totally inappropriate to correct the imbalances by reducing productivity growth. However, it would be important to design corrective policies that reduce the imbalances while leaving productivity growth untouched. He suggested assigning priority to a restoration of public saving; although private savings would also need to be increased, it was less clear how this could be achieved. Other priorities would be a pick-up in domestic demand in other parts of the world, underpinned by structural reforms in Europe and Japan and exchange rate adjustments in Asia. **Martin Wolf** added that he found the idea that the US deficit could be explained by high US productivity growth completely implausible. Until 2001 the explanation had been plausible, as it had promoted huge capital inflows in the form of equity or foreign direct investment, but since 2001, the US balance of payments had been financed mainly by official creditors buying short-term securities. The US current account was therefore financed by economic agents who did not reason in terms of returns or productivity performance.

Daniel Gros supported preventive action to address global imbalances, as he saw a risk that the absence of any action could upset the position of the US dollar as the most important international currency, something that could be coupled with sharp exchange rate and interest rate movements. Along the same lines, **Jacob A. Frenkel** warned that excessive reliance on an exchange rate based adjustment of imbalances could lead to very large exchange rate movements, with negative repercussions for global macroeconomic and financial stability. In the context of the US current account imbalance, a significant effort should be made to reduce the budget deficit. **Fred Bergsten** supported these points and saw the fear of a negative and self-reinforcing downward spiral as additional motivation for the adoption of correct economic policies, including much tighter fiscal policy in the United States, and the promotion of higher economic growth in Europe and other surplus countries. **Fabrizio Saccomanni** shared the impression that too much emphasis was placed on exchange rate matters rather than on macroeconomic adjustment. In his view, it would not seem reasonable to expect the Chinese authorities to allow a free floating of the currency, as that could provoke a serious financial crisis in the domestic banking system; instead, it would seem more

appropriate to propose a revaluation of the exchange rate without fundamentally changing the pegged currency regime. In **Martin Wolf**'s view, exchange rate adjustments should not be the only answer, although they should constitute an important part of the adjustment process. For instance, the current process of reserve accumulation in many Asian economies is clearly unsustainable and economically illogical, as it implies that countries that are still relatively poor are investing a large part of their GDP in the United States instead of investing in the domestic economy.

Jean-Claude Trichet wrapped up the session by noting that most of the remarks made by the panellists and audience on global imbalances were part of the consensus of the international community. The G7 communiqués, for instance, were saying precisely that the United States should enhance public savings and overall savings, that Europe must engage in structural reform in order to enhance its economic growth potential, and that more exchange rate flexibility was desirable where it did not yet exist. However, while there was broad agreement on the diagnosis, implementation of these policy recommendations remained more challenging. In the United States, there had not yet been a convincing sign that the lack of savings was starting to be corrected. And in Europe, while policy-makers were in agreement on the Lisbon agenda, the necessary structural reforms were still to be implemented.

CONCLUDING REMARKS BY TOMMASO PADOA-SCHIOPPA

MEMBER OF THE EXECUTIVE BOARD OF THE ECB

It is difficult to give a "concluding commentary" as the programme asks me to do. The audience is tired and the expression "concluding commentary" presupposes that the conclusion is drawn from the debates, not prepared beforehand. Throughout this memorable day, my task has indeed been to listen and reflect, trying to give some shape to thoughts triggered by what the speakers were saying. I will try now to express some of these thoughts and I ask for your indulgence, because you will find them somewhat dispersed.

Before getting into the subject, let me say again, as I did yesterday evening, what an extraordinary experience this meeting has been for me. Everything would have been fine, had it not been related to my person; it would have been a conference like others I have attended over the years, undoubtedly one of the liveliest and most stimulating. But what makes this gathering so special is the strong, deep human relationship I have with every person here. There are some of you I have not met for many years, but with each of you there has been a moment in our lives when we have been working extremely closely together: maybe in the 1990s, or in the 1980s, or as far back as the 1970s.

One of the elements that are common to all of us is that we are part of a society that spreads globally. Some of us are officials entrusted with a national mandate; others are international officials; others are in academic and scholarly life; others in business. Across this variety of positions, however, there are the common denominators of a deep involvement in international issues and the fact that very many of us have been in the public service at some stage in our life.

Now, this social group has something very special, which I would characterise as follows. The activities of its members have a dimension which is not fully embodied in the institutional arrangements defining their tasks and duty. International cooperation is not spelled out completely in the mandates of those who carry it out, although it is not really in contradiction with those mandates. Indeed, the legitimacy and accountability of international cooperation lacks the strong base that characterises the national public service and often even requires a difficult reconciliation with it. So, what we have gathered here is a group of people who really share an extra dimension in their responsibility and find a source of strength precisely in such sharing. Undoubtedly, what I call here an "extra dimension" is a potential conflict of loyalty. In my view, however, the conflict is in most cases not between the national and the international "good", but rather between the short and the long-term interest.

While I am not aware of a piece of economic analysis describing the function and role of this particular social group, the literature of political science gives it full recognition. Let me just quote, by way of example, two of my recent readings. First, a booklet by Michael Howard – not the Michael Howard that is trying to become Prime Minister in the United Kingdom, but the famous scholar of military history – the title of which is "The invention of peace". The book ends

with an analysis of the way the problem of peace is being faced today and assigns a fundamental role to the international community of officials, a society of individuals carrying the very unique responsibility of protecting and nurturing the fragile plant of international cooperation in today's world.

The same analysis can be found in "The breaking of nations" by Robert Cooper, an official of the British Foreign Office serving in Brussels. In his book, Cooper describes what he calls the post-modern state, a state in which unbounded domestic sovereignty and balance of power (the two pillars of the Westphalian order) are no longer valid safeguards for peace. Cooper describes the path from the modern to the post-modern order as one towards peace based on interference, transparency and acceptance of mutual influence. He describes the EU as the most advanced example of this post-modern world and depicts the United States as the example of a modern state where the idea, perhaps the illusion, of sovereignty without upper bounds is still strong. The problem, he says, is that not all the world is post-modern. The further complication is that there are dozens of countries which are pre-modern. The way in which these three components interact is extremely difficult.

Here again, the critical role is assigned to the social group that is meeting here.

As Fabrizio referred to it, I would like to clarify one point concerning the "house in order" proposition. We all know how frequently this proposition recurs in international gatherings. The proposition is used to restrict, or even suppress, the scope for international policy cooperation. Well, the point I want to make is the following: the precept that keeping one's house in order is all we need to do to deal with international interdependence is wrong and even dangerous. Of course, as soon as one pronounces the sentence I have just pronounced, he may be accused of being soft on price stability and fiscal discipline, of not praising sufficiently the merits of economic order, and of being prone to some other sins. The accusation, however, is completely unfounded.

Just as vices dress up in the clothes of virtue, so it happens that the virtue of keeping the house in order is used to justify the vice of rejecting international policy cooperation. The flaw in the "house in order proposition" consists in pretending that the practice of domestic virtue is a *precondition and/or a sufficient condition* to deal effectively with the problems posed by international interdependence. In point of fact, the "house in order" proposition has no basis in any serious literature, neither the modern analytics of policy coordination nor the classic thinking of liberal economists.

The international society that I have briefly described, which has gathered here today, has to hold a shared view of how to deal with interdependence, a view which is necessarily somewhat unrealistic or even visionary, because it is not based on an established set of institutions in the same way that domestic policies are.

Let me say that, if this is the common denominator of all of us here, it means that what we share is the sense that there are common problems that we have to address together, struggling to find agreement even when our views differ very

much on what exactly is to be done, even knowing that we may be criticised "at home" for paying insufficient attention to the short-term interests of our respective constituencies.

The most cryptic part of the title of this colloquium lies in the words "and beyond". Indeed, the first part of the title, "the Eurosystem, the Union" is relatively clear. It is interesting to note that the "and beyond" part of the title has pervaded all the sessions. All the speakers were focusing on the future and conveyed a sense of incompleteness, the perception that the present arrangements are not adequate, that the existing instruments to deal with common problems are insufficient.

It would be impossible to go through all the panels and within each panel to reflect the very careful division of labour that a discrete, even invisible, hand must have organised. To me it was really fascinating to note how – within each panel – different views emerged; not only different opinions on the same issue, but also different angles taken to look at the title of the session. It is impossible to do justice to that in a few minutes. So I will just pick very briefly a few points for each of the three sessions. They refer respectively to the Eurosystem, to Europe, and to the world.

On the Eurosystem, among the critical issues which emerged today, I will consider three which I regard as crucially important in these early years of EMU, where institution building is the primary task. The issues are the Treaty and the textbook (I will explain in a moment what I mean by this), collegiality and financial stability.

In stressing that the Eurosystem is still in the process of becoming "a system" and that, in the view of some panellists, it may even be incomplete in its design owing to an insufficient attribution of certain policy tasks, such as financial stability, what struck me were the references to the Treaty. To put it somewhat bluntly, I suggest that in shaping the Eurosystem the key reference should be the textbook on central banking, not the Treaty. I had been in a central bank for about 30 years before coming to Frankfurt to help build a new one. I rarely looked at the legislation defining the mandate of my central bank and I wonder how often anybody in this room who has served for years in a national central bank has consulted the charter and how much inspiration he could get from it.

In the charter of a central bank you find very many *general* sentences, particularly in those of more than 20 or 25 years ago, which reflect a deeper wisdom than some of the more *specific* and more recent legal formulations. I do not know how the early years of the Fed were in this respect (and let me say, in passing, how fascinating I found Roger's presentation), but I wonder how much the legislation establishing the Fed was the key reference text in those early years. To my mind, the road map and the compass are in the textbook on central banking more than in the law. Of course there must be compliance with the law, but it is extremely difficult to read the road without having a clear notion of what central banking is about.

If the Eurosystem is gradually growing into a living central bank, spanning in a consistent way all the aspects of its public function, it is because it follows the textbook. By following the notions and the wisdom accumulated over decades about what central banking is, we discover that the Treaty allows us to gradually implement those notions. The way we read it today already differs from the way we read it six or seven years ago.

Turning to collegiality, many comments were made on consensus and voting. Here I just want to stress the value of collegiality. I asked myself, and it was mentioned by you, Jean-Claude, how it is that in the EMI it was difficult to decide and in the Governing Council it is not, despite the fact that we rarely vote. It is so because the mere existence of a majority rule in decision-making has been internalised to the point of influencing our way of thinking, our way of listening to each other. We are aware that now we have to persuade the others with the quality of our argument, because merely asserting our point of view is no longer enough. Having participated for years in many meetings of the EMI first, and, later, of the ECB, meetings largely attended by the very same people, I have witnessed the almost dramatic change that occurred from the very first meeting of the ECB Governing Council.

Collegiality presupposes confidence that a decision can and will be taken. This in turn postulates that no member of the college has the power to impede a decision by exerting a veto. Collegiality also requires that those who sit around the table are people, not representatives of somebody else, mere interpreters of an interested party outside the room. So it requires the "one person, one vote" rule, a rule which, in an act of extraordinary wisdom, was almost immediately agreed upon when the Treaty was written. I always feel great admiration for those who reached that agreement, in particular for the German officials who discussed and accepted it – in spite of their country being so much larger than any other in the Union – as an indispensable feature of an institution such as the ECB. It should also be noted that collegiality is a powerful safeguard of independence. Not only does it presuppose the independence of the individuals, it also protects the independence of the components.

Finally, financial stability. A much longer comment would be required than the few words I will say. Of the many aspects where incompleteness characterises the Eurosystem in the seventh year of its life, financial stability is one of the foremost. Alexandre has stressed this point, so did Charles.

I am not convinced that unless there is a European fiscal authority, there can be no European responsibility for financial stability. What I think is needed is to find an arrangement that meets the increasingly urgent need to provide a single supervisor to the very few banks who truly operate euro area-wide. There are very few indeed. While there are almost 7,000 banks in the euro area, we are talking here about a few dozen. For those few banks, it is indispensable, and I think it is possible, to define appropriate arrangements. I apologise for just stating this point without giving the argumentation.

The second topic is Europe. Here again, the theme of incompleteness was very strongly present, as I will show by picking just a couple of points.

One concerns the Lisbon agenda. Daniel Gros and Vítor Gaspar suggested that the remedy for the incompleteness of its implementation should be more policy coordination, the attribution of more competence to Brussels. The point is that "coordination" and "Brussels" are very ambiguous words in the context of economic policy. As for "coordination", we should not forget that competition in the market – including competition among national policies – is a form of coordination. As for "Brussels", this is the name of the place where two very different types of meetings are held: meetings of the European government, which promote open competition, and meetings of the cartel of national governments, which block competition; in short, the Commission and the Council.

Now, which of these two Brussels-based powers should be strengthened? My view is that the former should be strengthened in order to weaken the second. We should allow more competition, not put up more centralised policies. Competition is one of the most sophisticated forms of coordination, but it requires a very strong framework for the interaction between economic agents to be a creative game rather than destructive warfare. When discussing the Lisbon agenda and ways to make it more effective, there is very often an unresolved ambiguity between asking to empower Brussels to give a freer rein to competition or else taking more dirigistic decisions uniformly replacing decisions now taken in the capitals.

The other point concerns the Stability and Growth Pact, today's debate on which was a fascinating one. Here I would only wish to say that I do not share Martin Wolf's very negative view. I don't, because I take a longer-term perspective, which puts things in a different light.

By putting in place something like the Stability and Growth Pact, the EU, still an infant federal system, has taken an enormous leap forward in terms of the distribution of power between the Union and its parts. It has given to the Union an authority on national budgets that no federation that I know has ever had. Indeed, there is no Stability and Growth Pact in Germany for the Länder, not in the United States for the states (where rules on state budgets are written in the constitutions of the states, not in any legislation emanating from Washington), not in Switzerland, Belgium, Canada or Australia. The EU has gone even farther: to decide on these issues, it has adopted the majority rule, at a stage of its development in which unanimity is still required to decide on much more trivial issues.

Now, if the difficulties encountered by the Stability and Growth Pact in recent years are assessed against this background, and if we add that such difficulties were exacerbated by the longest stagnation of the last half century, then we are bound to pass a more balanced judgement. The truth of the matter is that we are in the initial phase of a most ambitious constitutional requirement. It is normal that the testing is difficult. The early years of the EMS were even more difficult.

The key question is not whether the formulation of the Pact is the absolute best one can conceive, or if its rules could be improved here or there: on this,

economists and policy-makers could discuss for decades. The key questions are, first, whether a fiscal framework is desirable and, second, whether the Treaty formulation has any serious flaws. In my view, the answer is unambiguously "yes" to the first question and "no" to the second.

Of course, there may be details which people can discuss and where improvements can be made, but fundamentally the Pact is ok. The process underway concerns its implementation and whether the struggle for fiscal discipline will be won or lost; here, the outcome is entirely open. Of course, the recent developments are not positive, but there is little doubt that the existence of a common framework helps. This is why I think it is not right to consider this struggle as closed in a negative way.

The third session concerned the world. The global perspective is the one where the euro makes perhaps the smallest difference. Fred would perhaps not agree, but I tend to think that the presence of the new European single currency did not make today's discussion of the global outlook very different from a debate that could have taken place some 15 years ago.

The fact is that the euro has not really altered the architecture of the international monetary system, except for removing from the world a factor of instability. Before the euro, Europe was an area of monetary, exchange rate and macroeconomic instability. But the advent of the euro has left basically unchanged the floating system that emerged in the second part of the 1970s and in the 1980s.

There is a big difference, here, between the perception of the public and the focus of policy-makers. In my sample of taxi drivers and restaurant waiters, whom I have interrogated for years on what they thought of the euro, one of the most frequent answers was "I am in favour because this will be a counterweight to the dollar". Yet, I can assure you that in none of the innumerable meetings I have attended from the late 1980s to the early 1990s, and which led to the Maastricht Treaty, the international role of the euro was an important item on the agenda. Rightly or wrongly, the considerations which led to the creation of the euro were predominantly intra-European, not really part of the agenda of global or international issues.

None of this means that the euro is a minor event in the international arena. It is, indeed, a major event; but one that does not, at least for the moment, change the nature of the system. The major challenges of the US external imbalance and the emergence of India and China would not be very different if the euro did not exist. I tend to think that the terms of the analysis are – at least for the time being – not altered by the euro. For it to come to play the role of an alternative to the US dollar, much time is required. These are long historical processes.

I conclude by striking a note of hope. The concomitant facts that this colloquium was so strongly forward-looking, so strongly emphasising problems for which we are still searching for a solution; that it was conducted by a group of people who really come from every part of the world; that such people share the same sense of responsibility for the way economic and financial matters evolve in the world; well, the combination of these three facts is in itself a strong reason to look to the future with confidence and hope.

CLOSING REMARKS BY LUCAS D. PAPADEMOS

VICE-PRESIDENT OF THE EUROPEAN CENTRAL BANK

Dear Tommaso,

Dear friends,

Mark Twain once made a remark that I will paraphrase somewhat: "What a good thing Adam and Eve had. When they said something good they knew nobody had said it before". I am not as fortunate tonight. At the end of this great colloquium, so stimulating and intellectually enriching, with the participation of so many outstanding colleagues – and especially after Tommaso has already added his own concluding commentary – my task appears as a "mission impossible". When almost everything has been said, and said so well, it is not easy to find the appropriate theme and words for some closing comments without risking repeating what has been discussed. But I will try nevertheless to rise to the challenge and attempt the impossible. Just like Tommaso and many others in this auditorium who started to work towards the goal of a single currency in Europe at a time when most people thought this to be an idealistic pipe-dream.

I believe there is one thing about Tommaso that has not been looked at today: "What's in the name?" After all, nomen est omen. Our first association is probably that of Saint Thomas. "Doubting Thomas". Not particularly flattering, prima facie. But the doubts that Saint Thomas is famous for also reveal a very inquisitive mind, a deep desire to get to the bottom of things, to comprehend and grasp matters in a profound way. Looking at it from this angle, I can see a clear connection with Tommaso.

And Tommaso has certainly penetrated deeply into the subject-matter of many central banking themes, at times very technical ones like payment systems, and he has established an expertise that has commanded great respect not only in his native Italy, but in Europe and beyond. But this does not mean that he has become a narrowly focused central banking specialist, even though most of his career, so far, has been spent in central banking and adjacent fields. On the contrary.

As the themes of this colloquium have shown, Tommaso's interests have been wide-ranging indeed, not limited to the rather confined space of the technicalities of central banking. It appears to me that the many themes and issues which have captured Tommaso's particular interest over the past few years – and some of these he pursued with great fervour and passion – can be subsumed under three general headings broadly corresponding to those we have addressed today: the single currency and the functioning of the Eurosystem; the European economy and the unification of Europe; and the euro and international cooperation. In fact, when I looked at the title of the colloquium "The Eurosystem, the Union and beyond", and knowing Tommaso's broad range of interests, I wasn't exactly sure whether the term "and beyond" would be associated with any confines.

In all the areas where Tommaso gets involved, he always seeks to define a framework that aims to encompass all the relevant elements and to adequately capture the complexity of the relationships among them. In so doing, the insights from history have always played a crucial role, because history not only teaches us lessons, it also provides a context and a narrative and even gives us clues about the future. For example, as has been mentioned, Tommaso sought to conceptualise central banking functions in terms of the three distinct roles of money and how they have evolved over the centuries. In order to explain and help us understand the evolution of the Union, he devised a framework that combines economic and political developments into a comprehensive and holistic approach and sheds light on the interdependencies between the politics and economics of European unification. It is not paradoxical at all that Tommaso's ambition to formulate a framework to conceptualise Europe, a framework that is both comprehensive and consistent, led him to the "inconsistent quartet" and to a proposal for its resolution.

What is unique about Tommaso's work and personality is his ability to achieve originality in both substance and style. New ways of looking at problems and innovative – and refreshingly simple – ways of expressing complex issues has been, and continues to be, a landmark of Tommaso's style. Of course, this is no simple matter, it requires an outstanding intellectual aptitude and mastery of the issues at hand. "Rem tene, verba sequenter", Cato reminds us: Master the matter, the words will follow.

When I personally had the opportunity to work with Tommaso, I witnessed his capacity to address substance with style. This was first in the mid-1980s, when we collaborated on a project that resulted in the book "Efficiency, Stability and Equity" and is often referred to as the "Padoa-Schioppa Report". I saw how Tommaso sought to foster cooperation among participants – through charm, intellectual rigour and humour – in a direction that was consistent with his vision and style. My second working period with him was, of course, much more extended: our joint work on the ECB's Executive Board. He made a major contribution in setting up and developing the areas of financial stability and international and European cooperation at the ECB. This was no mean feat, given that it involved territories which were less well defined and we had to sail in essentially uncharted waters, owing to limitations reflecting the prevailing institutional environment.

Beyond the ECB, his wide range of interests and activities and his desire to communicate his views to the public at large are manifested by his series of monthly columns in a large Italian newspaper. Their titles very much exemplify Tommaso's broad horizons: "Il carattere dell'Europa" or "Quale Alitalia per gli Italiani" are still reasonably close to home; "La saggezza di chi sa osare" ("The wisdom of those who are able to dare") or "Agamennone e quei litigi tra alleati" ("Agamemnon and those disputes among allies") are a different matter. I leave it to you to second-guess what might be hidden behind those titles. Obviously, the connection between these themes and the rather technical world of central banking is – how shall I say – somewhat less direct. But Tommaso's published views on these matters bear witness to his standing in public life as much more

than a European Central Banker – as a sharp-witted intellectual and perceptive commentator on current affairs.

Looking to the future, Tommaso has identified in his work a number of challenges that the euro and its central bank will face on the road to full maturity. We have addressed and discussed most of them in this colloquium. But let me briefly focus on one of them regarding the fundamental issue of stability and growth to further highlight Tommaso's penetrating thinking.

Tommaso shares the view that the ECB and the Eurosystem will be judged in the years to come by the ability to maintain price stability. He argues, however, that the success of EMU will depend, and be evaluated, on a more ambitious standard: the ability to secure a combination of price stability and growth and to create jobs and reabsorb unemployment. He assesses the debate on whether the combination of high growth and stability is within reach in the coming years as inconclusive, for "the knowledge over the ultimate determinants of growth is not sufficiently complete for economists to predict and for policy-makers to engineer". Such an inconclusive conclusion potentially raises serious questions.

If the period of slow growth and high unemployment persists, Tommaso perceives risks for the Eurosystem regardless of its success in maintaining price stability. The risks are functional and institutional. As the attitudes of society are influenced by the economic environment and institutions respond to these attitudes, the Eurosystem may face the risk that in the future its mission may not receive the same strong support – from the public and from governments – that resulted from two decades of inflation. It may not be easy for a central bank to convince, especially the younger generation, of the benefits of stable prices if they have not experienced the costs of inflation. Put simply: In an environment of persistently low growth, a central bank can find itself in an awkward position and some could argue, as Tommaso notes in his characteristic style: "Independence does not mean infallibility".

These are provocative questions for central bankers. But they are illustrative of Tommaso's inquisitive mind and probing analysis. He provides tentative answers particularly regarding a central bank's communication. We have also discussed pertinent issues during the colloquium: the need to enhance market flexibility, productivity and labour utilisation in the euro area economy so as to strengthen sustainably its growth performance. Yet, a broader assessment of the risks Tommaso has pointed out and the formulation of appropriate policy responses would seem to require a more extensive debate. A crucial issue is, in my view, to secure the maintenance of public confidence in the central bank, which is the essential condition for the preservation of price stability and the attainment of higher and durable growth. And I am sure that Tommaso will be ready to further contribute to such a debate, as well as to learn from it, during his very active retirement, which has been predicted by all of us.

Overall, in his professional life, Tommaso has pursued a path characterised – regardless of the specific field or task – by four phases: probing, analysing,

synthesising and proposing. The outcome of his activities has been outstanding from a professional point of view, but also, I believe, personally rewarding, a source of life-time, continuous learning for himself, his colleagues and friends. And this has also given him a sense of great personal satisfaction and pleasure. For as Aristotle wrote in his Poetics (1.5): "To learn is a natural pleasure, not confined to philosophers but common to all men."

Let me close by coming back to the name Tommaso: I find it intriguing that Saint Thomas is also the patron saint of architects and builders – because this fits very well with Tommaso's role in the construction of Economic and Monetary Union in Europe: his contributions to the debate and the processes related to the single currency, to the euro area's economic policies and to the functioning of the ECB as a European institution are cornerstones of the intellectual edifice on which the euro rests.

So, Tommaso, for myself and, I am sure, on behalf of all of your colleagues and friends, I will conclude with two words: Thank you.

The Eurosystem, the Union and beyond

The single currency and implications for governance

An ECB colloquium held in honour of Tommaso Padoa-Schioppa

Wednesday, 27 April 2005
Steigenberger Frankfurter Hof, Frankfurt am Main

10.15 a.m.	**Welcome speech** Jean-Claude Trichet President of the European Central Bank
10.30 a.m.	**Panel session I:** **A single currency and a team of 13 central banks** Chair: **Willem F. Duisenberg** Former President of the European Central Bank Speakers: **Alexandre Lamfalussy** Former President of the European Monetary Institute **Roger W. Ferguson, Jr.** Vice Chairman, Board of Governors of the Federal Reserve System **Charles Goodhart** Norman Sosnow Professor of Banking and Finance, London School of Economics **Hans Tietmeyer** Former President of the Deutsche Bundesbank
12.30 p.m.	Lunch
2 p.m.	**Panel session II:** **A single currency and a Union of 25 Member States** Chair: **Giuliano Amato** Former Vice-President of the European Convention

Speakers:
Vítor Gaspar
Special Adviser to the Board of Directors of the Banco de Portugal

Daniel Gros
Director of the Centre for European Policy Studies

Karl Lamers
Former Foreign Affairs Spokesperson of the CDU/CSU Parliamentary Group in the Deutscher Bundestag

Mario Monti
Former Member of the European Commission
President of Bocconi University

3.45 p.m. Coffee break

4 p.m. **Panel session III:**
The single currency and the world

Chair:
Jean-Claude Trichet
President of the European Central Bank

Speakers:
C. Fred Bergsten
Director of the Institute for International Economics

Toyoo Gyohten
President of the Institute for International Monetary Affairs

Fabrizio Saccomanni
Vice President of the European Bank for Reconstruction and Development

Martin Wolf
Associate Editor and Chief Economics Commentator at the Financial Times

5.45 p.m. Concluding commentary by Tommaso Padoa-Schioppa

6 p.m. **Closing remarks**
Lucas D. Papademos
Vice-President of the European Central Bank

Followed by a reception