



Cato Institute Foreign Policy Briefing No. 28: European Monetary Reform: The Pitfalls of Central Planning

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Executive Summary

The Maastricht Treaty of 1991 is a classic example of the fatal conceit of central planners who think that they can impose their will on peoples and markets regardless of economic rationality or even common sense. The treaty sets out a blueprint for significantly increasing the powers of the EC "government" in Brussels, establishing a European central bank (ECB), and replacing national currencies with a new common currency. The ratification process and the treaty itself are open to a number of serious objections.

The treaty was motivated by political factors.

The way the treaty was ratified in countries such as Britain and Denmark destroyed whatever legitimacy it might have had.

The treaty undermines the ECB's "commitment" to price stability by failing to safeguard the ECB's independence.

The treaty is vague and self-contradictory.

The European governments could not deceive the financial markets, which delivered a devastating verdict against the treaty by destroying the platform--the Exchange Rate Mechanism--on which European monetary union was to be built.

Introduction

One of the ironies of recent years is that while central planning was being thrown out in Eastern Europe, the countries of the European Community (EC) were going in the opposite direction in a misguided effort to establish a dirigiste superstate. That effort culminated in the Maastricht Treaty of 1991, which set out a blueprint to significantly increase the powers of the EC "government" in Brussels, establish a European central bank (ECB), and replace the present national currencies with a new common currency.

The authors of the treaty--the would-be Founding Fathers of a United States of Europe--set out to centrally plan the future of 300 million people regardless of whether those people wanted it or not. Not surprisingly, the treaty provoked a storm of controversy, and the process by which member governments sought to ratify the treaty effectively destroyed whatever "legitimacy" it might have had.

In Britain, calls for a referendum were ignored because polls suggested the people did not want the treaty, and the

government managed to get the treaty through Parliament only by the narrowest of majorities and by blackmailing skeptical MPs from its own party. The Danish experience was even worse. The Danish government put the treaty to a referendum, and the Danish people rejected it.

Rather than accept the result of the referendum, the EC heads of government responded by trying to make the Danish people think that the treaty had been altered to take their concerns into account. They did so by producing a "declaration"--a meaningless piece of paper with no legal standing whatsoever--at the Edinburgh summit of December 1992. That declaration said that, while the treaty remained unchanged, Denmark would not be bound by the provisions on European monetary union, common citizenship in the European union, and common defense and security issues. The Danish government then took that legally worthless declaration as an excuse to present the same Maastricht Treaty, completely unaltered, for a second referendum. The government managed to persuade enough voters that the treaty had been altered to meet their concerns, and the treaty was accepted in the second referendum.

But European governments could not deceive the financial markets, which delivered a devastating verdict against the treaty by destroying the platform--the Exchange Rate Mechanism (ERM)--on which European monetary union was to be built. The treaty calls for the ERM to be expanded and "solidified" into a genuinely fixed exchange rate system, and the final transition to a common currency can only take place once that task has been completed. However, the policies of different governments are fundamentally inconsistent, and market operators were not fooled by attempts to disguise those inconsistencies. There were speculative attacks on the ERM, and by the summer of 1993 it had effectively been destroyed. Whatever European politicians and bureaucrats may say, and despite the fact that the treaty has just gone into effect, without the ERM, the Maastricht Treaty is essentially a dead letter.

The Background to the Maastricht Treaty

The roots of the debacle go a long way back. Most European politicians and civil servants see a "strong" state as necessary to protect "their" citizens, whom they regard as unable to look after themselves. That paternalism in domestic policy goes hand in hand with a mercantilistic view of the world according to which the world economy is a group of mutually antagonistic trading blocs in a state of nearly permanent trade war. That "Fortress Europe" mentality has been associated with the promotion of an artificial sense of European nationalism, the principal characteristic of which is animosity toward the United States and Japan.

A second contributing factor is realpolitik. The EC was originally built on a bilateral axis between France and Germany, and in recent years the relationship between those two countries has become increasingly unbalanced. The French political establishment--the French government, and the president of the EC Commission, Jacques Delors--became increasingly concerned with Germany's renewed assertiveness. If they could not contain Germany indefinitely by themselves, they concluded, they should contain Germany by establishing a federal superstructure above her, and they set about to persuade German politicians to accept that superstructure while they still had the influence to do so.

A third factor was dissatisfaction with Bundesbank "dominance" within the ERM. The ERM had been set up in 1979 to provide a zone of exchange rate stability in Europe, and the Bundesbank's relatively conservative monetary policies had helped reduce inflation in countries such as France and Italy. Despite those benefits, the Bundesbank's dominance within the ERM was widely disliked by politicians in France, and to some extent in the United Kingdom, who saw in it sinister overtones of German hegemony in Europe. Much the same group of politicians also resented what they regarded as the excessively conservative policies followed by the Bundesbank, and they wanted a more amenable European central bank (i.e., one that would inflate more) that did not share the Bundesbank's "obsession" with inflation.

The Delors Plan

In June 1988 Delors persuaded the heads of government at their summit in Hanover to establish a committee, under his chairmanship, that would put together a program to implement his vision of Europe. The Delors Report, which appeared in 1989, set out a detailed plan for a federal European superstate. There was to be a radical centralization of fiscal powers and a massive increase in the resources channeled through the EC itself (i.e., the Brussels bureaucracy). The separate European central banks were also to be merged into a new supranational central bank modeled on the Federal Reserve System of the United States, and the existing European currencies were to be merged into one. As a

preliminary step, Britain, Spain, and Portugal were to join the ERM, which they had hitherto not done. Member governments then agreed at their Rome summit in December 1990 to hold a further intergovernmental conference to agree to a new treaty that would amend the Treaty of Rome of 1957 on which the original European Economic Community had been founded.

One might have thought that such an ambitious plan would have merited mature consideration of possible alternatives. Instead, the committee produced their plan with such speed that one can only suppose that they already knew what they were going to say before they started. As Professor Charles Goodhart of the London School of Economics wrote, the Delors Report

reads as if its authors were convinced that there is only one currently feasible strategy for the coming phases of European monetary unification: this is a federal strategy, a Hamiltonian strategy, to transfer increasing powers to a federal centre of the United States of Europe. No alternative is even considered.[1]

The plan was to be accepted in toto and implemented according to a tight and rigid timetable. There was no willingness to engage in debate even after the documents had been produced, and those who criticized the plan were ignored or dismissed as "bad Europeans" who stood in the way of "progress." Eleven of the 12 member governments promptly accepted the plan; only the British government rejected it. A lot of pressure was brought to bear on the British government to fall into line, however, and the British prime minister, Margaret Thatcher, eventually felt obliged to make concessions, the most significant of which was sterling's entry into the ERM in October 1990.

The Maastricht Treaty

The heads of government met to hammer out the new treaty at their Maastricht summit in December 1991. The resulting Maastricht Treaty set out the objectives of the new European Central Bank (ECB), as well as its structure and governance. The ECB was to be a federal central bank modeled on the Federal Reserve System of the United States. Existing national central banks would become branches of the ECB with a status analogous to that of the individual Federal Reserve banks within the Federal Reserve System.

The treaty also set out a timetable for implementing the reforms, the most important feature of which was that the final stage (i.e., stage 3, which covers the irrevocable fixing of exchange rates and the transition to the common currency) should begin no later than January 1, 1999. To reduce transition problems before monetary union, the treaty also set out "convergence criteria" that should be met before any currency was to be admitted into the "final" system of fixed exchange rates before the start of stage 3.

Once the treaty had been agreed to at Maastricht, it had to be ratified by each member state according to each state's own political system. The treaty was not open to further negotiation, and no contingency plan was made for its rejection by any member state. With characteristic hubris, the framers of the treaty saw the ratification process as little more than a formality, and each government was concerned only to ensure that the treaty was ratified back home with minimum political inconvenience.

No Guarantees against Inflation

The Maastricht Treaty is riddled with problems. Perhaps the most important is that it provides no guarantees about the value of the currency. Admittedly, article 2 of the protocols of the treaty, which deals with the ECB, does state that the bank's "primary objective . . . shall be to maintain price stability," and any other objectives it might pursue has to be consistent with that objective. But unfortunately, the substance of that clause is undermined by the fact that the treaty does not define what is meant by "price stability." The "objective" of price stability thus becomes operationally meaningless, and the central bank can always claim to have achieved it in its periodic reports. As Goodhart says:

Such Reports are occasions for the expressions of ex-post justification of whatever, for good or ill, those in authority have chosen to do. Without a clear definition of price stability, and preferably some incentive in the form of bonus payments for achieving that outcome, there is no firm basis for accountability. The ECB's report is bound to state that their actions were consistent, as they saw best, with the achievement of price stability over the appropriate horizon. Most Central Bank reports have made that claim year after year for decades! . . . The failure to define price stability

provides . . . a system constructed by, with, and for Central Bankers, to give them an easier life. It is neither necessary nor desirable.[2]

The Maastricht "guarantee" of price stability is thus unconvincing. At the very least, the authors of the treaty needed to provide a reasonably precise definition of price stability so that people could assess whether or not that objective had been met. Price stability might have been defined in terms of a retail price index showing no trend rate of growth, for example, with year-to-year deviations that remain within some relatively narrow range. In addition, the treaty should have included some provisions to encourage the central bank to meet its price stability objective and to penalize it if it failed. Everyone concerned could then judge whether the central bank had been successful or not, and appropriate penalties could be imposed if the central bank was deemed to have failed. The governor of the central bank could automatically be fired, for example.

The Failure to Safeguard the ECB's "Independence"

The ECB's "commitment" to price stability is also undermined in other ways. An important issue in the constitution of any central bank is the extent of the central bank's independence from political interference. There are good reasons to expect that the political authorities will be more inclined than central bankers to resort to inflation--they usually have shorter horizons, they have an incentive to use short-term monetary policy to engineer preelection booms, and so on--and the empirical evidence strongly suggests that the more independent central banks deliver lower inflation rates. If the ECB is to be expected to deliver stable prices, it needs to be independent of the political authorities.

Once again, the treaty provides only superficial reassurance. Article 7 of the protocols and article 107 of the treaty explicitly state that the ECB should be independent of the political authorities, and that "independence" is reinforced by article 104(1) of the treaty prohibiting loans by the ECB or national central banks to EC institutions or member governments, a stipulation that would appear at first sight to protect the bank by prohibiting predatory government demands for cheap credit.

The problem is that the "prohibition" of loans to governments is immediately qualified in article 104a(1), which stated that it applies only to credit that cannot be justified by "prudential considerations." Since "prudential considerations" have not yet been defined, we cannot be sure of the circumstances in which this exception actually applies. A more serious loophole is found in article 103a(2), which states that EC institutions can extend financial assistance if a government is "in difficulties or is seriously threatened with severe difficulties caused by exceptional circumstances beyond its control," and the treaty makes it clear that the ECB would be regarded as an EC institution. In other words, despite the "prohibition" against central bank loans to member governments in article 104(1), article 103a(2) implies that the ECB can provide such loans by virtue of its status as an EC institution. The ECB would thus be allowed to make loans to member governments despite the prohibition against doing so!

What that means in practice is that when a national government is finally faced with fiscal crisis brought on by its own past policies, the EC need only declare that the crisis is an exceptional circumstance beyond the control of the government concerned--the veracity or plausibility of the announcement does not matter--and it can authorize an ECB bailout. Any idea that the ECB would be protected against predatory government demands for credit is an illusion.

Worse still, the same article actually encourages member governments to pursue irresponsible fiscal policies, since a government that pursues such policies gets a handout that more responsible governments do not receive. Such an incentive undermines fiscal prudence and creates the very problems supporters of the treaty claim they want to avoid. A rational fiscal federalism would have put the responsibility for fiscal policies firmly where it belongs, on the member governments themselves, and would not have encouraged them to play irresponsible fiscal games at other people's expense. Europeans cannot expect individual member governments to adopt the unpopular policies needed to restore fiscal health if the governments think they can avoid difficult decisions and rely on an EC bailout instead.

The Regulatory Powers of the ECB

The treaty is also very unclear on the regulatory powers of the ECB. Article 2 of the protocols states, reasonably enough, that the ECB "shall act in accordance with the principle of an open market economy with free competition, favoring an efficient allocation of resources." However, those words of article 2 are undermined by the fact that the

treaty avoids the issue of what an efficient open market economy with free competition actually implies. The content of article 2 is undermined further by the treaty's implication, explained in more detail elsewhere,[3] that this kind of issue is to be settled in practice by the appropriate authorities as they see fit, which in effect means that the authorities can do whatever they like.

Article 2 also sidesteps various other awkward issues: How can the ECB act in "accordance with the principle of an open market economy with free competition" in an economy that is not open--recall the EC's protectionist policies--does not have free competition, and would have even less under the social chapter of the treaty? Similarly, article 104(6) of the treaty allows the bank, under relatively lax conditions, to assume (unspecified) "specific tasks concerning . . . the prudential supervision of credit institutions." The floodgates thus seem to be open to the ECB's acquiring whatever regulatory powers the appropriate authorities feel it should have.

Even when the treaty purports to give some indication of the ECB's future prudential role, it usually does so in a vague and confusing manner. A good example of the muddled thinking that permeates the treaty is its treatment of the (normally) straightforward question of reserve requirements on commercial banks. Are central banks to be allowed to impose reserve requirements or not? There is much to be said for their abolition, and article 104a of the treaty calls for them to be abolished in stage 2 (i.e., the intermediate stage) except as required for "prudential considerations." Leaving aside the fact that "prudential considerations" are not defined, article 19 of the protocols then does an about-face and states that the ECB and national central banks will be allowed to impose reserve requirements in stage 3 "in pursuance of [undefined] monetary policy objectives." Having given up their reserve requirements in stage 2, the German and Italian central banks are to be allowed to reimpose them in stage 3.

It is here that the treaty becomes really confusing. The reserve requirements imposed in article 19 are subject to the provisions of article 2 of the protocols, which requires that the ECB "act in accordance with the principle of an open market economy with free competition" and promote economic efficiency. Many monetary economists would argue that reserve requirements are consistent with neither free markets nor efficient resource allocation, so we might be tempted to conclude that reserve requirements are meant to be banned after all. But then again, article 2 of the protocols is itself subject to article 3a of the treaty, which talks vaguely about the policy objectives of the EC and member governments, and there is a clear implication that those objectives could override free competition and the efficient allocation of resources if the appropriate authorities were inclined to use them for that purpose. In any case, as the advocate of reserve requirements might argue, why include article 19 at all if reserve requirements were meant to be eliminated?

We thus have one article of the protocols that appears to prohibit reserve requirements, subject to the prudential caveat, and an article in the treaty that appears to allow them, subject only to the provisions of a second article of the protocols, a reasonable reading of which would suggest that those conditions could not be met. But the latter article is itself subject to the provisions of two other articles of the protocols that suggest that reserve requirements might be allowed after all. To make the issue even more confusing, there is also the unclear legal question of whether the treaty article prohibiting imprudent reserve requirements overrides, or is overridden by, the two protocols articles that appear to allow them. Where all of this leaves reserve requirements in the end is anyone's guess.

The Undermining of the Treaty

The Danish Referendum and Its Aftermath

It turned out that ratifying the treaty was not the straightforward formality that member governments had anticipated. Two governments, those of Denmark and Ireland, chose to put the treaty to a popular vote. The Danish vote, which took place in June 1992, turned the treaty down. Given that the treaty had to be ratified by all member governments, the Danish result meant that the treaty was legally dead.

Yet, rather than accept that outcome, EC leaders took the line that the Danish government should simply hold as many referenda as it took for the Danish people to produce the "right" answer, the underlying argument presumably being that the Danes were to be allowed to accept the treaty but not to reject it. As explained already, the cracks in the Maastricht ratification process were duly papered over by the meaningless Edinburgh "declaration" of December 1992, and the Danish government then put the treaty to a second popular vote. Despite that obvious sleight-of-hand, and

despite the fact that a few weeks after Edinburgh, the Danish prime minister was forced to resign for lying to the Danish parliament, the result of the first, legitimate referendum was overturned by the second referendum in May 1993. European political leaders congratulated themselves on solving the Danish "problem," but in the process the treaty had lost whatever legitimacy it might otherwise have had.

The Crisis in the ERM

There were also other problems. Financial markets had never been convinced of the merits of the treaty or that individual member governments were prepared to make the sacrifices of their own individual autonomy that the unification process required, and those doubts came to a head with the ERM crisis in September 1992. The ERM was to play a pivotal role in the unification process, and it was essential that it operate smoothly and build up the credibility with the market that the transition process required. Yet, at the same time, it was clear in the market that certain governments--the British and Italian governments especially--were reluctant to pay the price that maintaining their exchange rates within the bounds set by the ERM would entail. The obvious course of action in the marketplace was to bet against the currencies that stood to be devalued. Speculative sales of those currencies soon became unstoppable, and the lira, sterling, and the peseta were each driven out of the ERM. The macroeconomic policies of the respective governments had been torn to shreds. The British government had seen the "centerpiece" of its macroeconomic policy destroyed and most of its foreign exchange reserves wiped out in a few hours in a futile attempt to defend the pound.

While the British government continued to pay lip service to the principle of ERM membership, it was clear that government leaders were in no hurry to return to the system. In any case, it was also clear that the British government would have found it very difficult to maintain any new set of exchange rate bounds even if it had had the stomach to try. The pressure then intensified on the French franc, which only just managed to survive the attack and stay within its ERM bounds. However, its survival in the ERM was short-lived, and a new attack the next summer forced European monetary authorities to widen allowable exchange rate movements within the ERM and thus, in effect, to surrender to market forces. What remained of the ERM was only a ghost of its former self, and any idea that it could somehow "grow" into a unified monetary system had to be dismissed as sheer fantasy. The ERM had effectively been destroyed.

Alternatives to Maastricht

If Maastricht was not the way forward, what else could European political leaders have done? One option would have been to continue with the ERM as it was. Countries such as Britain, France, and Italy would have enjoyed some benefits of the relatively conservative monetary policies of the Bundesbank, much as France and Italy had already done for a number of years. The ERM would then have been regarded as it was in earlier years--as a zone of exchange rate stability in which other countries benefited from relatively tough German monetary policy. The ERM would arguably have been under less strain, and it might have survived in reasonable shape.

A better option, however, would have been for individual countries to institute more thoroughgoing monetary reforms. If the citizens of any given country desire price stability--as they presumably do--then the most natural option would be for the government concerned to implement its own independent monetary reform to achieve price stability. Such reform would involve, at the very least, the passing of legislation to impose an operational price-level target on the central bank. That target would be stated in terms of a measurable price index, and there would be clearly defined penalties imposed on the central bank or its officials, or both, in the event of failure.

A good example of such an approach is the New Zealand Reserve Bank Act of 1990, which set out a price-level target and gave the central bank incentives to achieve it. A particular advantage of that sort of approach in the European context is that it would have required little or no negotiation with the governments of other EC countries and would thus have circumvented the horse-trading and general compromising that invariably go on when EC heads of government try to agree on anything. If individual European leaders had genuinely wanted monetary reform, they would have been much better off putting their own domestic monetary houses in order--and they could easily have done so.

Conclusion

The Maastricht Treaty is the wrong program implemented by the wrong people for the wrong reasons. It is a classic

example of the fatal conceit of central planners, who have the supreme arrogance to think that they can impose their will on peoples and markets alike in total disregard of economic rationality or even basic common sense. As Adam Smith once noted, allocating capital is too complicated a business to entrust to any government body, especially one presumptuous enough to fancy itself qualified to do the job. One suspects, however, that the lessons of Maastricht are lost on those who most need to learn them, and one can only wonder what they will dream up next.

Notes

[1] Charles A. E. Goodhart, "The Delors Report: Was Lawson's Reaction Justifiable?" Special Paper Series, no. 15, London School of Economics Financial Markets Group, 1989, p. 24.

[2] Charles A. E. Goodhart, "The ECSB after Maastricht," Special Paper Series, no. 44, London School of Economics Financial Markets Group, 1992, p. 32.

[3] Kevin Dowd, "The Misguided Drive toward European Monetary Union: A Case Study in the Pitfalls of Monetary Central Planning," in Dowd and R. H. Timberlake, Jr., *Money and the Nation State* (Oakland, Calif.: Independent Institute, forthcoming).