
**Reputation Failure: The Economic and Monetary Union
and its Institutional Flaws**

by

Kurt Hübner

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Kurt Huebner is the DAAD Visiting Professor of Politics and Economics at the Canadian Centre for German and European Studies. He can be reached by email at: khuebner@yorku.ca

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Université de Montréal
Pavillon 3744, rue Jean- Brillant, bureau 525
Montréal, Qc, Canada
H3T 1P1

Abstract/Résumé/Zusammenfassung

The Euro, counter to critical prognostications from both conservative and liberal commentators, has enjoyed relative success. Judging by the rate of inflation, the common currency is a success story, mitigated solely by the strong drop in its external value as compared to the US-dollar (as well as the British pound and the Japanese yen). However, the actual problems of the common currency are, according to the analysis presented below, inconsistencies in the institutional design which, in addition to effects upon monetary policy, more tellingly produce negative real economy effects. The monetary policy of the European Central Bank and the Stability and Growth Pact reflect and constitute a market confidence problem for the new currency, which diminishes the growth dynamic of the Eurozone.

L'Euro, contrairement à tous les pronostics scientifiques de droite et de gauche, a connu un succès relatif. A en juger par le taux d'inflation, la monnaie commune est un succès, mitigé seulement par une forte chute de sa valeur externe face au dollar américain, comme à la livre anglaise et au yen japonais. Quoi qu'il en soit, les problèmes actuels de la monnaie commune, d'après l'analyse ci-dessous, sont des incohérences dans le dessein institutionnel, incohérences qui affectent la politique monétaire, et ce qui est plus grave, ont des effets négatifs sur l'économie réelle. La politique monétaire de la Banque Centrale Européenne et du Pacte de Stabilité et Croissance reflète et constitue un manque de confiance du marché en la monnaie nouvelle, ce qui diminue la dynamique de croissance de la zone Euro.

Entgegen kritischen Analysen von orthodoxer wie heterodoxer Seite ist der Euro zu einem relativen Erfolg geworden. Mit Blick auf die Inflationsrate ist die gemeinsame Währung eine Erfolgsgeschichte, die allein durch den starken Verfall des Aussenwertes gegenüber dem US-Dollar (sowie dem britischen Pfund und den japanischen Yen) getrübt ist. Die eigentliche Probleme der gemeinsamen Währung sind der Analyse zufolge allerdings Inkonsistenzen des institutionellen Designs, die neben währungspolitischen vor allem negative realökonomische Effekte zeitigen. Die geldpolitische Philosophie der Europäischen Zentralbank und der Stabilitäts- und Wachstumspakt reflektieren und konstituieren ein Vertrauensproblem der neuen Währung, das die Wachstumsdynamik der Eurozone beeinträchtigt

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I. Expectations and Evaluations¹

Before the launch of the new currency on January 1, 1999, the controversy in the member states of the European Union over the benefits and shortcomings of the project of an Economic and Monetary Union (EMU) was quite intense. This was especially true for the debates in academia and the media, where the discussions were controversial and at times very harsh. For example, in Germany a group of academics even went to the *Bundesverfassungsgericht*, the highest court in the German legal system, to stop the Euro project. But whereas in Europe the radical critique of the common currency was mainly dominated by the two poles of the political spectrum, Northern American skepticism in regard to the overall project of a common currency was expressed by mainstream economists who haven't taken pleasure in radical views in the past.

In more analytical terms, the so-called convergence criteria generated the most thorough critique due to their potentially retarding consequences, at least in the short term, for economic growth. The ceiling on public spending and the necessary reduction of public debt according to two out of six convergence criteria, so the argument, would slow down economic growth and thus risk increasing unemployment². Some writers also warned of a looming race to the bottom in the arena of wages, or even of productivity wars between the member states and the rest of the developed market economies. With the deletion of the depreciation instrument, economies could only rely on the reduction of unit labor costs to succeed in the race towards international competitiveness (Altwater/ Mahnkopf 1998; Flassbeck 1998) as of January, 1999. Until the project finally started, the debate in the US was characterized by the position that the EURO is a plan among many others of the European Commission which will not actually

¹ I would like to thank my colleague Claude P. Desmarais, who generously helped me improve both my English style and my thought while editing this text.

² De Grauwe (1998) presented one of the first critiques along this line. According to this view, the fiscal discipline applied throughout the first half of the 1990s was responsible for the build-up of both unemployment and for the sluggish growth of GDP.

be realized. To give a more prominent example, Obstfeld (1998) presented the argument that the overall project is a risky gamble, basing his prognosis on a careful evaluation of costs and benefits of the common currency. He highlighted in particular the different speeds of economic growth that could undermine the working of a common currency. Believing in the rationality of markets and policy makers, he came up with the conclusion that the Euro will not come into being. Following the line of reasoning set up by Mundell's (1961) Optimum Currency Area-approach, Eichengreen (1997) convincingly shows that the Euro zone did not fulfill the criteria necessary for the creation of such an area and thus would be confronted with high economic and social costs in the case of asymmetric shocks. Obviously this attitude had to change when the project reached a point-of-no-return.

However, even with the Euro in action this skepticism did not fade away. On the contrary, prominent analysts like Martin Feldstein maintain their skeptic views and have arrived at rather devastating evaluations of the first years of the Euro. It is true that the Euro and its sustainability since its launch are interpreted as remarkable events. But it is still argued that the new currency will have adverse medium-term and long-term effects on employment and inflation, as well as likely be the source of political conflicts within Europe and between Europe and the U.S. (Feldstein 2000; Feldstein 1997,1998)³.

Once the decision to introduce the Euro seemed irreversible, the debate of European scholars also took on a different hue. Whereas mainstream economists still expressed their fear that the newly founded European Central Bank would follow rather lax monetary policies and undermine the external value

³ Scepticism of this kind is not unsubstantiated. Cohen (2002) shows that there are only few examples of successful monetary unions in the past.

of the new currency by allowing comparatively high inflation rates (Ohr 2001)⁴, many heterodox critiques of this project turned their attention to different topics. One group of critics centered their attention on the newly founded European Central Bank and its obligation to a strict Bundesbank-type of monetary policy (Hübner 1999; Wyplosz 2001). Other highlighted the implications of the modalities of EMU for fiscal policy, interpreting the Stability and Growth Pact as a straitjacket that hinders any government in their efforts to stabilize economic growth and employment (Arestis/McCauley/Sawyer 2001).

It is true, however, that those critical attitudes have been outweighed by much more positive evaluations of the Common Currency. Prominent among these was the expectation that the Euro would take on the former role of the Deutschmark as a regional hegemonic currency, and even expand its role to that of an international vehicle currency (Hartmann 1998; Detken/Hartmann 2000). Others argued that the Euro could provide the monetary base for a shelter against the negative effects of economic globalization (Altvater 2000). Wallace (2000) is one of the optimistic writers arguing that the European Union, due to its overall successful institution building strategies, is rather well prepared to face the challenges stemming from globalization. Thus, he sees the EMU as a cornerstone for this sheltering strategy. Indeed, it is certain that the European Union has changed its policy of negative integration and developed strong signs of a positive integration.

This essay will analyze the performance of the Euro and its institutional setting, and discuss if and how the European Union has started to develop the basis for an attractive model to cope with economic globalization. Following the idea that

⁴ The events since January 1999 have demonstrated the dramatic manner in which models of neoclassical mainstream economists miss the point. Actually, the warning tones of this at times shrill camp have been proven to be wrong. As I will show in this paper, the main problem of EMU seems to be precisely of an opposite nature, i.e. due to the overly restrictive policy of the ECB, the economies of the Euro zone are running the risk of entering a deflationary spiral.

the process of economic and monetary integration allows member states to isolate themselves from at least some of the devastating effects of globalization by increasing the weight of the internal markets, this paper will focus on one prominent institution, the European Central Bank (ECB), and ask how the institutional setting of a unified monetary policy can assist such a function. I want to demonstrate that the Euro and its institutional representation were, from the very beginning, involved in a reputation game with the private global financial markets. To this day, the ECB has been the loser in this game. Demonstrating the dire need for changes in the political and institutional design of the ECB, this essay will challenge the argument that there is no alternative (TINA) to this undertaking. I will show that most of the popular interpretations of a failure of the Euro in respect to its weak performance against the US-dollar are misleading. The problem with the common currency is not its external weakness in terms of a significant depreciation against the US-dollar, but the way it establishes a deflationary regime in Europe that undermines the potential benefits of the Euro for the social model of the EU.

II. Euro Realities

The launch of the Euro was an historic event. Although there have been several monetary unions in European history, it is the first time since the Roman Empire that the greater part of Western Europe utilizes the same currency. Including the delayed membership of Greece in 2000, twelve countries out of fifteen member states of the EU have introduced the Euro. Their national currencies have been irrevocably locked together by fixed exchange rates. With the introduction of the Euro many financial instruments were immediately redenominated into Euro. This was especially true of government bonds and securities. The private business sector also switched its bookkeeping into Euro denominations. Foreign exchange markets started to trade Euro too. Most importantly, with the launch of the Euro in January 1999 the national central banks lost their former monopolies to issue and to control national monies. With regard to monetary policy, Euroland since

the launch consists of the European System of Central Banks, consisting of, at this point, the twelve national central banks that serve as regional branches of the ECB. This European System of Central Banks determines the monetary policy for Euroland. The Governing Council, consisting of the Executive Board of the European Central Bank and the presidents of the national central banks, is the authority which decides upon monetary policy for the Euro zone⁵.

As of January 1, 1999 the Euro started fulfilling textbook case monetary functions. With the distribution of coins and notes in 2002, the Euro finally possessed all the ingredients of 'real' money so that private actors could settle their bills and credits with Euros as cash money. From the very beginning the Euro fulfilled the functions of: a store of value, a means of contract and a unit of account. Although the European public was confronted with new phenomena like 'feeling inflation'⁶, it seems to be fair to state that the logistical part of the currency launch was highly successful. A shortage of Euros could neither be observed, nor did the Euro zone experience a sudden increase in prices.

The empirical data shows that the Euro has been widely accepted. The Euro is used as a financial instrument far beyond the borders of the Euro zone; its shares on a global scale are between 22 and 34 per cent of all financial instruments, depending on the concrete type of instruments measured. As an investment currency the Euro shares a range between 22 and 32 per cent (ECB 2001:5pp.). Although the Euro has not fulfilled the expectations of some

⁵ In the conference version of this paper I suggested that the ECB is one of the most important unknowns of this new approach: Even though we know the phone number of Mr. Duisenberg, we don't know much about his monetary philosophy. To this very day, this situation remains unchanged. Still, the ECB is much too young an institution to make any good predictions about its future, so we will have to monitor its development.

⁶ This phenomenon refers to the difference between measured inflation rates and the price impressions of individual economic actors, especially of households. Statistically, there was no observation of a significant price increase due to the substitution of the old by a new money. This measurement was contradicted by the impression of individuals who, when polled about those effects, stated that some prices increased dramatically (*Statistisches Bundesamt* 2002).

commentators to overtake and even expand its role to that of a international vehicle currency to replace the former Deutschmark, it has turned into the second most important international reserve currency after the US-dollar with a share of 12.5 per cent of official global reserves. In 2001, its share of international bonds issuance was, at 44 %, only slightly lower than the US-dollar share of 48 % (European Commission 2002:34). Most impressive is the Euro's role as an anchor currency in the global economy. No fewer than 56 economies outside the Euro zone make use of it in their own exchange rate regimes. This group includes a majority of the 13 applicant countries for EU accession.

Compared to the period of 1992-97, since 1999 the Euro zone has experienced a return to an economic path characterized by stronger economic growth, strong price stability, and a significant reduction of unemployment. Public debt as well as public deficits shrank remarkably, demonstrating the establishment of a 'stability culture' (European Commission 2001:6) long sought after by the Europeans. Especially the former high inflation economies of the southern periphery of the Euro zone benefited from this path with a significantly lower inflation rate. Due to the lower risk premium, this also led to much lower nominal interest rates, which helped to reduce those nation's debt payments and to increase the maneuvering space with regards to fiscal policy, even under the tight restrictions of the Stability and Growth Pact that came with the Euro⁷.

III. Lack of Cost Competitiveness and the Wage Relation

In a comparative perspective, however, Euro zone performance is disappointing. The economies of the Euro zone lost significant ground compared to the US, which experienced in the second half of the 1990s a staggering growth in overall output, productivity, and employment (Herr/Hübner 2001). This paper takes as a starting point the position that the Euro, at least, has not prevented the

⁷ Arestis/Brown/Mouratidis/Sawyer (2002) and Artis (2002) presented a critical review of the first three years of the Euro.

economies of the Euro zone from participating in the US-led strong growth of the world economy. The more precise analysis will show, however, that the modalities of the Euro are mainly responsible for the overall disappointing performance. As will be shown here, this widening gap fulfills exactly the prognosis of some of the most devastating critics of the Euro project, who argued that the common currency will lead to disaster due to the still simmering 'Eurosclerosis.' Following this line of analysis, it is necessary to demonstrate that the growth gap is caused by the wage-induced loss of competitiveness in the Euro economies. Unfortunately, this line of reasoning does not hold water empirically. The period since the launch of the Euro has been marked by comparatively small increases of unit wage costs for most of the Euro zone members. The zone itself shows for 2000 and for 2001 (small) absolute decreases of unit wage costs, and for 1999 a slight increase of 2 per cent (SVR 2001). In terms of wage costs competitiveness the Euro zone economies have strengthened their international position since the launch of the new money.

The empirical data seems to contradict the above mentioned approach and to verify an alternative line of criticism presented at the start-up of the Euro. Namely that the new currency will generate a redistribution of income in favor of capital (Hübner 1999). The general thrust of this argument is that with the dissolution of the shelter function of national exchange rates, the wage relation will play the role of a substitute. In a macroeconomic dimension we can accept, at least for the moment, the notion that wages are the dependent variable determined by the process of capital accumulation. It follows then that any disturbances of the accumulation process have negative consequences for the dependent variable. If it can be shown that the introduction of the common currency generated problems for accumulation and overall growth, it should not surprise us that the wage relation will be affected by processes of devalorization. Devalorization in regard to labor power implies a downward pressure on wages and an upward pressure on the degree of the intensity of work. Methods of absolute and relative surplus production become, to use these outdated terms, more important at such

times. Relatively decreasing wages and increasing efficiency of work translate into an overall decrease of unit labor costs, which entail an upgrade of the profit quota. In a closed economy this mechanism is rather familiar. In an open economy the same mechanism is at works. But in contrast to the closed economy, in the latter the use of the exchange rate as an instrument of economic policy can reduce the pressure on wages. If the currency depreciates, unit labor costs expressed in foreign currency are reduced and exports can increase even if the internal wages-profit-relation remains constant. Using the exchange rate in this manner is a kind of beggar-thy-neighbor policy that externalizes some of the adjustment loads to the rest of the world. For the actors of the wage relation this means relief. The pressure on wages is mitigated.

In an open economy consisting of several nation states with one common currency, such relief no longer exists. If one of the member economies shows a reduction of economic growth, it is the *national wage relation* that has to come into action. Without the possibility to buy time by a depreciation of the national currency, the wages and/or the unit labor costs in the region in question have to be decreased immediately. In general, there are two ways to achieve this: (i) to increase labor productivity, (ii) to decrease wages. In terms of adjustment time, the second way is the fastest, but presupposes that the systems of collective bargaining allow such quick adjustments. The *Deutsche Bundesbank* put forward this argument in the following words: "The expected gains in welfare in the longer run due to the Currency Union can only be achieved if wage policy and social policy in particular are very fast in their adjustment to the new environment" (Deutsche Bundesbank 1998: 39).

This argument needs to be examined more closely by explaining the importance of expectations for the role of the wage relation caused by the establishment of a common currency. By using wage as a dependent variable, national economies have the possibility to adjust to adverse developments by reducing nominal wages, and/or by increasing labor productivity. Wage setting is a procedure

whereby employers and employees, or their respective organizational representatives, negotiate the price of one unit of labor in nominal terms. For the most part, it is a state-free arena due to the laws which obtain in the sphere of industrial relations. Thus, labor market organizations set the nominal wages but cannot directly influence real wages. The process of price formation in national economies brings a third actor to the table, the national central banks. Let us assume that the outcome of wage negotiations in an economy would be a general increase of ten percent of the average nominal wage. If the central bank becomes anxious about the creation of an inflationary process due to a wage-price-spiral, it will respond to such an outcome of negotiations with a restrictive monetary policy. The specific form of the reaction function of the central bank will decide the exact form of this response. If the response is strong enough, it will make investments in equipment more expensive, increase the costs for consumer credits and mortgages, and will privilege monetary accumulation in contrast to productive accumulation. The overall result will be a policy-induced recession leading to an increase in unemployment, and even to a decrease in (nominal) wages. In other words, wage increases that exceed the expectations of central banks can be punished by the monetary policy responses of these same central banks⁸.

In the past, Southern European economies in particular have shown comparatively higher inflation rates than their Northern European counterparts. Due to institutional and political-historical peculiarities, Southern European central banks have not been as interested in low inflation rates as the central banks of the North⁹. The German *Bundesbank* was notoriously famous for its fight against inflation and its very strong asymmetric reaction function. German trade unions were immediately punished for wage rates that didn't fit into the *Bundesbank* calculus. Each wage agreement that disrupted price stability was punished through an increase in the lead interest rate and by a subsequent rise

⁸ Soskice/Iversen (1999) show that in the case of large price or wage setters, the monetary policy of the Central Bank loses any neutrality in terms of employment and output.

in unemployment. In times of high unemployment and low to zero nominal wage increases, on the other hand side, the *Bundesbank* was not willing to lower the interest rate as quickly as it had raised it. However, central banks and wage bargainers successfully established a *signaling process* (Hall/Franzese 1997) that was helpful in balancing employment with inflation rate targets¹⁰.

With the arrival of the Euro and the launching of the European Central Bank this game changed. Although wage relations and therefore the process of wage setting still takes place on the national level, the ECB enters this structure in a very prominent way by setting monetary price signals for the whole EU area. With the start of the Common Currency, the ECB was the main unknown in the Euro equation. This was especially true with regard to the reaction function of the ECB and its specific monetary policy. The ECB's definition of price stability as an increase in the Harmonised Index of Consumer Prices for the Euro area of below 2 % over the medium run was a shocking signal for wage bargainers, in particular for trade unions. If we use the German inflation experience between the early 1950s and the late 1990s as a benchmark, then the level of price stability targeted by the ECB seems rather challenging. Only in one of three years of the period in question was this target achieved in Germany; the record for the second most price-stable economy, Switzerland, is only slightly better (Wyplosz 2001). The very ambitious definition of price stability went along with a rather sophisticated understanding of the relevant inflation indicator. To overcome the problem of referring to selective national indicators, the ECB developed the concept of the harmonized index of consumer prices. This concept allows for comparisons of consumer price inflation between economies that show different consumer baskets of goods and services. Due to rather marked differences in tastes and cultural values, those baskets are very different. The final HIPC is insofar an artificial index as it expresses a Euro area-wide rate of inflation beyond the actual price increases in the different constituencies of the

⁹ An overview on different systems of wage bargaining can be found in Regini (2000).

¹⁰ Soskice (1998) gives a concise interpretation of the German case.

Euro zone (see OECD 2001:pp.29). For example, when area-wide inflation was at 2.9 per cent at the end of 2000, it ranged from a low value of 2.2 per cent in France to 6 per cent in Ireland. Wage setters have had trouble with this kind of signaling process. However, contradicting the expectations of critical commentators (IMF 1998; Heine/Herr 1999; Hübner 1999), the differential developments in individual economies and therefore the difficulties for monetary policy haven't influenced national wage bargaining in a significant way. Between 1999 and 2001, the dispersion of nominal and real wages in the Euro area has only slightly increased. More importantly, over the (short) period the average real unit wage costs have decreased (Schulten 2001:409). If it has had any effect at all, the target of price stability and its reflection in the interest rate policy of the ECB have influenced the behavior of the wage setters in the big economies of the Euro area. In the German case, for example, wage bargaining followed a pattern of wage increases below the average increases of labor productivity (SVR 2001:pp.357).

This outcome corresponds exactly with the expectations of some critics (Hübner 1999)¹¹. Political actors respond to this by overarching the wage relation toward price stability and toward improvements in international price competitiveness. Race-to-the-bottom behavior results and transforms the overall landscape of collective bargaining in Euroland (Heine/Herr 1999: 7). The most prominent way to achieve such a transformation of the established wage relation is evident in the complete decentralization of collective bargaining to the firm level. Following the internal logic of markets, wage setting behavior should be oriented to the firm level in order to reflect the different economic conditions of each sector and firm. Bargaining on this level will lead workers and their organization to wage demands that secure profits and do not risk job losses. In the end, this means a broad range of wage contracts accompanied by an increase in the degree of

¹¹ Let me underline that I am referring to the predicted outcome, the reasons for which differ from the arguments brought forward by those authors.

flexibility of wage contracts. Such practices would transform one of the main features of most European economies: centralized collective bargaining.

This proposition is in stark contrast to some of the economic reasoning about trade unions. According to such views wage earners are confronted with a prisoner's dilemma. As long as they act on their own and do not cooperate, they can only attain a sub-optimal market result. Cooperation means that competition between workers is reduced by institutionalized solidarity. The more workers are organized, the more successful the trade unions will be. If negotiations were highly decentralized and wage setting is made on the level of individual firms, trade union power would be weakened, and in the last instance trade unions in their traditional form would cease to exist. It is commonly accepted that there is no appropriate place for trade unions in neoclassical textbook economies. In the textbook design of Euroland, trade unions are still allowed to exist but are restricted to workers organizations at the firm level. According to this view, there is no alternative to such a fundamental transformation of the wage relation. Empirically, the work of Calmfors/Driffill (1988) has postulated a hump-shaped relation between the degree of centralization of wage bargaining and labor market outcomes. Focussing on unemployment they showed that totally centralized, as well as totally decentralized systems, are equally successful in keeping the trade-off between unemployment and wage increases in balance.

From the start of EMU, the European Central Bank was seen as the institution for punishing overshooting wage setters. Thus, the future model for wage bargaining was seen in the combination of a politically independent European Central Bank with a decentralized system of collective bargaining. Such a project was in stark contrast to the existing landscape, which was characterized by highly centralized collective bargaining together with pockets of decentralization. Hall/Franzese (1998) have shown that the combination of a politically independent central bank with a highly-centralized system of wage bargaining in the sense of a high degree of vertical and horizontal co-ordination of wage bargaining gets the best

results in regard to a 'misery index' (sum of the inflation rate and the unemployment rate on a year-to-year base). Those results have been confirmed by Kenworthy (2001). Given the autonomous status of the ECB, I calculated a growth-adjusted misery index¹² for the member states of the Euro area from 1998 to 2001. The lower the misery index, the better the overall performance of a economy. The results provide us with a rather mixed picture. The growth-adjusted misery index ranges from negative values for Ireland (-6.6) and Luxembourg (-8.0), to very high positive values for Spain (57.9) and Italy (44.1). Using an index for wage co-ordination constructed by the European Commission (2001:54), I related this growth-adjusted misery index with the index for wage co-ordination. The result confirmed the critical stance developed above.

Whereas wage co-ordination seems to support wage restraint in a situation where there is an autonomous Central bank, it shows no significant support for economic growth. High levels of wage co-ordination go hand in hand with very high and very low growth-adjusted misery indexes. Wage restraint policies of trade unions are not gratified by high rates of economic growth. In the cases of Spain and Italy, where a decentralization of bargaining could be observed throughout the 1990s, the overall results have been disappointing. These countries' growth-adjusted misery indexes are the highest in the sample. Despite such sober outcomes, the drive for more decentralization hasn't yet stopped. According to the remedies of the German *Sachverständigenrat*, the only way to reconcile low inflation with high employment is through a differentiation of wages, along with skills, and sector or company based rates of return in combination with a decentralization of wage bargaining (SVR 2001:pp 378).

Approaches which focus on the strong role of the wage relation, however, lack explanatory power. Moreover, one of their main implicit assumptions is flawed.

¹² This index is constructed by adding standardised figures for real unemployment and the price index for private households, and subtracting the growth rate for real GDP. For data see SVR 2001: pp. 78.

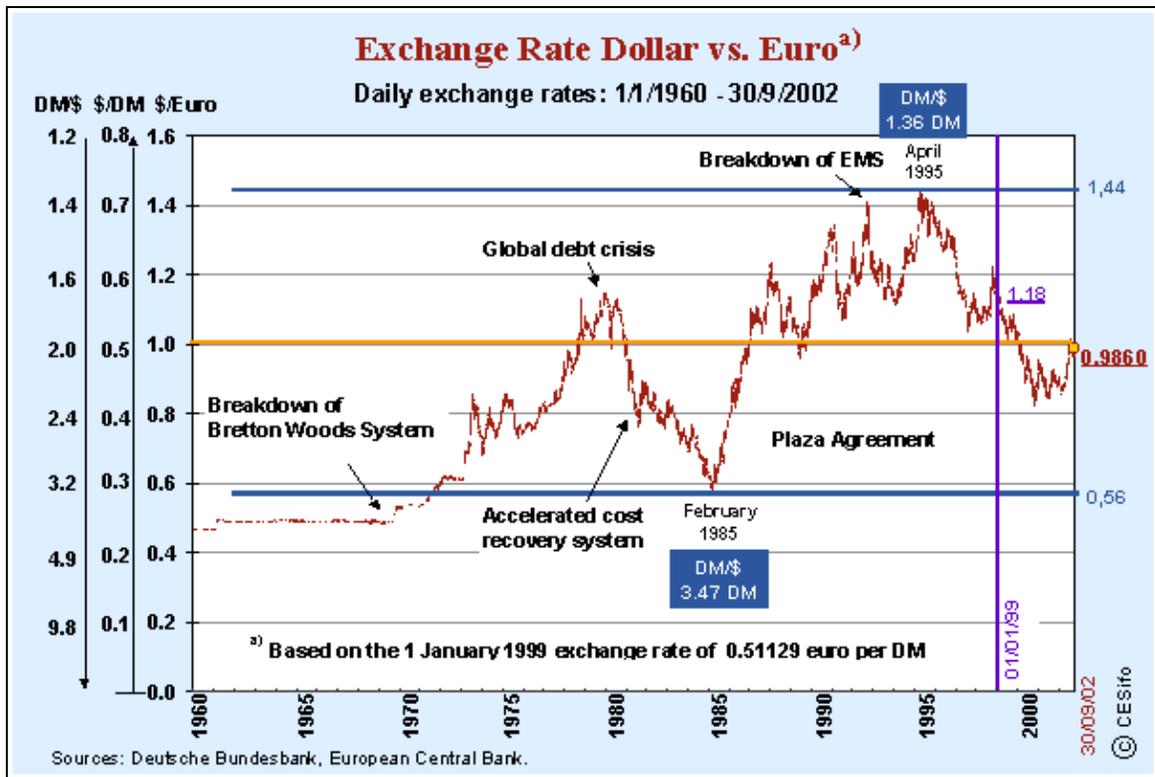
Contrary to the proposition that the introduction of the Euro implies the dissolution of the protective function of the exchange rate, the Euro made precisely this function work in favor of the whole zone. Since its launch, the Euro shows an expressive depreciation against major international currencies, in particular against the US-Dollar. Thanks to the depreciation of the Euro, the comparatively modest increases of unit wages denominated in Euro actually improved the cost competitiveness of the Euro zone economies, without exerting severe pressures on the parties of the labor markets.

By the end of 2000, the nominal exchange rate of the Euro against the US-Dollar was about 13 per cent lower than its launch rate; the real effective rate of depreciation was even larger at roughly 17 per cent. Until the end of 2001 the depreciation rate was roughly 24 per cent in comparison to the start rate of the Euro (ECB 2001:45pp.). This depreciation not only fed the export sectors of the Euro zone, but at the same time provided shelter for import competing sectors. These benefits have not been incurred without a price. First, the depreciation produced economic incentives to shift exports to the US-Dollar space, making the Euro zone more and not less dependent on the US. Second, the depreciation weakened the external role of the Euro and limited the international functions of the new currency (Hau/Killeen/Moore 2001). Third, the negative effects for the terms of trade of the Euro zone led to a much higher bill for raw oil and decreased effective private spending on consumer goods. Finally, the expected upward effects on the inflation rate of the Euro zone were countered by comparatively high nominal and real interest rates on the part of the ECB. The main victims of such developments have been the processes of economic growth and the labor markets. Let me now turn to the depreciation topic.

IV. The Depreciation Puzzle

The debate over the reasons for the plunge of the Euro against the US-Dollar was intense. However, it has not yet produced convincing single-issue results. From an analytical as well as from an historical point of view, it was argued that the depreciation of the Euro was, at any rate, not a problem. First, the depreciation was the main motor of economic growth in the Euro zone and opened the possibility for the member economies to benefit in a strong way from the long-lasting growth acceleration of the US economy. Between 1999 and 2001 the Euro zone economies registered a steady increase in the share of their trade surplus in GDP, from 1.4 per cent to 2.4 per cent (DIW 2001). Economic growth, therefore, was fostered by exports and not so much by increases in internal demand. Given this outcome, so the argument, there is no real concern about the Euro's external value. In a second line of reasoning commentators referred to the exchange rate history of the Deutschmark (see graph 1). Europe's former hegemonic currency experienced in its exchange rate against the US-Dollar over time huge swings, which have been more pronounced than the depreciation of the Euro. Graph 1 shows the enormous fluctuations of a virtual Euro since the breakdown of the Bretton Woods System.

Table 1: Exchange Rate Dollar vs. Euro



Between 1983 and 1999, the average value of the Deutschmark was at 2.04 to the US-Dollar. Most of the exchange rate movements were inside a range of 0.43 Deutschmark. At least two episodes show remarkable signs of (upward and downward) overshooting. In 1984 the US-Dollar started an upward path that lifted the exchange rate to nearly 3.50 Deutschmark per US-Dollar in February, 1985. The other episode occurred in 1995 when the US-Dollar bottomed-out, bringing the exchange rate to 1.36 Deutschmark per US-Dollar (Kotz 2001:65).

Given the longer history of exchange rate swings, the Euro depreciation (see graph 2) is no news at all. Compared with the low rate of the Deutschmark in 1985, the Euro seems less volatile towards the bottom.

Table 2.1: The Euro Against the Dollar and the Yen, June 99-November 01

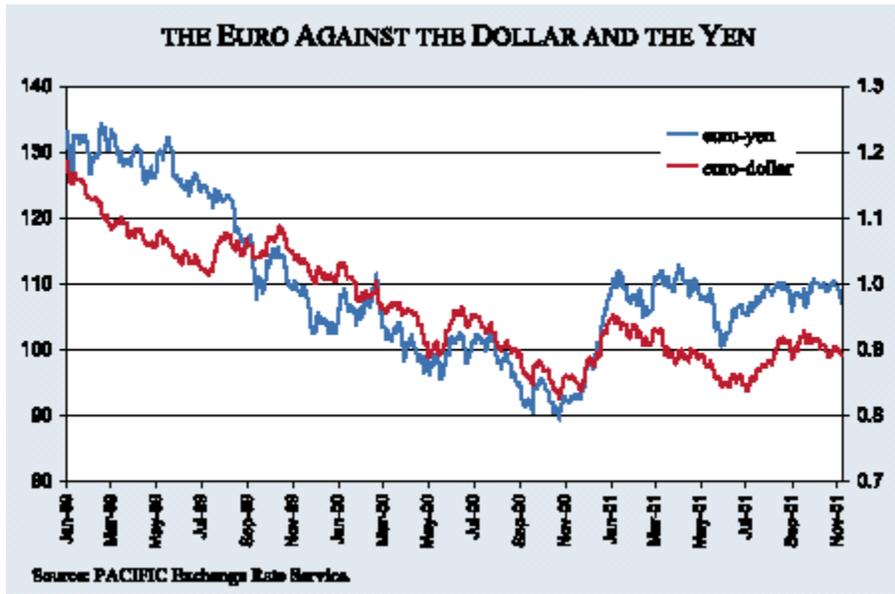
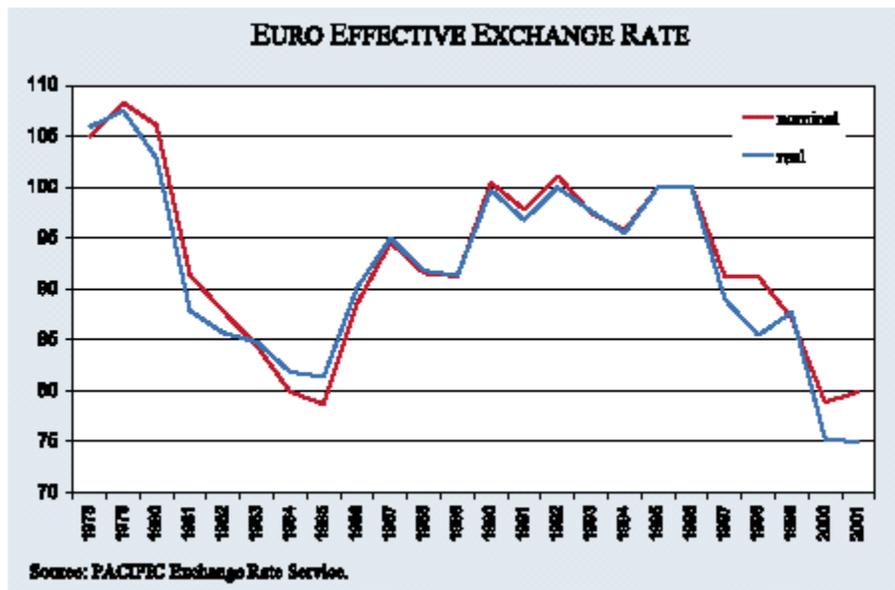


Table 2.2: Euro Effective Exchange Rate, 1978-2001



Obviously, both arguments have a high degree of evidence. However, a closer look shows both references are not overwhelmingly convincing. The introduction of a common currency intended to make the EU more independent from the US-Dollar actually dominated global economic spheres. The immediate depreciation of the Euro showed that such an expectation was wrong-headed. In a world of highly globalized financial markets, the external value of a currency is not solely determined by internal economic data, but by comparisons with data from competitors. The benchmark for the Euro remains the US-Dollar. While it is true that the Euro has strengthened its volume of internal trade in goods and services, US-Dollar denominated markets still play an important role for Europe. The depreciation of the Euro supported this role by increasing the price competitiveness of Euro zone economies against their US competitors.

The history of the Deutschmark's exchange rate vis-à-vis the US currency gives us ample evidence of episodes of downward undershooting of the Deutschmark followed by strong processes of overshooting. Even if it is true that history is not repeating itself, it could have been thought that investors would be confident that a market correction would be effected over time. But in contrast to the Deutschmark, the Euro lacks such a history. This situation of a currency without market experience created a momentum of uncertainty that supported the tendency to flee the Euro, or to choose a more reliable currency as denomination. The behavior of international investors created a situation where the ECB was forced to defend the external value of the Euro and to strengthen the reputation of the new currency. Instead of using traditional tools of monetary policy, the ECB decided to intervene on the international foreign exchange markets. Yet its half-hearted interventions in 2001 were not successful in lifting the Euro to a sustainable higher level. Quite contrary to its intentions, these interventions demonstrated that the ECB was, as a monetary institution, not powerful enough to set the preferred exchange rate against the valuations of the foreign exchange markets. This defeat made the ECB still more cautious in its interest rate policy. Due to the danger of an upcoming depreciation-inflation spiral, the ECB kept

close to its prevailing rates in order to make it clear to market participants that it will defend its inflation rate target in the range of zero to two per cent in the medium run at nearly any cost.

A brief review of the most prominent explanations of the depreciation of the Euro can help to establish a better understanding of the interplay between depreciation and the interest rate policy of the ECB. (i) One well-known hypothesis sees the reason for the depreciation in the growth differentials between the Euro zone and the US economy. Relatively higher economic growth in the US generated strong imports of goods and services, which led to higher exports from the Euro zone. In the simple world of textbook economics this should bring about an appreciation of the Euro and a depreciation of the US-Dollar. In real life, things are different. Business sectors outside the US want to participate and send foreign direct investment to the US. Furthermore, the boom in the US sends stock markets to new heights and thus generates short-term capital inflows to the US. Both flows offset the appreciation tendency of the Euro, and actually turn this projected phenomenon into a strong appreciation of the US-Dollar. The combination of higher exports of goods and services, and higher foreign investments turned the current account of the Euro zone into negative figures and provided one main reason for the depreciation of the new currency. The more elaborate version of this explanation argues not solely with growth differentials, but also with *expectations of growth rate differentials* (Corsetti/Pesenti 1999). Given such a framework, the depreciation of the Euro can be explained by the fact that from the very beginning, the exchange rate of the Euro was set too high. The result of such a policy being that every bit of news about the relative lead in economic growth of the US against the Euro zone is translated by the actors of the foreign exchange markets into a revision of expected exchange rates, resulting in a selling of Euro.

This explanation is sometimes combined with (ii) the argument of herd behavior and irrational interpretation of fundamentals. According to this view, market

makers on the foreign exchange markets tend to overinterpret any positive news about the US economy and underestimate positive signs in the Euro zone (Kotz 2001:64; Corsetti 2000:3)¹³. Herdlike, they follow an asymmetrical interpretation of economic data and sink the Euro to remarkable lows. Representatives of the ECB seem to be convinced of just such an explanation. Otherwise, one couldn't understand their permanent hints that the Euro is undervalued in relations to its healthy fundamentals¹⁴. In times of globalized financial markets, such a tight relation between 'fundamentals' and the exchange rate no longer holds true. Although it is still true that the exchange rate is not solely determined by the beliefs of market participants, such beliefs in an 'equilibrium' or 'real rate' play an orienting role. Once set in motion, they can move markets and make it very hard for central banks to intervene in favor of their own policy targets. The main problem with this overall explanation of the depreciation of the Euro is more empirical in nature. If it were to hold true, than such an explanation should at least cover all cases within one time period. Unfortunately, the Euro depreciated not only against the US-Dollar, but also against the Japanese Yen. However, the growth rate differential between the Euro zone economies and Japan has been positive. Following the logic of the explanatory model cited above, this should have resulted in an appreciation of the Euro. The fact that the Euro rate behaved differently weakens the growth rate argument substantively.

Differences between Euro zone economies and its main competitors are not restricted to economic growth, but also include interest rates. Even in a globalizing world nominal and real interest rates can differ. This was true for the US and the Euro zone between 1999 and 2001. According to this view, (iii) higher interest rates in the US have induced capital outflows from the Euro zone which produced pressure on the exchange rate. Until the end of 2000 long-term

¹³ Such behavior is not irrational. The hypothesis goes hand in hand with the Eurosclerosis-hypothesis: Due to the sick structures of the European economies, any news from the Euro zone economies must be bad news. This codification of economic data is strongly reproduced by the media, in Europe as well as in North America.

as well as short-term interest rates of the US have been above Euro zone levels. Since the last quarter of 2000 this differential has changed fundamentally. The aggressive interest rate policy of the Fed has driven US rates below the levels of the Euro zone. Symmetrically, this should have turned the capital flows in favor of the Euro exchange rate. As it stands, this turnaround has stopped neither capital inflows to the US, nor the depreciation of the Euro against the US-Dollar. Even with the evolving recession in the US and the implications of the terrorist attack from September 11, 2001, the US-Dollar resumed its established role as a safe haven. Even the ongoing recession tendencies in the US and the enormous meltdown of the main stock indices, together with the seemingly never-ending accounting scandals in the US, haven't led to a sustainable reversal of the supremacy of the US-Dollar. Hysteresis-like, the exchange rate of the Euro seems trapped at a relatively low level.

Another approach explains the appreciation of the US-Dollar and the depreciation of the Euro by (iv) comparatively higher rates of return on US equity markets. According to this view, the enormous jumps in the DOW JONES and NASDAQ stock market indexes induced massive capital outflows from the Euro zone economies that drove the Euro exchange rate down. Those flows have been significant, however, Koen/Boone/de Serres/Fuchs (2001) are skeptical about this channel of influence. They refer to econometrical work by Bernard/Galati (2000) that shows no statistically significant correlation between Dollar-Euro exchange rate movements and equity-oriented capital outflows. Other work shows at least a rather close relationship for some periods in time (Huebner/Herr 2001; IMF 2001). From such a perspective, the depreciation of the Euro is either the result of a lack in equity culture in Europe, or, as suggested by Huebner/Herr (2001), the outcome of Europe being a later-comer with regards to the 'new economy.' Again, this explanation is flawed in its non-symmetric explanatory power.

¹⁴ These hints are legendary. The Euro homepage managed by C. Corsetti gives proof for this proposition. <http://www.econ.yale.edu/>

Yet another explanatory model points to the fact that (v) the launch of the Euro was accompanied by a strong rise of the US-Dollar denominated price for raw oil, increasing the national as well as the individual oil bill for members of the Euro zone. Between January 1999 and the summer of 2000, the price for raw oil tripled. The price increase not only fuelled ECB suspicions of an increase in the rate of inflation, but also reduced the spending power of private households. This price increase implied a higher demand for the US-Dollar in the Euro zone, depressing the exchange rate of the Euro. The loss in consumer demand due to higher rents for oil producers and distributors reduced the effective demand of the Euro zone economies. The resulting slower growth convinced international investors in their prejudices against the Euro and supported the flight out of the Euro. The rationale of this argument is that the inflationary pressure stems from the increase in oil prices, which is in turn strengthened by the depreciation of the Euro. Whether there was a serious depreciation-inflation spiral starting, as Herr (2002) assumes, seems doubtful. Compared with prior OPEC price hikes, it seems that the repercussions were much smaller, not least of all due to diversified supplier chains and to reduced dependence on raw oil. At least in terms of the core inflation rate, such an upward pressure could not be observed.

For their model, (vi) Sinn/Westermann (2001) test some of the above discussed explanations and introduce a new argument by referring to the large black markets consisting of cash-type Deutschmark, circulating above all in Eastern Europe. The final step of the Euro procedure, substituting bills and coins of the former national monies by Euro cash, urged the actors of the black market to convert and/or whitewash their currency holdings. The stock of Deutschmark circulating outside Germany together with the stocks of illegal money in the member states of the Euro zone is estimated at about 80 billion Euro. This is a huge amount in terms of official intervention volumes. The preferred currency for the stockholders in the black market economies is the US-Dollar. The conversion of Deutschmark into US-Dollars is, in the view of these authors, particularly

responsible for the appreciation of the former currency and for the weak performance of the Euro. Although it is by nature difficult to obtain empirically strong evidence for this argument, reports about such flows are widespread. However, as a strong explanation this argument fails. Even if it explains the immediate depreciation of the Euro, the expectation would be that this depreciating influence would cease once the changeover of monies is completed. It seems questionable at best that this changeover lasted for the more than two year period of Euro depreciation.

Another approach explains the depreciation of the Euro (vii) with the unfortunate communication policy of the ECB, which did not transmit its monetary policy in a successful manner. In an environment dominated by herds of financial analysts, market watchers, and superficial observers of monetary affairs, the ECB failed the beauty contest. In the shadow of the Fed's Alan Greenspan, the ECB with its president Wim Duisenberg was never a convincing or evenly accepted actor for the private markets (Blinder/Goodhart/Hildebrand/Lipton/Wyplosz 2001).

These explanations do not have much in common, but at least they refer to the *factum* that is described in the literature as a de-coupling of the exchange rates from the underlying productive forces (Hübner 1998:pp.86). In such an environment, a *lack of trust* – whatever its origins - in the new currency is supported by self-fulfilling expectations. This lack of trust has, no doubt, several causes. One of the most prominent is definitely the 'Eurosclerosis,' a term heavily in use since the 1970s. Revived in papers by Feldstein (2000) on the dangerous effects of the new currency for Euro zone economies, this kind of analysis was shared both by scholars inside Europe and especially by those in the US. It made the Euro a weak candidate for international investors from the very beginning. From the outset the European Union responded to such an attitude towards its project by providing guarantees to the international markets that the Euro will be used to support market-driven reforms in member states. The so-called convergence criteria were developed to keep inflation on as low a level as

possible, and to create an environment of fiscal prudence in terms of stocks (debt ratio in relation to GDP) and flows (public budget deficits in regard to GDP). The institution of the Stability and Growth Pact (SGP), finally, tried to make sure that the European Union would punish any violation of fiscal policy discipline among the member states. All these political maneuvers demonstrate a high degree of adjustment to the expectations of private capital markets. This strategy produced two main results. First, the national governments of the Euro zone economies concentrated their efforts on fulfilling the criteria of fiscal discipline. News about possible divergences inside the Euro zone not only questioned the one-size-fits-all approach of the ECB, but also immediately translated into a loss of trust in the common currency. Second, the ECB tried, through its own means, to tackle skeptical attitudes by demonstrating a strong stand in its fight against inflation. This attitude made its interest rate policy into a rather unique showcase of a single-target policy that did not receive the applause of international markets.

V. Institutional Flaws and the Deflationary Bias in the Euro Equation

From a macroeconomic point of view, the shift in functional income distribution in favor of capital generated anything but a win-win situation. The increase of profits in the Euro area, which could be observed from the early 1990s onwards and accelerated slightly in 1999 and 2000, did not lead to strong growth in the investment goods sector, but fuelled the growth of financial markets¹⁵. Moreover, the rigid and overambitious ‘inflation target’ set by the ECB was of no help for the process of economic accumulation, and led the economies of the Euro area on a sub-optimal path of economic growth. In a phase of the global economy dominated by overheating and the evolution of financial bubbles in the US, by a stagnating or even deflationary development in the US and by low growth in the Euro zone economies, the ECB presented itself as a highly confused institution. According to its official monetary philosophy, two pillars should inform market participants about the behavior of the ECB, and thus build up endogenous

anticipations. Pillar 1 is a 'reference value' for monetary growth, pillar 2 an open-ended list of inflation indicators. Pillar 1 was set at a reference value of 4 – 4.5 per cent of M3. Pillar 2 was set as an inflation rate of less than 2 per cent in the medium period. The public was never sure which of the pillars would be more important in determining the actions of the ECB. Even when it turned out that M3 was most of the time far ahead of its reference value, the question arose when the ECB would act to bring M3 back on track, independently of the actual rate of inflation. Stranger yet, the ECB also did not strictly maintain its inflation target. In 2001 and also in 2002 it tolerated an inflation rate higher than 2 per cent, without initiating adequate changes in its interest rate policy. Its behavior made clear that the ECB is not independent in its monetary policy, but instead that it responds to the Fed (Fratzscher 2002).

Nonetheless, the interest rate set by the ECB did not foster economic growth. Whereas the rate was too low in case of a high-inflation/high growth-economy like Ireland, it was much too high in case of the low inflation/low growth-economy Germany¹⁶. Following the route taken by Akerlof/Dickens/Perry (1996) for the case of the US, it seems that too low an inflation rate may result in a high rate of unemployment. According to their calculations, an inflation rate in the range between 1.5 and 4 per cent would be optimal in terms of a high level of employment (Akerlof/Dickens/Perry 2000). Work by Dickens (2001) and Wyplosz (2001) for the Euro area hasn't successfully made "an iron clad case against a target range for inflation of 0-2 %, but [it] should give the ECB reason for concern" (Dickens 2001:44). The findings by Wyplosz for the Euro area, that unemployment decreases with rates of inflation above 2 per cent, is supported by the findings in this paper. Varghese (2001: pp. 734) and Calistri/Galbraith (2001) have demonstrated that a policy of wage restraint is no guarantee for increasing employment. Using the annual data for real wage growth in the overall economy, adjusted for the annual growth rate of labor productivity, results in low unit wage

¹⁵ The European Commission (2002: 27) reluctantly documents these developments.

costs going hand in hand with relatively high rates of unemployment (Varghese 2001). This result for the period from 1991 to 1998 is supported by Breuss (2002), who shows in simulations for the period 1999/2001 that a 1 per cent cut in short-term interest rates would have resulted in a slight increase of .2 percentage points in growth, an improvement of the current account by .2 per cent of GDP, and a decline of unemployment by .1 per cent. In the case of Germany the effects would have been significantly higher.

Breuss bases his results on a econometrically estimated Taylor rule for the Euro zone, using the inflation target of the ECB as a benchmark. The results would be different if one allows for a tolerated higher inflation rate. If, for example, Germany would be allowed an inflation rate of 2 per cent, this would increase the tolerated rate for the overall zone to about 3 per cent. Following an adjusted Taylor rule for the Euro zone, this would result in a much lower interest rate being set by the ECB, and therefore in higher positive growth and employment effects.

Although this paper supports the critique of a non-accommodative policy by the ECB, it does not go so far as to speak of a *Japanese sickness* in the Euro area. Deflation is not yet on the European agenda. However, the ECB's desperate fight to gain a winner's reputation in the international capital and foreign exchange markets, by keeping its firm monetary policy throughout the early phases of the recession of the world economy in 2001, has contributed to the comparatively low economic growth in the Euro area.

Sluggish growth has its roots not only in the monetary philosophy of the ECB, but also in the design of the so-called Stability and Growth Pact (SGP). Contrary to its name, this pact produced a pronounced strangling of fiscal policy. Based on article 104c of the Maastricht Treaty, which states that "Member States shall avoid excessive government deficits," the former German Finance Minister, Theo

¹⁶ Hallett/PiScitelli (2002) support such a thesis through their analysis of asymmetric transmissions of monetary policy by the member states of the Euro zone.

Waigel, with support of the German Central Bank, put forward a proposal for a 'Stability Pact for Europe' in November 1995. Negotiations were conducted during 1996 and 1997, when the European Council in Amsterdam finally adopted the re-named Stability and Growth Pact. The core elements of this pact included one of the former convergence criteria, namely a medium-term objective of budgetary positions close to balance or in surplus. This implied that even in economic downturns the 3 per cent ceiling had to be respected. Only in exceptional cases, defined as a fall in real GDP of at least 2 per cent on a year-to-year base, could a deficit overshooting be accepted. In all other cases, a system of sanctions is activated, which consists of a non-interest bearing deposit in the first year as a fixed component equal to 0.2 per cent of GDP, and a variable component equal to one-tenth of the difference between the deficit and the 3 per cent reference value. The overall ceiling for this sanction was set at 0.5 per cent of GDP (European Commission 1996).

It has been stressed in the literature that it is impossible to justify the chosen reference value of 3 per cent with sound theoretical arguments. Moreover, several authors have demonstrated that governments, in terms of controlling the budget deficit, are not autonomous. Any ceiling in terms of percentages of GDP has to take into consideration that this ceiling depends on the outcome of interdependent market processes beyond the power and political will of governments (Artis/Buti/Franco/ Ongena 1998; Heine/Herr 1999). Oblivious to established economic wisdom, SGP restricts the working of automatic stabilizers and thus reinforces the downturn of economic cycles. While it can be also argued that the main rationale behind the SGP is to overcome any country-specific temptation for excessive budget deficits as a way of exploiting the EMU after entering the Euro area (Beetsma/Uhlig 1999), it is also true that the SGP introduces a deflationary bias into the economies of the Euro area. The widening of the output gap since 2000 would have to be the moment for fiscal policy to

push growth¹⁷. Due to SGP, however, the members of the Euro zone, on average, run along a path of low growth which reinforces the budgetary problems of the majority of the member economies. Working in a pro-cyclical manner, SGP contributes strongly to the deflationary tendencies in the Euro zone.

This is particularly the case in terms of how, by separating the monetary authority and the national fiscal authorities from each other (article 107 of the amended Treaty of Rome), any basis for a policy co-ordination which can find the optimal mix has vanished (Arestis/McCauley/Sawyer2001; Arestis/Sawyer 2001a). Moreover, it has been shown that the reaction function of the ECB in targeting an Euro-area wide ceiling of fiscal prudence ultimately will engender a co-operation failure among fiscal authorities (Gatti/van Wijnbergen 2002).

Seen in such a light the Euro area seems unprepared to tackle the effects of the recession in the world economy which started in early 2001. In contradiction to the assumed fiscal flexibility of the SGP (Canzoneri/Diba 2000), the Euro area suffers under the influence of its definition of fiscal prudence. In times where a more demand-sided variant of fiscal policy is needed, one that goes beyond the effects of the automatic stabilizers, the governments of the Euro zone struggle to escape from a trap they have set. When in late 2001 the German government had to adjust its growth expectations downwards and to increase its expected budget deficit to 2.5 per cent of GDP, thereby violating its promise for a balanced budget by 2004, the European Commission as well as political representatives of member states started to complain. "Bigger countries have really not consolidated their budgets as committed in their stability programs," so Austria's right-wing Finance Minister Karl-Heinz Grassler (BBC News, 04-12-01). Political comments like this refer to the inflexible character of the SGP, which condemns budget deficits to an economic evil and undermines the strength of the Euro area.

¹⁷ Data on the output gap and a short methodological discussion about this measurement can be found in EEAG (2002:13).

VI. The Need for an Alternative

The final launch of the Euro as proper money in January 1, 2002 was accompanied by a recession in the world economy. Although this recession had its roots outside the economies of the Euro area, subsequent developments have shown that the European economies as a whole, and the economies of the Euro area in particular, haven't been able to insulate their national economies from this downturn. Nor have these economies been able to play the role of a locomotive for the world economy. Instead, the Euro area follows rather closely the path of the US economy. The ECB in particular has earned severe criticism for its rather inflexible interest rate policy. In times of recession, it turns out, even a close movement of the lead interest rate with average output gaps and inflation rates (*Taylor rule*) seems insufficient to ensure that international market actors hold on to the Euro. The single-minded orientation of the ECB on price stability produced this adverse effect. In comparison to the Fed, and also to the Bank of England, the ECB was evaluated as an inexperienced player, which must first prove it is equal to the challenge. In the public debate, the ECB was widely accused of not being able to communicate its policy in a proper fashion. As early as 1999, a former member of bank of England's Monetary Policy Committee, William Buiter (1999), criticized the ECB for its lack of transparency. In addition, comparisons of the degree of transparency of central banks have shown that although in a more formal sense the ECB rates at the top (Issing 1999; Jensen 2000), complaints about actual transparency remain and explanations of ECB policies still disappoint (Blinder/Goodhart/Hildebrand/ Lipton/Wyplosz 2001). According to the analysis presented in this paper this comes as no surprise. The ECB's lack of proper communication with political and economic actors, particularly with the international financial markets, is mainly rooted in its narrow mandate of price stability, defined in a rather restrictive way. Seen in this light, an explanation for the external weakness of the Euro cannot simply be reduced to central bank failure (Bibow 2002), but should be seen as the outcome of a flawed institutional framework for the common currency. In comparison, the US Federal Reserve

has a much broader and much more complex target system in promoting price stability, economic growth, and employment at the same time. This not only gives the Fed more room to maneuver, but also allows a higher degree of flexibility in its monetary policy. Independent of the issue of the FED's use of this room to maneuver, the FED's broader target system produces a higher level of credibility in the public eye. In an economic situation where signs of deflation overturn processes of inflation the ECB runs the risk, at least for the time being, of fighting yesterday's battles.

There is no shortage of proposals on how to overcome the deflationary bias of the institutional design of the Euro. Unfortunately, none of these proposals is a political starter. Suggestions to increase fiscal coordination between the governments of the member economies, and to strengthen the political role of the Economic and Finance Committee (ECOFIN) of the European Union in order to counterbalance the monopoly of the ECB have been buried since the start of the Euro. Proposals for a political integration of the European Union run the risk of encountering the same fate. Both suggestions are interpreted as a politicization of economic affairs that undermines the reputation of the Euro. The same holds true for the very elaborate plans for an alternative Pact that is labeled as Full Employment, Growth and Stability Pact (Arestis/McCauley/Sawyer 2001). Such a Pact would bring the ECB much closer to the political design of the US Federal Reserve, whose institutional workings demonstrate a more complex mix of the targets of economic growth, price stability, and employment. Due to the fact that not all central banks are born equal, such a redefinition of the role of the European Central Bank could not take place without punishment from market-players. This will likely remain the case for as long as the ECB and its political creators remain unwilling or unable to rethink that institution's function and duties in light of past experience. The historical lesson of monetary history has shown that political factors are central determinants of the proper working of economic institutions (Bordo/Jonung 1999). Today, the institutional design of the Euro area is trapped in a double bind. To overcome this dilemma more than political will

and courage are required. Above all, what is needed is a reasoned public debate, taking into account the fact that the world has changed since the period in which the design of the Euro area was negotiated. The economic and political events of 2001 have shown that the international financial markets are willing to accept turns in economic policy, particularly turns towards a growth accommodating strategy of monetary and fiscal policy. The world has learnt that political orthodoxy has a high price. The same is true for orthodoxy in economic policy.

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