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WORKSHOP PAPER

Comments on J. Christl: "Regional currency arrangements: insights from Europe"

Lars Jonung

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The paper by Josef Christl covers a large number of monetary policy issues in a limited space. He deals with the OCA literature, the European experience of monetary unification, the Maastricht treaty, fiscal rules, the benefits of the euro, the monetary situation of Eastern Europe, Asia and Latin America and the rise of inflation targeting as an alternative to monetary unions. The purpose of his panorama is to draw lessons from the European experience of monetary unification for the rest of the world.

He summarizes these lessons in four points:

1. Monetary unification rests on economic and political integration
2. Political union is not required in advance of monetary unification
3. There is an ongoing international trend towards pooling of economic sovereignty
4. Convergence criteria and fiscal rules are necessary for successful monetary unification

These conclusions are roughly in line with the conventional wisdom today. I will not challenge this body of mainstream thinking. Instead, I would like to add to Christl's discussion by bringing in four additional aspects that I feel deserve attention.

1. The political economy of monetary unification
2. The endogeneity of monetary unions
3. Fiscal rules and fiscal independence
4. 'Muddling through' or policy-learning

The views expressed here are my own and should not be attributed to the European Commission.

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The political economy of monetary unification Christl's discussion is based on the theory of optimum currency areas (OCA). The OCA approach is based upon a trade-off between efficiency and stabilization. This is the standard tool used by economists when analyzing monetary unification. Here the unit of observation is traditionally the nation state. Nation states make decisions to join or to abstain from joining monetary unions.

Of course, this approach is a simplification of real world conditions. In modern democracies, the decision to join or not to join a monetary union is made in the political sphere, ultimately by the public in their capacities of voters. Voters commonly ask: what is in it for me? They focus on the effects of any policy proposal on the distribution of income and wealth. This holds for monetary unification as well.

Thus, to get a better understanding of the outlook for monetary unification outside Europe we should look at the distributive issues involved in joining a monetary union. These issues were clearly brought out in the election that took place in Sweden on Sunday September 14, 2003. That day Swedish voters went to the polls to answer this question: "Do you think that Sweden should introduce the euro as its official currency?"

The Swedish referendum in September 2003 on adopting the euro or keeping the domestic currency, the krona, represents a unique opportunity to examine the perceptions of the different groups in society of the benefits and costs of monetary unification. The voters chose between the two polar cases of exchange rate regimes (the corner solutions): either a freely floating exchange rate combined with inflation targeting or membership in a monetary union, the euro area.[1]

How did the voters cast their votes? Let us first assume that voters act in their self-interest and are well-informed — that they calculate the respective costs and benefits of the common currency and the national currency.

The question underlying differences in voting patterns among voters is: Who will benefit and who will lose from membership in a monetary union? Thus, distributional issues immediately take centre stage. The OCA approach provides a number of testable hypotheses. Voters in the tradable sector or in other sectors exposed to the international economy could be expected to be more in favour of the euro than voters in the non-tradable sector or other sectors sheltered from international influences. Voters with no or little exposure to the international economy, who depend primarily on domestic economic and political developments, are likely to prefer national policy autonomy. Such independence gives them better insurance against domestic and international disturbances, both symmetric and asymmetric, than an irrevocably fixed rate. Voters who depend on the public sector (the welfare state) could be expected to favour the krona, as euro membership is viewed as a threat to a large public sector.

High income earners and well educated voters would be expected to vote yes to the euro as they have insurance through the private sector. Low income voters would be expected to vote no as their insurance and protection against shocks comes

[1] The discussion of the Swedish euro referendum is based on Jonung (2004).

primarily from the public sector. Women tend to prefer public sector solutions; hence, more women than men could be expected to vote against the euro.

The outcome of the Swedish referendum confirms these predictions of the OCA approach. However, political attitudes and ideology influenced voters as well. The outcomes of the various referenda on membership in the European Union in other European countries are also consistent with these predictions. Consequently, we should expect similar patterns to hold for the rest of the world. Thus, domestic political conditions are likely to be important determinants of membership in any future monetary union.

The endogeneity of monetary unions Christl gives considerable credence to the idea that monetary union performance is endogenous. In other words, the longer you are a member of a club, the better you will fit into it. There is considerable evidence that such mechanisms are at work. However, today we also notice a number of tendencies that challenge this interpretation in the euro area.

First of all, “Maastricht fatigue” on the budgetary side is clearly evident in several countries. Fiscal discipline has been difficult to maintain once countries have entered the euro area. This fatigue contributed to the modifications of the initial Stability and Growth Pact.

We also see real interest rate differentials arising across the euro area. There is no consensus regarding the role of these developments. Some economists argue that they simply reflect the workings of a monetary union, and thus should not be viewed as a source of tension. Others argue that they demonstrate that a common nominal interest rate across the euro area will foster different growth rates across the unions and thus strengthen imbalances.

The success of the common currency depends on the flexibility of the real economy of the euro area. For this reason economic reforms are important to make the euro area move towards an optimal monetary area. However, since the downturn of economic activity in Europe following the stock market bust in 2000–2001, political resistance towards economic reforms has been strong. Interest groups across EU have mobilized the public and politicians against productivity-enhancing reforms, thus preventing EU from reaping the full advantages of a common currency.

There is presently a risk that the euro is turning into a scapegoat for the economic problems facing Europe. In this blame-game, some politicians may be tempted to question euro-membership instead of tackling the domestic roots of slow growth and high unemployment. This type of behaviour has a long tradition in history. It is not the first time that international cooperation has been exploited for domestic purposes by populist forces.

Christl shows that Austria created the necessary domestic fiscal and monetary discipline prior to entry into the euro-area by using the “structural whip”. This whip worked successfully in Austria *before* euro-membership. However, the challenge is to maintain a well-functioning whip now that Austria is inside the monetary union. This holds not only for Austria, but for all members of the euro area.

Fiscal rules and fiscal independence Christl argues forcefully for the use of fiscal rules. However, experience has proved that such rules are difficult to enforce, since policy-makers are innovative and tend to develop techniques to circumvent any straitjacket constructed to rein them in.

Much suggests that fiscal rules should be complemented by other techniques to foster fiscal performance. Fiscal governance may be improved through reforms of the institutions involved in the framing of fiscal measures. Let me give some examples. Within the EU, statistical offices may be more independent from the executive power. In a similar way, independent forecasting authorities, such as exist in Austria, Belgium and the Netherlands, can be set up in countries where the ministry of finance has systematically biased its forecasts concerning future growth and thus ex post created a budget deficit bias.[2] Independent budgetary offices may also be part of an institutional reform of fiscal policy-making.

The idea of independent fiscal bodies that are not under the immediate control of the ministry of finance and the government is an attractive one, regardless of the specific exchange rate arrangement adopted. It is an idea worth exporting from Europe to the rest of the world.

Muddling through or policy-learning Christl views Europe and the euro area as involved in a process of muddling through. I would like to suggest a more positive interpretation. The euro area is going through a learning process. As Christl stresses, European monetary unification is not following a master plan. Instead Europe is adjusting to new disturbances and new challenges as they emerge while at the same time learning about the new economic and political landscape.

The euro is a large full-scale experiment — unique in monetary and economic history. As long as there is a learning process going on, new lessons will be learnt and thus improvements can be made. This flexibility is important to ensure the sustainability of the monetary unification process.[3] This message should be conveyed to the rest of the world.

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[2] The case for independent forecasting authorities in the EU is given in Jonung and Larch (2004).

[3] This argument is developed in Jonung (2002).