Problems that were Neglected at Maastricht

Tim Congdon argues that the neglect of vital practical issues calls into question the viability of the Maastricht process

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Millions of words continue to be written every week on the subject of European economic and monetary union. Scepticism about the idea may be growing in the wake of the Danish referendum rejecting the Maastricht Treaty, but Europe's leaders still insist that the Treaty will be ratified. The purpose of this paper is to argue that, despite the flood of words, most of the discussion until now has missed the point. Indeed, its central argument will be that certain vital practical issues – the logistical requirements of EMU – have been so thoroughly neglected as to raise basic questions about the viability of the whole process envisaged in the Maastricht Treaty.

A monetary union is, of course, an altogether different structure from an arrangement to maintain fixed exchange rates, such as the present European Monetary System. A fixed-exchange rate system by definition recognises the separate existence of its constituent currencies and therefore of the central banks which issue them. By contrast, a monetary union involves the extinction of national currencies and their replacement by a single currency issued by a single central bank. According to the Maastricht Treaty, monetary union in Europe will establish a European central bank which is to coexist with national governments. This central bank is supposed to come into being by 1997, or, at the latest, by 1st January 1999.

Essential to the success of the whole enterprise is a clear statement of how the new institution will operate and relate to national governments. But in their analysis of the Treaty most economists have neglected the operational aspects. Instead they have focussed on a number of "convergence requirements" (budget deficit less than 3% of GDP; public debt less than 60% of GDP; inflation in line with the EC average) which have to be met by EC members in Stage Two of EMU and are deemed to be preconditions for a move to Stage Three. We shall argue that there is a very serious misunderstanding here. The convergence requirements are necessary and sufficient for the long-run success of a fixed-exchange-rate system; they are certainly not sufficient for the monetary union envisaged by full EMU.

As we shall see, monetary union cannot be contemplated unless the nations involved have reached a further understanding not only about the objectives, i.e. price stability, but also about a number of key operational matters. The

day-to-day actions and procedures of the ECB are not a minor technical detail, but raise fundamental questions about the various governments' ability to govern. These questions are intensely political. Once they are recognised, it emerges that the Maastricht Treaty is an incomplete specification of EMU. Even if the convergence requirements had been met by all the countries in mid-1996 or in mid-1998 (which anyhow appears now to be impossible), Europe could not then leap to a single currency. There would still have to be a great deal of negotiation and probably another treaty before monetary union could take place. As a number of German commentators have correctly perceived, that treaty would need to have far more detail on the political repercussions of EMU than is contained in the Maastricht Treaty.

All central banks have two acknowledged functions – to serve as banker to the government and banker to the banking system. (Central banks only rarely provide banking facilities to non-banks.) If it were to be a meaningful entity, the new European Central Bank would have to perform the two functions in the European context. Our discussion of the operational aspects of EMU will therefore ask whether the Maastricht Treaty gives any worthwhile guidance on how these functions might be carried out in the real world.

Banker to the government

Traditionally, a nation's central bank has acted as *banker to its government* in transactions in both the domestic currency and in foreign currencies. The ECB would have to assume these functions in the European context. Operations in the domestic currency (i.e., the ECU from early 1997 or 1999) would have the most direct bearing on European governments' powers. The ECB would have to take over various existing arrangements in the different countries, and somehow make them all viable and consistent across Europe. At present most governments have a working balance at the central bank which fluctuates from day to day, depending on the ebb and flow of tax receipts and government disbursements; they also have automatic access to an overdraft facility.

The question is, "what would happen if the national central banks no longer had a genuine separate existence and were instead subordinate to the ECB?" (The reference to "the European System of Central Banks" in the Treaty could not disguise the underlying power realities, once the right to issue legal tender had been concentrated

in the ECB.) As at present, governments would need to have an account with the central bank, which would mean with the ECB. The Treaty does indeed state – in article 21.2 of the Protocol on the European System of Central Banks – that "The ECB and the national central banks may act as fiscal agents" for governments. However, article 21.3 says that "overdrafts or any other type of credit facility by the ECB or by the national central banks" to governments and other public sector bodies "shall be prohibited".

Secondary market purchases

With central bank overdrafts ruled out, arrangements would have to be made for the issue of short-term government paper, which we may call the "Treasury bill issue" for short. At present these arrangements vary widely across Europe and attempts to harmonise them would be contentious. The Maastricht Treaty does not appear to forbid Treasury bill issues, although it does say that the ECB must not be allowed to purchase government debt directly (i.e., at issue). But there is no objection to the ECB buying government debt in the secondary market, which arguably makes a mockery of the prohibition of overdrafts and direct purchases. The ECB directors would certainly come under strong pressure to "accommodate" such indirect government borrowing and all kinds of plausible argument (and other kinds of persuasion) would be used by governments to gain access to finance. Only if the ECB had limits on its secondary market purchases of individual governments' debt would the spirit of the prohibition be maintained.

Vital question of state financing

Clearly, vital practical questions remain unresolved, notably on the exact framework of Treasury bill issuance. To maintain full control over monetary conditions, the ECB would have to decide the details of each Treasury bill (or equivalent) issue by national government, and monitor closely who took up the issue. For instance, if one country's Treasury bill issue was purchased by one of its commercial banks, and that bank was known by the market to be in effect guaranteed by the government, it would quickly acquire many central banking functions (for instance, other banks would soon start to leave balances with it and clear balances through it). To ensure adequate control, the ECB would therefore be led into ever more detailed intervention in the commercial banking system of each country.

The essence of the problems is that there is acute tension between the financing objective of Europe's governments and the monetary control objectives of the ECB, between national politicians and the central bank bureaucracy. When a central bank holds government debt it is effectively lending to the government concerned. Suppose that, as in most national contexts at present, Treasury bill finance is cheaper and more flexible than bond finance. Then governments would undoubtedly like to raise as much money as possible from Treasury bill issuance, but the ECB would – in all probability – like to restrict its purchases of Treasury bills, because expansion of its balance sheet would be inflationary.

Quotas for national short-term debt?

Extremely awkward questions relate to the ECB's holdings of different governments' debts. In European countries today central banks' holdings of short-term government debt are often the dominant element in their total assets. A vital concern for the ECB would therefore be the proportion of its assets that it would be willing (or would be allowed) to hold in the form of each individual government's debt. Would it be right if short-term Italian public debt (or French or British) came to represent over 50% of the ECB's assets? Should the ECB have complete discretion about which government's paper it might acquire or should the Council of Ministers lay down criteria for eligibility? Specifically, should the ECB and/or the Council of Ministers set quotas for the amount of each government's short-term debt that might be included in the ECB's assets?

Blurred responsibilities

If monetary union is to be attempted before political union, a single European currency would carry greater inflationary temptations than the existing multi-currency situation. At present every European country has one government, one currency and one central bank. If a country suffers from rapid inflation (because of excessive growth of the central bank's balance sheet, i.e. high-powered money), it is clear where responsibility lies. The government and central bank concerned are undoubtedly responsible. But the position is far more confused and opaque if there are several governments, one currency and one central bank. If a particular government is somehow able to persuade the ECB to purchase its debt (even "indirectly"), any resulting inflation can be blamed on "Europe" as a whole or the actions of other governments. The identification of responsibility is

more difficult. This may be the main reason that federal nation states such as the USA and Canada have explicit limits on states' or provinces' borrowing from the central bank and banking system.

To maintain undisputed control over monetary policy, the ECB would have to instruct governments on the permitted size of their short-term and long-term borrowings, and on the maturity profile of their debt. In other words, it would be an ECB official, not Parliament, that would sanction British (or Italian or German) government borrowing and determine its form. The withdrawal of governments' right to borrow from the central bank strikes at the heart of their ability to govern. Lord Tebbitt, when he was still in the House of Commons, was correct to complain that in this respect EMU would reduce the British government, and other European governments, to the status of local authorities.

ECB decisions about public finance would be highly controversial, just as decisions about local government finance are controversial in the context of nation states. They would inevitably arouse intense feelings of patriotic pride and national identity. The acrimony would be heightened by the marked differences that at present exist between European countries in arrangements for the short-term financing of budget deficits, in the maturity profile of public debts and in the amount of central bank financing of government. The Maastricht Treaty has rightly tried to pre-empt some of these issues by laying down restrictions on budget deficits and public debt. But it has avoided the many highly contentious nitty-gritty technicalities. Europe's banking and capital market structures still vary widely from one country to another; these would all have to be ironed out. This cannot be done quickly – or only at great cost. Ultimately these technicalities boil down to one question, "who would give orders to whom about what?" To be more polemical, in what circumstances would the ECB bureaucrats give orders to the politicians rather than the politicians give orders to the bureaucrats?

External vs internal objectives

Enough has been said to show that the Maastricht Treaty is cursory, superficial and inadequate as a guide to how the ECB might act as banker to the governments of Europe in ECU (i.e., domestic currency) transactions. The Treaty considers the second dimension of central banks' involvement in public finances – namely, their transactions in foreign

currencies – in much more detail. Remarks relevant to foreign exchange intervention and exchange rate policy appear in articles 105 and 109 of the Treaty, and articles 3, 23, 30 and 31 of the Protocol on the ECB. The subject has clearly exercised the drafters of the Treaty and other officials involved.

However, the outcome is far from satisfactory. Over the last 20 years events in Britain and elsewhere have taught one lesson time and again. Because external and domestic objectives in monetary policy are frequently in conflict, the two dimensions of monetary policy need to be consistent and they should ideally be under the control of a single policy-making authority. If one set of policy-makers is wedded to an exchange rate target and another to domestic monetary control, squabbles and muddles are inevitable. (The row between Mrs. Thatcher and Mr. Lawson about the European exchange rate mechanism in early 1988 was a good example of the problem.) But the Maastricht Treaty puts the domestic side of monetary policy on a collision course with the external side. Indeed, it does so almost in successive articles.

Some passages in the Treaty say that the ECB is to be outside politics and independent of government. It is meant to be committed unequivocally to the objective of domestic price stability. Article 107 states, rather loftily, that "When exercising the powers and carrying out the tasks and duties conferred upon them by this Treaty..., neither the ECB, nor a national central bank,... shall seek or take instructions from Community institutions or bodies, from any Government of a Member State or from any other body." In short, monetary policy, focussed on price stability, is to be the responsibility solely of the ECB. But article 109 says, "The Council [of Ministers] may, acting by a qualified majority on a recommendation from the ECB or *from the Commission* [our italics],...adopt, adjust or abandon the ECU central rates of the ECU within the exchange rate system." So – if the Commission and the Council of Ministers want the ECU devalued or revalued against the dollar – the ECB must abide by their decision. A devaluation or a revaluation is undoubtedly an act of monetary policy. In other words, monetary policy is *not* to be the responsibility of the ECB. This political compromise is a basic flaw at the heart of the proposed system.

Ownership of foreign reserves still vested in nation states

There is also a conflict between national ownership of the foreign exchange reserves and supra-national control over them which is inherent in the concept of monetary union without an accompanying political union. Of course, it could be overcome if the nations of Europe were to form a political union. In that case not only would the control of the reserves be transferred to a central ECB, but also – and much more fundamentally – their ownership would be vested in a central European government. But that is not envisaged in the Maastricht Treaty. Instead article 30.3 of the Protocol on the ECB says that, "Each national central bank shall be credited by the ECB with a claim equivalent to its contribution. The Governing Council [of the ECB] shall determine the denomination and remuneration of such claims". On this basis it is still the national central banks (and ultimately national governments) that own the reserves transferred to the ECB. Our analysis leads to an inescapable conclusion: unless monetary union is accompanied by genuine political union, the Maastricht Treaty is a recipe for confusion and wrangling about the ECB's foreign-currency operations. This verdict is justified both by the intrinsic incoherence of a single currency without political union and by the textual inconsistencies in the Treaty itself.

Banker to the banking system

What, then, of the second group of functions of the ECB, those connected with its work as banker to Europe's banking systems? The subject can be dealt with more quickly as its importance has already been recognised, notably and unsurprisingly by the banking industry itself. The first problem is the size of the cash reserves that banks would need to hold with the ECB, if and when a single European currency were introduced. The debate on this subject has already been well signposted. There are two conflicting positions, which can be fairly termed the "British" and "Continental" views. The British view is that banks' cash holdings should be voluntary and determined by functional needs (i.e., to meet deposit withdrawals and to fulfil clearing obligations); the "Continental" view is that their cash holdings should be mandatory and determined by other policy objectives, such as banking prudence and the easy financing of government deficits. If the British view were upheld, banks' balances at the ECB might be under 2% of assets; if the Continental view won the argument, the figure might be anywhere between 5% and 15% of assets. The outcome of this debate would

have significant effects on banks' profitability, their mode of operation and the cost of banking services. In article 19 of the ECB Protocal the Treaty says that the ECB is to determine banks' minimum reserves and, "in cases of non-compliance", can "levy penalty interest and impose other sanctions". But nowhere does the Treaty indicate how high the minimum reserves might be. If the Maastricht Treaty stays alive, considerable negotiation on this tricky subject is yet to come.

The essential point here is that throughout Europe methods of banking control as well as the techniques of central banking have evolved as means of providing sources of "soft" financing for national governments. It stretches imagination to believe that they are all, suddenly, going to give up these deep-seated habits and change the banking structures accordingly, especially when there are so many ways (more or less hidden) of circumventing the flimsy safeguards of the new system. For example, if one country, say France, experienced a sudden rise of 10 per cent in wage costs (as happened in 1968), and it was not allowed to cushion the shock by liberal credit, whole stretches of its industry would become uncompetitive and go bankrupt. ECB or no ECB, the French authorities would certainly find ways of extending assistance to enterprises in these circumstances (this example raises further questions about the role of credit guarantees and subsidies that are not addressed at all in the Union Treaty).

Lender of last resort

The second vital part of the ECB's role as the bankers' bank would be to serve as lender of last resort in emergencies. This is one of the most controversial tasks of any central bank. Because banking emergencies differ from each other in important and unpredictable ways, the central bank has to respond flexibly, pragmatically and with full discretion. Often there is a large element of rough justice in its actions. (Some banks are leant on to support weak institutions; certain institutions are allowed to go bust; others are not; and so on.) In the existing nation states of Europe, which have a single well-recognised government and a single long-established central bank, and where the individuals involved share the same culture and language, people tolerate the rough justice for the sake of the financial system (and the nation) as a whole.

A conspiracy of silence

Would they do this if the ECB assumed the functions of the national central banks? How would an ECB with headquarters

in Bonn have reacted to the Johnson Matthey crisis? Would large German or French banks have felt obligated to participate in the "life-boat" for the UK secondary banks in the mid-1970s? It is surely enough to ask the questions to understand that the responsibility to act as lender-of-last-resort would be far more difficult to exercise at a European level than at the national level. As it happens, the Maastricht Treaty says almost nothing about the subject. The omission is remarkable since the lender-of-last-resort role is the most basic rationale for the existence of a central bank. As explained earlier, it has been central banks' acceptance of a lender-of-last-resort role that has persuaded commercial banks to leave non-interest-bearing deposits with them.

Europe's banking systems are after all still national in character; the recent spate of bank mergers have made them even more so, since none has been an EC cross-border merger. A refusal by the ECB, on grounds of monetary discipline, to act as lender of last resort to a particular bank in a crisis could therefore severely damage one country's banking system without having corresponding effects on others. This is unthinkable. Therefore in practice LLR facilities are likely to be given quite liberally; knowing this, banks in time will tend to lower credit standards. This will in time increase the instability of the banking system.

Distinction between ERM and EMU

The widely-discussed convergence requirements are both necessary and sufficient for a successful European system of fixed exchange rates, such as the ERM. They are undoubtedly also necessary for the creation of a single European currency. But they are not sufficient for it. Monetary union is an altogether more ambitious venture than a system of fixed exchange rates. It would necessitate the effective amalgamation of central banks' balance sheets and an agreement on the ECB's operating practices. The agreement would have to spell out a number of vital logistical requirements which would be essential if the ECB were to serve traditional central-banking functions. These requirements are every bit as important as the more familiar convergence requirements. If the nations of Europe do not abide by them, the ECB could not act as banker to Europe's governments and or to its banking systems. Indeed, it would not be a central bank, except in name.

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