

## A BRIEF OVERVIEW OF MONETARY POLICY IN THE EUROPEAN UNION

### ABSTRACT

*In the first place this paper considers the monetary politics of Eurosystem. Secondly, the monetary politics strategy of the European Central Bank (ECB) is analysed, emphasizing the target of price stability and that this has been achieved in the European Union. As a result it is concluded that the European Monetary Union is not an Optimum Currency Area. The Union's labour market is not an integrated and co-operative one. There exist, in fact, deep rooted differences between the labour markets of the countries in the Union, which do not permit work mobility or wage flexibility. There is another factor supporting this thesis, which is the impossibility of turning to tax transfers to contrast unemployment due to the drop in demand. Therefore, it is necessary to reduce the discretion left to the member States in terms of fiscal policy, but it is important, above all, that the countries in the Union respect the rules set up by the Stability and Growth Pact.*

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*Key words:* monetary system, Optimum Currency Area, price stability

### 1. Introduction

This study deals with the Eurosystem's (1) monetary policy and the role of the European Central Bank. The policy of a common monetary unit began the 1<sup>st</sup> of January 1999, when the 12 countries in the Union gave up control over their currencies to a higher institution, the ECB. The ECB chose the strategy of a single unit of currency, which would permit the attainment of efficient results for the Union and the creation of price stability (an objective defined by the EU Treaty). Even though the ECB is an independent body, as Mr. Padoa-Schioppa sustains, one nonetheless cannot speak of a: "(...)monopoly (...). Today, on the other hand, the Eurosystem is an archipelago of (...) the actual configuration of the Eurosystem is unsustainable in the long term because it is riddled with contradictions" (Padoa-Schioppa, 2004). In any case, it must be stressed, that what has rendered the monetary unit policy efficient has been the introduction of the *euro*. The original idea was to create, through the single currency, a wide internal European market and to facilitate commercial transactions. The single currency has therefore permitted meeting the objective of an internal area without boundaries which the European

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Union set for itself in the 1986 Common Act. Thanks to the *euro*, European citizens have more opportunities in terms of consumption and savings while for businesses there are greater prospects of growth, even if it is necessary to be able to take advantage of the changes of the Economic system in which they operate.

Lastly, one need note that the Economic and Monetary Union will not only foster the creation of a stable macroeconomic context, thanks above all to the stability of prices, but will also determine new challenges, which are:

- 1) The necessity for an appropriate *mix* between monetary and fiscal policies;
- 2) making the product and job markets more efficient.

Therefore, the fundamental objective of the Economic and monetary union is the creation of an efficient and stable area.

## 2. Which monetary policy for the ECB?

On the day after the birth of the European Central Bank and the consequent centralisation of the monetary policy decisions on a higher level, the debate between the economists on which monetary policy strategy was better, and above all which would be the more in accordance with the realities of the European Union, reopened.

The outlining of the *policy* followed by the National Centralised Banks was anything but homogeneous, due to the fact that in the post-war period two models of centralised banks emerged, the *Anglo-French* model on one side and the *German* on the other. In the *Anglo-French* model, the goals of the centralised bank are: price stability, the stabilisation of the economic cycle, maintaining a high rate of employment, financial stability. While in the *German* model, there is only one main objective, which is price stability. Between the two models, the ECB has undertaken the framework of the *Bundesbank*. The success of this model can be explained by two factors. The first is connected to the success of the Monetarist school of thought<sup>1</sup> (2), which became dominant as of the 1980s; the second to the strategic position assumed by Germany in the process of forming the EMU. According to the German authorities, the entrance into the Monetary Union would have meant accepting an inflation greater than the one within. To avoid this risk and therefore succeed in stabilising inflation, the ECB should have aimed at the stability of prices (3). The ECB today recognises price stability as its sole monetary policy objective and as an intermediary objective, it uses the mass of currency (the monetary mass is M3)- 4. In short the ECB retains its advantageous that the rate of growth of the mass of money compatible with the inflationary objective (which cannot go above 2 %) cannot grow beyond the quantitative reference value (in 1998 the quantitative reference value was fixed at 4.5%). This quantitative reference value was calculated using the well-known equation:  $MV=PY$  and considering, on one side, the relationship between currency and prices and, on the other, gross national product and rate of circulation.

With:

M, meaning money or currency;

V, meaning the speed of circulation (its rate uses the average period.);

P, meaning prices (referring to the IAPC index, created by Eurostat);

Y, meaning the gross national product (its rate uses the average period).

It is nonetheless necessary to specify that in the period between 1999-2002 the rate of growth of the monetary mass was above the reference value. Therefore not

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only does the monetary mass considered by the ECB not represent an explicit *target*, but the role performed by this pillar in the monetary policy strategy is not even clear.

In hopes of better understanding the approach taken by the ECB, discussion will be limited to two points which regard respectively:

- 1) the role given to monetary policy by the ECB in 1998;
- 2) the new role, specified, by the ECB, in 2003 (5).

At this point in the analysis, one must ask on what principles did the ECB base its decisions on monetary policy in 1998?

In 1997, the IME indicated the following strategies: *monetary targeting and inflation targeting*. In truth, the ECB chose a strategy which included elements of both options. Therefore, according to several writers (Buti and Sapir, 1999), "*the ECB's strategy of monetary policy does not follow in dogmatic fashion either monetary nor inflation targeting but includes elements of both. The outline proposed can be interpreted as a simultaneous targeting of currency and inflation*". If, therefore, in economic literature there appears an evident dichotomy between *monetary targeting and inflation targeting*, in the real world there exists a "quasi-equivalence" between the two strategies. In fact, this vision sustaining that: "(...) *the difference between monetary and inflation targeting is insignificant*" was made, beforehand by the IME, and later by the ECB.

Nevertheless, if the ECB in 1998 had indicated the key elements of its monetary policy strategy, that is: "*To maintain price stability, the ECB's governing has decided to adopt a monetary policy strategy which will be based on two key elements: (1) A primary role will be given to the currency; this will be signalled by the announcement of a quantitative reference value for the growth of a ample monetary mass.(...)(2)In parallel with the analysis of monetary growth in respect to the reference value, an important role in the strategy of the Eurosystem will be assigned to an evaluation with ample breathing space for the prospects of price trends (...). This evaluation will be made using a vast assortment of economic variables (...)*"<sup>2</sup>. In 2003 the ECB's governing Council revisited this approach, introducing the following innovations:

- 1) the change in the definition of price stability. In fact, the inflationary objective of average period which was "*positive but below 2%*", will be "*below but close to 2%*";
- 2) a lesser importance to the monetary variables in the context of monetary policy decisions.

Therefore, in May 2003, the ECB makes its decisions on monetary policy after having analysed the *economic variables*, while the *monetary variables* serve to confirm the conclusions which emerge from the analysis of the economic variables. These changes although considered important, in actual fact, do not modify the principal objectives of the ECB.

### **3. The asymmetrical effects of a common monetary policy**

As of 1999 the economies of the countries in the EMU ought to be somewhat synchronised, as they have a common currency and a common management over monetary policy. Nonetheless, the management itself of the common monetary policy

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can have asymmetrical effects. The cause of this is ascribable to the various market structures presented by the member states, to the various employment rates and to the various rates of inflation. All this also implies differing reaction mechanisms in each state.

For example, demand inflationary *shocks*, originally only at a local level, are transferred from country to country and influence all of the Union with varying times and ways based on the structure of intra-European commercial relations and also upon the different capacities to respond, of the single national productive apparatuses. The *Shocks* which determine appreciation and depreciation of the euro, in respect to other currencies, have an asymmetrical impact on the mass request of the various countries in the Union following the major or minor opening of each economy to extra-European exchanges.

Another reason for asymmetry in the transferring of monetary impulses is determined by the weight, differing from country to country, of the national debt. For example, restrictive measures aggravate in greater or lesser respect the budget of each country, this depends on the degree of accumulated debt and, therefore, on the extent of the additional burden which each state must tolerate due to the increase in interest rates. In conclusion, the economic operators in formulating the economic expectations will have to hold into account the present situation, a common monetary policy which transfers asymmetrically from nation to nation. More specifically, in light of the eventuality of monetary restrictions, the operators will expect (in the context of the stability Pact) consequent tax restrictions, more pronounced in countries with a greater debt, and consequently they will see growth expectations lower once again.

#### **4. Is the European Monetary Union an Optimum currency area?**

At this point in the analysis one must ask if the European Monetary Union is an Optimum currency area.

The theory of the Optimum currency area (OCA) comes from Robert Mundell in 1961. An *Optimum currency area* offers a system where exchange rates are fixed and therefore no longer susceptible to variations, and therefore, persists in time also in the presence of *asymmetrical shocks*. To bring an Optimum currency area into the discussion the following conditions must be present:

- 1) mobility of factors,
- 2) wage flexibility,
- 3) a centralised budget.

The *mobility of factors and wage flexibility*. Presuming the presence of an asymmetrical shock, which hits two countries A and B, the international demand of goods in country A will increase, while in country B it will decrease. An increase in production, the need for labour, income, consumption and the positive sales of current accounts will occur in A, while in B, there will be a drop in production, higher unemployment and a deficit in current accounts. To re-stabilise the balance, if work mobility persists, the workers in country B need only move to country A where there is a need for labour. Thus, in country B, the problem of unemployment disappears, subsidies will not increase and at the same time the problem of current accounts is solved (the workers in country B thanks to subsidies will buy foreign products even in the presence of a drop in production). In country A, there will not be any inflationary pressures as wages will not increase, furthermore the increase in production and of revenue will determine an increase in imports leading to the reduction of current account overflow. If instead of work mobility, wage flexibility is present, the

*asymmetric shock* which hits the two countries can be eliminated by reducing salary rates in B and increasing them in A. The drop in wages in B will lead to a reduction in production costs, the country will then be more competitive, thanks to the lower prices and will re-stabilise the balance of payments. In A the increase in wages will determine the increase in prices, thus, the country will be less competitive and the balance of payments will balance itself out.

*A centralised budget.* The last solution to re-stabilising the balance between the two countries, according to the theory of the Optimum Currency Area, would be through taxes, or rather fiscal transfers, would be used by country B to eliminate the negative effects on employment, due above all to the drop in demand.

In the absence of mobility of labour and wage flexibility, and of a centralised budget, the balance would be regained thanks to a flexible exchange rate, with a depreciation in the exchange rate in B and appreciation in A (6)<sup>3</sup>.

The advantages and disadvantages brought by the introduction of the *euro* in the common market can be examined in relation to the theory of the Optimum Currency Area.

The greatest advantage will be the creation of a more efficient common Market, both because there is no longer the risk of exchange rates, and because there are fewer conversion fees due to the use of different currencies.

It is important to point out that this advantage was mentioned by the Commission in 1990 in the document, *One market, one currency*, which sustains that in the European Union, during the 1980s, the transaction costs due to the presence of different national currencies added up 0.5% of the GNP (European Commission, 1990).

In regards to the disadvantages, economic literature on the theory of the Optimum Currency area lingers on those derived from the presence of *shocks* which interest single states. Since the labour market in EU countries is not flexible, there is no elevated mobility of production factors, just as there is no price or wage flexibility. The shock cannot be reabsorbed by these mechanisms. Nor will a new equilibrium due to transfers of a fiscal nature be possible. In truth, this last solution would only be possible in the presence of a centralised budget within the Union, which would involve less discretionary fiscal policy.

Therefore, from the previous analysis, it can be concluded that the European Monetary Union is not an Optimum Currency Area. The Union's labour market is not an integrated and co-operative one. There exist, in fact, deep rooted differences between the labour markets of the countries in the Union, which do not permit work mobility or wage flexibility. There is another factor supporting this thesis, which is the impossibility of turning to tax transfers to contrast unemployment due to the drop in demand. Therefore, it is necessary to reduce the discretion left to the member States in terms of fiscal policy, but it is important, above all, that the countries in the Union respect the rules set up by the Stability and Growth Pact.

## 5. Closing remarks

In conclusion, an evaluation can be made of the monetary policy put into effect by the ECB. The ECB has a single objective: price stability (art. 105 of the TUE), which it tries to attain through a precise strategy on monetary policy. A strategy based on

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two pillars: the first regarding the fixing of the quantity of currency; the second pillar regards the analysis of certain indicators, included among these are, wage and price trends, yield curves, and the trend of the *euro*'s exchange rate. Through analysis of the two pillars, the monetary authority decides on the corrective measures to be taken. It is therefore clear that the ECB has given the currency a fundamental role, as it is able to guarantee the stability of prices. Therefore, the ECB's actions tend to contrast inflationary pressures. Furthermore, to render the ECB's actions more efficient, it handles the monetary policy in absolute independence, nonetheless their activities have been kept visibly transparent as of 2000 by publishing their decisions in the *Monthly Bulletin*. It is also necessary to comment on monetary analysis. According to the directions of the ECB's governing council, the monetary mass M3, as of the second half of 2004, shows a rising trend, in large part determined by the low level of interest rates. In fact, one must recall that the governing council has left the ECB's interest rates of reference unvaried, choosing to maintain the offered minimum rate applied to the principal refinancing operations of the Eurosystem at 2%, the interest rate on refinancing operations at 3% and on deposits care of the central bank at 1% (BCE, 2005). These choices made by the governing Council are explained by the fact that it does not see significant inflationary pressures in the area of the *euro*, and therefore, historically low interest rates favour economic growth. But the scenario outlined is not free of risks. Just as the increase of the M3 has favoured the growth of liquidity, this could lead to risks in the stability of prices mid term. Therefore a watchful eye on the part of the Council is requested.

Lastly, one must recall that not only the ECB, with its choices, but also the *euro* can contribute to the growth of the Union. In fact, the introduction of the single monetary unit has taken away from the member states the possibility to decide monetary policy autonomously and to confront asymmetrical shocks manoeuvring the exchange rate. This has therefore obliged them to turn to policies lying on the supply side and to take on structural reforms, to once again be competitive.

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## KRATKI PREGLED MONETARNE POLITIKE EUROPSKE UNIJE

### SAŽETAK

*U radu se prvenstveno razmatra monetarna politika Europske unije (EU). Analizira se strategija monetarne politike Europske središnje banke (ESB), s naglaskom na cilj stabilnosti cijena i njegovo postignuće. Autor zaključuje da Europska Monetarna Unija (EMU) nije optimalno valutno područje. Tržište rada Europske unije nije integrirano i međusobno povezano. Štoviše prisutne su značajne razlike između tržišta rada pojedinih zemalja članica Unije, koje su prepreka mobilnosti radne snage u fleksibilnosti nadnica. Tu tezu potvrđuje činjenica da je uslijed pada potražnje onemogućeno oporezivanje transfera za nezaposlene. Stoga je nužno smanjiti diskrecijska prva zemalja članica u pogledu fiskalne politike, pri čemu je iznad svega važno da zemlje članice Europske Unije poštvaju pravila postavljena paktom stabilizacije i rasta.*

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