

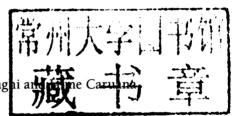
With a Foreword by MARIO DRAGHI and JAIME CARUANA

# Making the European Monetary Union

The Role of the Committee of Central Bank Governors and the Origins of the European Central Bank

## Harold James

With a Foreword by Mario Dragni as



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## Making the European Monetary Union

European monetary union came to fruition with the creation of the European Central Bank on June 1, 1998, followed by the introduction of the Euro on January 1, 1999. Euro banknotes and coins were issued on January 1, 2002. Behind this achievement lay a unique process of monetary cooperation and unification that was set in motion by the 1957 Treaty of Rome. As this initiative was driven primarily by the political will to give the Common Market a stable monetary anchor and to set Europe on course toward an ever closer integration, it was only natural that the political decisionmakers were the key players. These included the heads of states and governments acting through the European Council; the European Commission and the EU Monetary Committee working from Brussels; and the European Parliament and the national parliaments. A very important role was also played by the central banks of the European Economic Community (later European Union) member states and particularly by the central bank governors. As guardians of monetary and financial stability at the national level, the central banks were directly affected by the European monetary cooperation and unification process. However, their specific contribution since the late 1950s is neither widely known nor well understood, either in academic circles or by the broader public.

In order to fill this gap, in 2008 the European Central Bank (ECB) and the Bank for International Settlements (BIS) commissioned the present historical study by a renowned expert, Professor Harold James. The forum in which EU governors cooperated and prepared for monetary union was the Committee of Governors of the Central Banks of the Member States of the European Economic Community (Committee of Governors for short), created in 1964 by a European Council decision. As the Committee of Governors played such an important role in the European monetary unification process over three decades (1964–1993), it was felt it deserved a history of its own. Somewhat surprisingly, the Committee of Governors held its regular meetings at the BIS in Basel,

Switzerland, that is to say outside the European Union, until its successor—the European Monetary Institute (EMI)—moved to Frankfurt in 1994. In that way, the governors not only underlined their independence from the EU's political center in Brussels, but also were able to draw on the secretariat services provided by the BIS to the central bank community.

The cutoff date for this study is the end of 1993. This date marks the formal end of the Committee of Governors as it had existed since 1964, and its replacement by the newly created EMI. It can therefore be considered an important milestone on the road to European monetary unification. Following the three-stage process toward European Economic and Monetary Union outlined in the 1992 Maastricht Treaty, the EMI would itself be superseded by the creation of the ECB on June 1, 1998, and the introduction of the Euro shortly afterward. These latter events, however, are not the subject of this book. Ending the story in 1993 has allowed enough time to pass to permit a sober historical assessment of a crucial transitional period. Yet the events are still sufficiently recent that many of the protagonists could be interviewed or otherwise consulted for this project.

Because this history was commissioned jointly by the ECB and the BIS, both institutions exceptionally waived the thirty-year restriction on access to their archives, including the historical records of the Committee of Governors (held by the ECB in Frankfurt). In exchange, Professor James agreed to use the more recent archival materials solely for the writing of this history. Under the same conditions, certain other central banks likewise agreed to open their archives up to 1993.

A panel of distinguished experts on European monetary history and on the monetary unification process was invited to review the manuscript. Its members—Barry Eichengreen, Marc Flandreau, Gert Jan Hogeweg, Hanspeter Scheller, Niels Thygesen, Gianni Toniolo, and Jürgen von Hagen—have provided helpful feedback and further input, for which they rightly deserve our gratitude.

Finally, although the BIS and the ECB have commissioned and given their full support to this research project, it should be clear that this book does not in any way present an official BIS or ECB view. What is offered here for the benefit of a wider audience is Professor James's own analysis and interpretation, based on the original source material, of

the role played by the central banks in this important episode of European integration. We hope that readers will agree that this is a story well worth the telling, and that Harold James has done it justice.

Mario Draghi, President, European Central Bank, Frankfurt am Main Jaime Caruana, General Manager, Bank for International Settlements, Basel

#### Abbreviations Used in Text

BCCI	Bank of Credit and Commerce International
BIS	Bank for International Settlements
CoG	Committee of Governors of the Central Banks of the Member States of the European Economic Community
EC	European Communities
ECB	European Central Bank
ECOFIN	Council of Ministers of European Communities (economy and finance ministers)
ECU	European Currency Unit
EEC	European Economic Community
<b>EMCF</b>	European Monetary Cooperation Fund
EMF	European Monetary Fund (proposed)
EMI	European Monetary Institute
EMS	European Monetary System
<b>EMU</b>	Economic and Monetary Union
ERM	exchange rate mechanism
ESCB	European System of Central Banks
EU	European Union
GDP	gross domestic product
G-7	Group of Seven (heads of state and government plus finance ministers of Canada, France, Germany, Italy, Japan, United Kingdom, and United States)
G-10	Group of Ten (central banks of Belgium, Canada, France, Germany, Italy, Japan, the Netherlands, Sweden, United Kingdom, and United States, plus Switzerland as associated member)
IGC	Intergovernmental Conference (European Union)

xiv	Abbreviations Used in Text
IMF	International Monetary Fund
MC	Monetary Committee of the European Community
OECD	Organization for Economic Cooperation and Development
SDR	Special Drawing Right

VSTF Very-Short-Term Facility

# Making the European Monetary Union

#### Contents

	List of Figures	vii
	Foreword by Mario Draghi and Jaime Caruana	ix
	Abbreviations Used in Text	xiii
	Introduction: The Making of a Non-National Currency	1
1	A Napoleonic Prelude	29
2	The Origins of the Committee of Governors	36
3	The Response to Global Monetary Turbulence	62
4	The Snake and Other Animals	89
5	Negotiating the European Monetary System	146
6	The Malaise of the 1980s	181
7	The Delors Committee and the Relaunching of Europe	210
8	Designing a Central Bank	265
9	The EMS Crises	324
	Conclusion: The Euro and the Legacy of the	
	Committee of Governors	382
	Appendix A: Maastricht Treaty Text and Committee of	
	Governors' Draft of the Statute of the	
	European Monetary Institute	403
	Appendix B: Maastricht Treaty Text and Committee of	
	Governors' Draft of the Statute of the	
	European Central Bank	425
	Appendix C: Dramatis Personae	463
	Appendix D: Members of the Committee of Governors	477
	Appendix E: Committee for the Study of Economic and	
	Monetary Union (Delors Committee),	
	1988–1989	481

Appendix F: Cl	nairmen of the Monetary Committee	
of	the European Community, 1958–1998	483
Appendix G: Eu	ropean Commission Presidents and	
Co	ommissioners for Economics and Finance,	
19	58–	485
Appendix H: Cl	rronology	487
Appendix I: In	terest Rates and Fiscal Balance	499
Notes		505
Acknowledgments		
Index		559

## Figures

I.1.	I.1. Sum of current account imbalances of deficit and	
	surplus countries, 1960–2010	11
I.2.	Committees and comitology	21
4.1.	Exchange rates, 1971–1979	106
4.2.	Real effective exchange rate for Deutsche Mark,	
	1963–1993	110
6.1.	Net positions in EMCF, 1979–1995	185
6.2.	Exchange rates, 1979-1983	186
7.1.	Deutsche Mark interventions in dollars, 1979-1993	216
7.2.	Exchange rates, 1982-1989	217
7.3.	Marginal and intramarginal interventions, 1986-1993	224
9.1.	Exchange rates, 1989-1993	330
9.2.	Operations to defend the British pound,	
	July-September 1992	350
9.3.	Competitiveness and overall trade balance, 1990-1992	370
9.4.	Interventions in French franc crisis, June 25-	
	July 31, 1993	376
AI.1.	Inflation, 1965–2000	499
AI.2	. Nominal policy interest rates, 1960–2012	500
AI.3.	Real policy interest rates, 1960–2012	501
AI.4.	General government budget balances, 1960-2010	502
AI.5.	Current account balances, 1965–2000	503

# The Making of a Non-National Currency

This book examines the whys, whens, hows, whos, and what-ifs of the process of making the European monetary union. Why was this innovative, daring, and risk-filled experiment undertaken? How was the process designed, and who did the designing? What were the risks, and were they calculated correctly?

First, why? The major theme of this book is that the quest for European monetary coordination and then for union was a response to genuine (and still-existing) problems of currency instability and misalignment at the international level. It was not simply—as it has often been represented—a fundamentally political project "to make a future European war impossible, and to set the stage for a federal United States of Europe." Such an endeavor would have been rather strange, as there is no evidence that common money prevents wars (think of the U.S. Civil War or, more recently, Yugoslavia). Nevertheless, the idea has been endlessly repeated by high-minded European politicians with a rhetorical bent, from Roy Jenkins to Hans-Dietrich Genscher. The rhetoric derives from the very beginning of the effort at European integration, when German Chancellor Konrad Adenauer in 1950 told parliament that "the importance of this project is above all political and not economic."<sup>2</sup> That a currency union can be driven by an urgent political concern, overriding economic logic, was demonstrated in a costly way by the case of the 1990 German-German currency union that preceded political unification; but it will be clear in the subsequent account that there was a clear economic as well as a political logic behind the creation of a single European currency.

The erroneous political interpretation of the move to a European money spawned a flurry of conspiracy theories, seeing the Euro as a plot by central bankers, technocrats at the European Commission (especially Jacques Delors, the highly influential president of the Commission from 1985 to 1994), or Germans seeking to preserve unfair advantages for their powerful export-driven economy and thus to achieve some sinister new mastery over Europe.

Second, when? The push to devise a European solution was particularly intense when global imbalances (also reflected in the emergence of large German current account surpluses) threatened the international system in the late 1960s, the late 1970s, and the late 1980s.

Third, by whom? In the late 1970s, politicians took charge of the process of finding solutions, and launched high-profile initiatives (the European Monetary System, EMS). But the results were disappointing, and in another series of initiatives, in the late 1980s and early 1990s, whose result was Monetary Union (but not really Economic and Monetary Union) as laid down in the Maastricht Treaty, the detailed planning of how to move was left to experts, and in particular central bankers. They designed both the road map for how to get to monetary union (in the work of the Delors Committee) and the actual operationalization through the statutes of the new European Monetary Institute, the future European Central Bank, and the European System of Central Banks.

Fourth, the problems and risks. EMU, as discussed in the 1970s and 1980s, stood for economic and monetary union. But the technical plans went ahead of the political initiatives on European integration, with the result that there was imperfect agreement on crucial aspects of the monetary union, in particular fiscal rules and banking supervision and regulation. Both these issue areas raised political concerns about loss of national sovereignty and about the redistributional consequences of Europeanizing a fundamental part of economic policy-making. As a result, the makers of the settlement looked back on a task that was only half accomplished. As former EU Commission President Jacques Delors put it, "the finance ministers did not want to see anything disagreeable which they would be forced to deal with."

#### The Quest for Stability

Jean-Claude Trichet, president of the European Central Bank from 2003 to 2011, liked to claim that money was like poetry, before adding that

both give a sense of stability.<sup>4</sup> This unusual but accurate formulation is reminiscent of the famous answer of the Prussian general August von Gneisenau, whose patriotic concerns in the early nineteenth century were dismissed by the Prussian king as "nothing more than poetry." Gneisenau replied: "Religion, prayer, love of one's ruler, love of the fatherland, what are these but poetry? Upon poetry is founded the security of the throne."5 The idea of stability is profoundly appealing because of European experiences of past disorder. Monetary instability decisively helped to threaten or even to blow apart fragile political systems. The monetary authority never agrees simply to convert every outstanding obligation into money. Instead, it will decide that some industries, or some banks, or some political authorities need to be kept going for the good of the general community, and that their debts should as a consequence be monetized. Those industries, banks, and political authorities that are not so privileged inevitably see the central bank's actions as an abuse of power. In federal systems, in particular, businesses and political authorities far removed from the center of the federation are most likely to be excluded from the monetary stimulus and hence inclined to be resentful.

Hyperinflation in early 1920s Germany fanned separatism in Bavaria, the Rhineland, and Saxony, because these remote areas thought that the German central bank and the central government in Berlin were discriminating against them and privileging the capital city and its interests. The separatists were radical: on the left in Saxony, on the far right in Bavaria and the Rhineland. The scar created by the memory of inflation is particularly acute in Germany, but it is by no means a purely German phenomenon. There are also more recent cases of federations eroded by inflation. In late 1980s Yugoslavia, as the socialist regime disintegrated, the monetary authorities in Belgrade were closest to Serbian politicians such as Slobodan Milošević and to Serbian business interests. The Croats and Slovenes wanted to get away. In the Soviet Union, inflation appeared as an instrument of the central Moscow bureaucrats, and more remote areas wanted to break away. Hyperinflation thus fueled the national tensions that broke up federal systems in the Soviet Union and Yugoslavia.

In the 1970s inflation became a general concern for all industrial countries. Previous views about how higher inflation might produce greater growth (as suggested in the Phillips curve literature) proved to be empirically unsustainable.<sup>6</sup> At the same time there was considerable

evidence that short-term political pressures on central banks led to higher levels of inflation—often, for instance, before elections. Given a general preference for price stability, there seemed to be an excellent case for democratically validated decisions on the delegating of monetary policy-making to central banks whose autonomy was legally guaranteed.

In consequence, the institutional framework for the single European currency was designed by central bankers, who tried to isolate themselves from political pressures. They gave a great deal of attention to central bank design, but other elements that would have been needed for the successful and enduring operation of a durable monetary union were neglected. In the draft of the European Central Bank statute produced by the central bankers, Article 2 on the objectives of the European System of Central Banks stated that it should "support the general economic policy of the Community." But on the grounds that there was a multiplicity of national economic policies, at a late stage in the Intergovernmental Conference that culminated in the Treaty of Maastricht, the Dutch presidency substituted the phrase "support the general economic policies in the Community." In other words, there was to be no mechanism for making an economic policy to go alongside the new monetary regime.<sup>7</sup>

The decisive debates about how monetary policy could respond to the challenges of global instability took place in a committee of central bankers established by the European Economic Community in 1964, and generally referred to as the Committee of Governors (or CoG). Writing the history of the CoG is in some ways an odd exercise. Why does this committee matter more than any other of a number of international forums that developed in the 1960s as a response to increasing strains in the international monetary order—for instance, the Group of Ten that managed the IMF's General Arrangements to Borrow (1962), or the OECD's Working Party Three (after 1966); or from subsequent institutions, many of which had a much higher initial profile, the G-5 (1974) and then G-7 finance ministers (1986-1987), or the G-20 (1999) that had evolved out of a G-22 and then a G-33?8 All enjoyed great vigor from the 1970s on, prompting political scientists Robert Keohane and Joseph Nye to see the "extensive and deep network of relationships" as building a new level of "transgovernmental coordination." Committees are the core mechanism in the networked world analyzed by Anne-Marie