The Future of the Euro and European Central Bank

An Honors Thesis (HONRS 499)

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Abstract

The European Central Bank is the key determiner of all monetary policies of the Eurozone’s member states. Its main stated policy goal is to effect price stability among the euro area by control of interest rates, the exchange rate, and fiscal policies. The ECB, however, has often come under criticism by its member states over the strict rules set in place on them by the Stability and Growth Pact. Currently, that attack is being led by France’s President, Nicolas Sarkozy, who has vehemently called for member states to be able to pierce the independence of the ECB and have some say in monetary policies of the euro area. These restrictions, as well as the idea of one central bank acting beneficially on behalf of fifteen members, fuel this belief that the ECB may not be flexible enough to handle the problems of individual members and that it will not allow for continued success under its current state. Despite these questions, the ECB has proven to be successful in allowing the euro to become very strong, while also allowing most Eurozone members to experience record lows of inflation, and will continue to be effective as the central bank of the single market area. In order to support this conclusion, I give a brief history of the euro, the organizational framework, goals, and policies of the ECB, and the current arguments in favor and against the ECB.
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The Euro and the European Central Bank

On November 1, 1993, with the Maastricht Treaty coming into effect, forty years of progress resulted in the European Union. The European Union traces itself back to the European Coal and Steel Community (ECSC) and has since taken on an entirely new role. It has now become the world’s only supranational organization of its kind. In essence, this means that this is the first time countries have given up so many of their national powers to a collective government. They have allowed EU law to supersede national law in certain areas and they must now keep their policies consistent with those EU laws. Still, the major area that the EU has governed for its member states is the economy of the EU as a whole. With the adoption of the euro, which came into force in 1999 and became physical coins and bank notes on January 1, 2002, the EU furthered its development into a single market area, its purpose since its creation. This group of fifteen members, with the recent edition of Cyprus and Malta, comprises the Eurozone, and each must now comply with the EU’s economic requirements to enter and remain a member. The future success and power of the euro has been questioned prior to and since its inception. As many countries have sacrificed national control in economic areas, to an extent, the euro still remains hotly contested. One of the main arguments countries and experts have with the EU is over the policies and role of the European Central Bank (ECB). Many believe the ECB must become more flexible to national needs or it will inevitably fail, however, I will provide evidence that in spite of these
complaints, the ECB has allowed the euro to reach significant success and will remain effective enough to allow the euro to continue to succeed.

**History of the Euro**

In order to understand the euro and the ECB, one must first delve into their past and understand where they came from and what they promised. The creation of a single market and currency has been a goal since the formation of the founding pre-EU organizations such as the European Coal and Steel Community in 1950. Since the design of Robert Schuman developed into the ECSC, the EU has undergone many changes that have led to where it is today. Before the adoption of the euro, there was a large amount of planning to handle the transition to the euro, as well as, the running and operation of the euro.

The major problem with the transition was the concern that there would be problems and slow downs that arose as the national currencies and the euro were still in translation. These transaction times were much less of an issue than expected. Also, a key to experience a successful transition to the euro was the need for consumer confidence to remain high. People needed to believe in the euro if it was to handle the transition period. The use of the euro in the transitional period presupposes that consumers are sure that they have nothing to lose and everything to gain by paying for their purchases in euros.\(^1\)

the Eurozone remained fairly enthusiastic about the euro and the transition period was relatively smooth.²

Institutions of the Euro

In creating the euro, the Eurozone members and the EU had to come up with a framework and create institutions in order to see that its management was properly run. The main institution involved in this is the European Central Bank (ECB). The ECB, together with the national central banks (NCBs) of EU member countries, constitutes the European System of Central banks (ESCB). These institutions work together in attempting to force compliance with the Stability and Growth Pact and to meet the goals set forth when the euro was accepted. The ECB is in charge of setting the monetary policy of the Eurozone, as a whole, and has the power to enact adjustments to interest rates, the exchange rate, and determine the fiscal actions of the entire Eurozone, while the ESCB is in charge of printing, minting, and distribution of the euro.³

Promises of the Euro

This planning by the euro’s creators, prior to the euro coming into effect, led to many promises being made about its expected and intended results. One of the major benefits promised by the euro was its ability to facilitate travel within the Eurozone. The idea was that if all member countries have the same currency, many of the problems arising because of exchange rate differences are eliminated. If a person were to travel

² “Scenario for Changeover to the Scriptural Euro”
³ “European Central Bank.” European Central Bank
into a neighboring country, he/she would not have to hassle with exchanging their currency. Because of the close proximity of European countries, this could save a lot of time, as travel among Europe is common. Also, gauging prices becomes much easier with a single currency. Prior to the euro, exchange rates could dictate the price of products a person intended to buy and force them to figure out the difference these created. “Now, comparing prices would be simpler, since a person can use their own currency anywhere.”

Also, a promise of the euro is that it can eliminate exchange rate fluctuations. Its creators believed that there were too many risks and uncertainties for importers and exporters to calculate with all the different national currencies. They argued that the euro would allow for a “more stable environment within the euro area”. Likewise, they felt that businesses and investors would benefit because they could better plan with these exchange rate fluctuations eliminated. With a single currency, there is less to consider when entering into a foreign market and the euro would make neighbor countries no longer foreign markets. Another benefit that would result from the elimination of these exchange rate issues come in the form of transaction costs. With the euro, costs from transactions between members are eliminated as differences in exchange rates no longer would need consideration.

Price transparency, which was alluded to before, was another major promise of the euro. It was argued that with a single currency, comparing prices of goods and services within the area would become a much simpler task when the prices are expressed

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5 “The Euro.”
in the same currency. This price transparency could then foster a growth in trade and competition which is the key to the success of a capitalist system. The greater the competition, the lower the prices and more fair the buying circumstances will be for a citizen in that system. “Consumers, wholesalers, and traders can buy from the cheapest sources, thus putting pressure on companies trying to charge a higher price”\(^6\). Because companies have a larger area in which to buy products at the lowest prices, they must keep their prices lower because citizens, likewise, have a larger area to shop in.

Adoption of the euro also promised benefits to investors and savers as well. The idea was that savers and investors could experience better success with more investment and savings opportunities. With a single currency, risks are spread more widely which leads to investors taking on riskier ventures. The euro thus would lead to markets being larger and more liquid. This all would stem from a single market for financial operators such as banks and insurers. Also, private corporate borrowers, as well as, equity issuers would benefit from better funding opportunities because money is easier to raise on capital markets\(^7\).

The creators of the euro also had macroeconomic goals in mind when pushing for the adoption of the euro. Some of these goals have already been touched on as they pertained to the benefits to individual citizens and companies. One of the predicted macroeconomic benefits was price stability, which is the primary objective of the European System of Central Banks (ESCB). As mentioned, a single currency market allows for prices to remain stable within the entire Eurozone. Also, by setting out

\(^6\)“The Euro”\(^6\)

requirements that must be adhered to, the Eurozone was aiming to force sound public finances before entry. This would prevent member states from operating at excessive levels of debts or deficits. These requirements are listed in the Stability and Growth Pact (SGP) which requires that a debt of below 3% of GDP must be maintained. The SGP attempts to keep governments operating with a balanced budget or in a surplus. Lastly, these requirements promise to facilitate lower interest rates as low inflation is to be expected. Through the inclusion of many countries, the Eurozone would become a larger economy better able to handle external shocks better than national economies individually.

Convergence Criteria

The convergence criteria of the Maastricht Treaty were set in place in order to achieve some level of stability before countries would be allowed entry into the Eurozone. There are four areas and requirements that need to be met. The first is that the interest rate cannot exceed by more than 1.5% the inflation rates of the three best performing member states in terms of price stability. Secondly, in line with the requirements of the Stability and Growth Pact, if countries want inclusion they must have a deficit below 3% of GDP and a debt below 60% of GDP. Third, there must be a long-term nominal interest rate which does not exceed by more than 2% that of the three best performing Member States in terms of price stability. Lastly, their normal fluctuation margins provided for by the exchange-rate mechanism must be respected without severe tensions for at least two years before the examination.  

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Stability and Growth Pact

The Stability and Growth Pact (SGP) is the agreement among Eurozone member states in regards to their fiscal policies and practices. This agreement was adopted in 1997 in attempt to ensure that member states act in accordance with the plans of price stability. There are essentially two major requirements handed down by the SGP in their 2005 revision. The first is that countries must maintain an annual deficit that is less than 3% of the GDP. Secondly, they need to keep a national debt lower than 60% of the GDP. These requirements are aimed simply at keeping the inflation down and achieving price stability.

This agreement, created in 1997, was proposed by then-German finance minister, Theo Waigel. It is appropriate that the Germans, with their extremely anti-inflationary policies since World War II, were the ones to propose the SGP and push for a central bank that sets its goal at maintaining low inflation. Germany, following the First World War, was hit extremely hard by inflation. This depression felt by the individuals gave rise to Adolf Hitler, whose policies and cruelty during WWII and the Holocaust is extremely well documented. In light of this history, it is easy to see why the Germans were so strong in favor of the SGP.

Doubts of the Euro's Success

Prior to its adoption, many experts believed the aforementioned benefits would never occur and that the euro was doomed for failure. They based this assessment on the

<http://europa.eu/portal/glossary/convergence_criteria_en.htm>
belief that the single currency could not account for economic shocks to individual countries or political discord. The first knock against the euro is essentially that if an economic shock occurs in one country, under the restrictions of the SGP, it will not be able to react adequately. In Understanding the Euro, Christian Chabot argues that an individual country handles these shocks in three ways: interest rate adjustment, exchange rate intervention, and fiscal adjustment. 9 Interest rate adjustments allow a country to lower interest rates during economic troubles to entice borrowing and stimulate the economy. Exchange rate intervention allows a country’s central bank to devalue its currency by selling more in foreign markets. This in turn decreases the prices of its goods. The last of the three tools, fiscal policy adjustment, is when a government increases spending during a recession to get more money into its country’s markets. The criticism of the euro is that without these tools, countries may not be able to ensure the safety of their own economy.

Political discord, another of Chabot’s concerns, raises the question of what happens if a country chooses to operate outside of the restrictions of the SGP. Because the Eurozone lacks the ability to punish those who misbehave economically, some feared that the euro would not succeed if member states are allowed to act without fear of punishment. As it will be mentioned later, this worry stated by Chabot in 1999, still holds some very real implications.

Another argument against the euro is that a uniform economic policy cannot possibly be good for every country under its watch. Renate Ohr, in “The Euro in its Fifth year: Expectations Fulfilled?”, brings this thought up. In his essay, he mentions that

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some critics believe that with differing economic structures and cycles, individual countries must have the ability to enact their own policies. An example of this is with the interest rate and exchange rates which can allow an individual country to stimulate a stagnating economy. If one country is the only one experiencing stagnation, then the ECB will not enact a change in policy to favor that one country. Also, Ohr notes that a uniform economic policy becomes ever more difficult as further accession of more countries occur. The question was that, as the Eurozone grows, can a uniform policy handle it?

Has the Euro Met its Promises?

Looking at the euro's results since its adoption in 1999, it would seem that up to this point, the promises about it have been met. Initially, the euro struggled, as the confidence in it and therefore investment in it started low. However, in its nine year history, the euro has experienced enormous growth in value. It maintains a position as the strongest currency in the world, in terms of exchange rate, partly behind its own success and partly based on the drop and weakness of the U.S. dollar, with most critics arguing that it mostly due to U.S. weakness. Since lows in October 2000, it has soared roughly 65% against the dollar and 83% against the Japanese yen. Joaquin Alunmia, on February 9, 2007, in his speech spoke of the "EU's robust recovery, with buoyant growth and a GDP growth of 2.8% in the EU and 2.6% growth in the euro area. Also, inflation is just above 2%, the lowest since the 1970s".

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Largely, the euro has met the goals it promised following its adoption. This growth in the euro is a direct result of the increased movement and competition it has facilitated within the Eurozone. Also, it has been able to withstand economic shocks such as a rise in oil prices that could have adversely affected the Eurozone's smaller countries. As for price stability, Gertrude Tumpel-Gugarell, a member of the executive board of the ECB, noted in 2004, the average inflation rates have been at 2%, which is the aim. It is important to note that this level still remains true. In this 2004 speech, she also notes that those that argued that one size cannot fit all were incorrect because countries' inflation rates were similar and the differences mostly arise from those that are still in a catch-up phase.\(^1\) By and large, the euro has been able to follow through on its promises of price stability and transparency. Its growth to the heights it has currently achieved, while somewhat overvalued, indicate that it has been able to maintain a stable economic environment for its member countries.

The ECB

As the main institution of the Eurozone, the ECB has the power in controlling the monetary policies of the Eurozone. For this reason, it is imperative that the ECB remain completely independent from the EU and the political forum. It must be allowed to enact these policies while not answering to the politicians. This need has been widely recognized, as even in 1998, Alan Greenspan, who was the chairman of the Board of

Governors of the U.S. Federal Reserve, stated that the success of the euro depended on the credibility of the new central bank that would watch over it. The ECB, which was established on June 1, 1998, has a considerably large say in the current success of the euro, as well as, its future success. It was created as the successor of the European Monetary Institute (EMI), with the EMI being dissolved at the ECB’s creation. The EMI was created to try and coordinate the actions of the national banks was in charge of pushing the EU towards the single currency market.

**ECB Framework**

The European Central Bank is made up of the Governing Council, the Executive Board, and the General Council. Its Governing Council consists of the six members of the Executive Board, as well as, all the governors of the fifteen national central banks (NCBs) of Eurozone members. This body is the primary decision-making body of the ECB and its job is to make the decisions that will keep the Eurozone’s economy in line with the goals of the euro. This means that it is in charge of creating the ECB’s monetary policy. As such, it “controls the monetary objectives, interest rates, supply of reserves, as well as, setting forth the ways in which their policies can be met”.

Along with the Governing Council, is the Executive Board which, as mentioned, has its six members on the Governing Council. The Executive Board has a president, a vice-president, and four other members. Its four other members are chosen by the heads

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of state or government of the Eurozone member countries. The president and vice-

president of the Executive Board hold those positions for the ECB as a whole. “Its duties involve implementing the monetary policy created by the Governing Council. Also, the Executive Board is in charge of preparing Governing Council meetings and managing the day-to-day business operations of the ECB”.\(^{15}\) Currently, Jean Trichet of France is the ECB’s President and Lucas D. Papademos of Greece is its Vice-President.

The third body of the ECB is the General Council. This body consists of the President Trichet and Vice-President Papademos of the ECB along with the governors of all twenty-seven of the NCBs of the European Union’s member states. The General Council is mostly an advisory body, “carrying out tasks such as collecting statistical information, preparing annual reports, as well as, establishing the necessary rules for standardizing the accounting and reporting of operations undertaken by the NCBs”\(^{16}\). Important to note when looking at the General Council is that it was designed to be ended once all twenty-seven member states of the European Union join the Eurozone. This is a key because it is indicative of the aim of the Eurozone to eventually include all the members of the EU.

**Tasks of the ECB**

In understanding the ECB, its bodies, and their roles, it is vital to review the overall tasks assigned to the ECB in order to meet its objectives. First and foremost, the


ECB is in charge of the Eurozone policies. This includes the monetary policy, which means it is in charge of interest rates, the exchange rate, and fiscal policies. Also, the ECB must come up with the ways in which the policies will be implemented, as well as, monitoring them to be able to force compliance with them. The ECB is also in control of issuing banknotes. National central banks have some say in this, however, the ECB controls how many banknotes are to be actually issued to the NCBs. It is also central in determining the Eurozone’s role in foreign exchange markets and managing the foreign reserves. These tasks essentially mean that the ECB takes over the jobs that national banks once did for their countries, but for the Eurozone as a whole. They now handle policies during recessions or economic crises to maintain the strength of the euro.

The ECB’s most basic policy tool is the minimum reserve requirement. This is a way in which the ECB can control the money supply. The minimum reserve requirement forces banks to deposit a specific amount of money into ECB accounts. It is in place because banks do not want to lend all the money they receive, but rather need to keep some liquid (easily turned into cash), in order to handle withdrawals. This requirement keeps some level of money out of circulation and controls the supply.

While the minimum reserve requirement is the most basic tool the ECB has, it is not the most important in the ECB’s everyday operations. The most important tool the ECB has is short-term refinancing operations. Such a tool is needed when a bank’s customer wants to withdraw an amount that will force the bank to dip into its ECB minimum deposit, and thus, drop under the requirement. To solve this dilemma, that bank then asks the ECB for a loan. The ECB will then buy some of the bank’s
government bonds with the condition that the bank buys them back two weeks later.\textsuperscript{17} This short-term refinancing allows a bank to break the minimum reserve requirement.

\textbf{Goals of the ECB}

The goals of the ECB are entwined with the goals of the euro. Over and above all the ECB’s aims is that of price stability. In essence, this means that the ECB wants to keep inflation low. Currently, the target inflation level of the ECB is below 2\%.

Inflation is a rise in a country's general price level. This means that inflation causes the value of its coins and notes to drop. There are many problems associated with inflation that make the ECB’s mission of price stability sensible. First off, inflation can confuse consumers who do not understand purchasing power when faced with rising prices. Inflation can also make investment very difficult. If costs of investment are changing monthly, making a large investment becomes much tougher. Another problem of inflation is that it hikes the tax rate for its citizens. When property has a real value, but inflation actually results in a higher price, the owner of that property is taxed based on the price after inflation, not the real value.\textsuperscript{18}

As a stated goal, many believe that the ECB’s price stability aim is general and unspecific. Chabot suggests that central banks must choose one of two methods in actually achieving a reduction in inflation. The two methods he notes are inflation targeting and money supply targeting. According to Chabot, the ECB actually utilizes both in its policies. The former is simply targeting inflation and tracking the inflation of the economy. Money supply targeting is the process of predicting inflationary pressures

\textsuperscript{17} Chabot Pg. 80
\textsuperscript{18} Chabot Pg. 70
by following the amount of money in the economy.\textsuperscript{19} Simply put, this is the total amount of money that is liquid, thus bonds or pension are not included, while a checking account is included.

In line with the goal of price stability, the ECB has set achieving high levels of economic activity and employment as ways in which price stability can be experienced. According to the ECB site, it attains this objective by improving the transparency of the price mechanism, reducing inflation risk in interest rates, avoiding unproductive activities to hedge against negative impact of inflation or deflation, reducing distortions of inflation or deflation, and preventing arbitrary redistribution of wealth and income as a result of inflation or deflation.\textsuperscript{20} Essentially, the ECB, through its monetary policies, attempts to control price stability by avoiding inflation or deflation along with allowing consumers to easily recognize relative prices, while not getting confounded by the overall price level. The ECB’s goals are thus in line with the policies set forth for it by the Maastricht Treaty and are in accordance with the goals of the euro.

The objectives of economic growth and employment for its member states are the reason ECB aims for the ideals of price transparency and stability in its policies. In controlling the interest rates and the exchange rate, the ECB attempts to inject shocks into the Eurozone economy and stimulate it during downturns by lowering interest rates or the exchange rate value to cause an upturn or by maintaining a steady ship when times are good, as they are now. The ECB also operates at an advisory level in order to achieve these objectives. In a July 2007 speech by Jean Trichet, the ECB President states that

\textsuperscript{19} Chabot Pg. 77
\url{<http://www.ecb.int/mopo/intro/html/benefits.en.html>}.
member states should reform tax and benefit systems to increase incentives to work. He also mentions that an increase in competition can, in turn, improve employment. To meet this goal, Trichet suggests that member states deepen the EU internal market. As the speech goes on, he also stresses that, in order to do this, the responsibility lies with the member states.21 The ECB wants to enable a growth in employment and competition and can enact policies aimed at doing so, but Trichet’s speech also gives indication that it is necessary for member states to create policies that assist in doing so as well. The two must work hand-in-hand in order to achieve these aims.

**Independence of the ECB**

The design of the ECB was created to largely model the German Bundesbank. As previously stated, at its creation, is the need to remain politically independent from EU institutions and member states. This was believed by economists to be the most effective way to avoid intrusion and influence from other political actors within the European Union. The ECB is, thus, not allowed to seek advice, nor is it allowed that EU institutions or member states try to influence the ECB in its actions.22 It must be free to influence the ECB in its actions. It must be free to set policies and have the controls in place to punish political offenders in order to force compliance.

One way the ECB maintains its independence is by having its own budget that is kept apart from the EU’s budget. The funding for this budget is provided by the national

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central banks of the Eurozone. By maintaining its own budget, the ECB is able to avoid a
dependence on the EU institutions, which are reliant upon political consideration for its
funding. This separate budget also means the Eurozone members cannot offer funding to
the ECB.

Another way the ECB maintains its independence is through a security of tenure
for governors of NCBs and the Executive Board of the ECB. "The NCB governors have
a minimum term of office of five years and the Executive Board members of the ECB
have a non-renewable term of office of eight years." The only way one of these
members can be removed by the European Court of Justice is for severe misconduct.

The major reason that the ECB’s independence is so important, and thus, closely
guarded is that it protects it from acting in the short-term with things that will prove
detrimental for the long-term. Politicians too often look at reelection as their main goal,
something that is not conducive to sound long-term economic practices. In order to
maintain popularity, they will pressure for a higher money supply even if it could lead to
inflation. The short-term growth would benefit them and they would potentially be out of
office before ever having to deal with the long-term ramifications. It is precisely this
reason that an independent ECB becomes so paramount.

Anti-ECB Arguments

There are those within the European Union, and more specifically within the
Eurozone, that believe the ECB has major flaws and cannot effectively manage the euro
and its future as it functions today. This is the major question that is at the heart of this
paper and needs to be examined when a person is forming an opinion on the future

23 "Independence"
potential success or failure of the euro and the ECB. The ECB manages the euro, and thus, its effectiveness remains the centerpiece in the euro’s future.

Critics of old and new have argued that, since its creation, the ECB would not be or is not effective in handling the future of the euro. For those who criticize the ECB, the majority opinion within this group is that the ECB is far too inflexible to handle the individual demands of its member states. This means that they feel that because of the strict requirements set forth by the ECB and the Stability and Growth Pact, national governments are hamstrung from effectively reactions to the individual shocks that affect it. The SGP requires of Eurozone members a deficit of no more than 3% of GDP. This requirement, along with an inflation requirement of below 2%, can potentially put some countries at risk in the case of asymmetric shocks as the ECB detractors argue.

An asymmetric shock is a shock in which the effects are not equally distributed among the Eurozone member states. Thus, a shock may impact France much more harshly than it does Germany. Those who believe the ECB cannot work in its current state use this scenario as the main source of their argument. They ask, how can a central bank that controls the economics of fifteen member states adequately benefit each individual country?

This question has been at the heart of Nicolas Sarkozy’s recent attacks against the European Central Bank. Sarkozy, France’s “hyper-active” President, upon the start of his term, quickly began taking a very outspoken stance against the ECB. This battle between Sarkozy and the ECB arose when he immediately announced his plan to miss the 2010 target of a balance budget for France promised by former President, Jacques Chirac.24

Currently, France’s economy has been struggling as unemployment is high and growth has been slow. Sarkozy has since proposed to increase government spending in an effort to stem these problems. The resulting dilemma is that France will have to operate at a deficit level above the 3% of GDP deficit level set forth by the SGP. This is not the first time this matter has been at issue. In 2003, Germany and France were able to gain some flexibility in the SGP as they were going to incur a deficit over 3 percent for the second consecutive year. This is one of the concerns of the ECB; that it caters to the larger countries because of their power position.

Sarkozy’s concerns about France’s situation are very real, even if one disagrees with the abrasive way he is going against the ECB. France currently has an unemployment rate as high as 9%. One of the main ways Sarkozy is attempting to combat this unemployment is to make all overtime work tax-free. This tax cut is an effort to cure a nationwide laziness, as he sees it. Another form of tax cut Sarkozy introduced was an exemption for student work. Also, he proposed a 20% tax credit on mortgage interest payments. These cuts combined will cost France 11 billion euros. It is this cost, that Sarkozy states will cause France to have to exceed the acceptable deficit limit.

For Sarkozy, improving the economy of France is the most important goal, outweighing the deficit restrictions placed on it. According to him, “The ECB is fostering an ‘overvalued’ euro and damaging European manufacturers’ competitiveness and hurting growth in Europe by being too concerned with fighting inflation”.  

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falls in line with the arguments before, in the case of asymmetric shocks. Essentially, Sarkozy believes the ECB is far too inflexible in its current form to handle the individual countries’ concerns. For him, sometimes a country must incur debt in order to answer the individual needs of its economy and be able to have some of the monetary policy controls at its disposal in order to facilitate an upturn.

It was this belief that led Sarkozy to do something very unusual and controversial. On September 15, 2007, he angered the finance ministers and central bank governors by arguing the need for France to operate in a debt over the acceptable level. The highly controversial action Sarkozy took, however, was his decision to attend an Ecofin meeting on July 8 and 9. Such an action is not popular or normal. In his argument at the Ecofin meeting he attended, Sarkozy argued that “the SGP is not flexible enough when governments undertake reform to boost growth”. This act has incensed the ECB, as they see this as an attack on their independence, which was precisely Sarkozy’s intent.

Another of the French feelings in regards to the central bank is that because of its inflexibility, it is necessary for national politicians to have some say in influencing the ECB’s monetary policies. In essence, Sarkozy is attacking one of the ECB’s core features, its independence, which was strongly argued for and fiercely protected. Sarkozy believes the ECB is “excessively concerned with fighting inflation while paying little heed to purchasing power and European industrial competitiveness.” For him, the proper functioning of the ECB needs to be a combination of finance ministers and the ECB working collectively. If the ECB works collectively with the finance members, Sarkozy believes individual countries’ needs will not be ignored. This would, he argues,

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26 Sarkozy in the Hotseat with EU Partners on Budget, Deficit Policies
27 Sarkozy in the Hotseat with EU Partners on Budget, Deficit Policies
prevent the ECB from being too focused on strengthening the euro with a tight monetary policy and, in turn, would keep French exports from being strangled.

Sarkozy also recently has criticized the ECB in regards to its specific decision on interest rates. Following the U.S.'s sub-prime mortgage crisis in early August of 2007, many financial markets across the globe experienced a tailspin. To answer this, the ECB decided to inject a massive amount of funds, around 300 billion euros into the European financial market. This was in attempt to prevent a liquidity crisis and ensure that cash remained for borrowing in the short-term. The problem is that many worried that job loss and economic slow down could occur from such a large influx of euros by the ECB. This concern was because the central bank accompanied this injection by keeping interest rates steady rather than increase it from 4 percent to 4.25 percent. It was believed that the interest rate would be changed in order to stem inflation. This change in interest rate was expected to be done in order to offset the influx of the euro by preventing the economy from moving too fast.

Sarkozy is actually a defender of the interest rate hold which he has tried taking credit for. This opinion has been received as comical for the ECB as Jean Trichet got laughter at a meeting of EU finance ministers by saying, “President Sarkozy said he approved of what we did and he thought it was due to his influence”. The problem Sarkozy has still with the interest rate is that he believes the ECB should cut the interest rates. He finds it “curious” that the bank has not done so. It is Sarkozy's contention that

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28 "Sarkozy under fire for renewed ECB criticism." EurActiv September 17, 2007

this policy helps speculators and makes life hard on entrepreneurs.\textsuperscript{30} This criticism is another of Sarkozy’s barbs against the ECB about what he perceives as a hindrance of growth. Sarkozy’s response came on September 15, following a meeting of financial ministers and central bank governors.

Since becoming France’s president, Nicolas Sarkozy has often been at odds with the ECB over its decisions on interest rates. Since 2005, there have been eight interest rate increases pushing the euro to an all-time high. “When the U.S. Central Bank lowers its rates, everything picks up; when we don’t lower ours, we go down. I’m telling Mr. Trichet, look at what others are doing.”\textsuperscript{31} This statement builds on Sarkozy’s argument that the ECB is far too concerned with one objective at the expense of competition within the Eurozone, that objective being strengthening the euro, its legal mandate.

\textbf{Pro-Euro Arguments}

France and Sarkozy’s criticisms have not been well-received by member states within the Eurozone area. Instead, they have taken Sarkozy’s remarks and turned them back on France by arguing that France should be more concerned with its own economy and falling in line with the requirements of the balanced budget that was promised by former President, Jacques Chirac. Trichet has recently returned this criticism back on France saying, “Sarkozy’s tax cuts could compromise a pledge to reduce the French

\textsuperscript{30} “Sarkozy under fire for renewed ECB criticism”

budget deficit".32 France’s fellow Eurozone members have not felt that Sarkozy’s attacks are warranted or justified.

As it turns out, it has seemed that all France has done is anger its fellow members who have somewhat isolated France and begun a push to attempt to force France to fall in line with the ECB’s and SGP’s deficit requirements. Luxembourg’s Prime-Minister, Jean-Claude Juncker stressed that France needed to consolidate its own budget. “The degree of ambition by France is not entirely in line with the expectations we have. In our view, France will have to step up efforts to reduce public spending”.33

Sarkozy has also allowed for criticisms at home as a result of his battle with the ECB. Francois Hollande, the French opposition leader, believes that Sarkozy is merely trying to blame the ECB for his own mistakes in France. Hollande feels that France must adhere to the requirements it agreed upon when entering the Eurozone area and not risk alienating its fellow European member states.34 The French opposition parties feel that to push the ECB and operate at an unacceptable level of debt can lead to negative ramifications from its partners.

Most of Sarkozy’s fellow Eurozone members believe Sarkozy’s criticisms are unproductive, as well as, disagreeing with them fundamentally. At the heart of their counter-arguments is the belief that the ECB must maintain its independence. To allow the ECB to succumb to political pressures is to totally undermine its initial design. Germany has taken an especially hard line against France’s push against ECB independence. “German chancellor, Angela Merkel, has said Germany has ‘no room for

32 “Sarkozy under fire for renewed ECB criticism”
33 “Sarkozy under fire for renewed ECB criticism”
34 “Sarkozy under fire for renewed ECB criticism”
maneuver’ on the ECB’s status”. The Eurozone members believe as Trichet asserts, that “any attempt to seek to influence the ECB in the performance of its tasks is a violation of the bank’s founding documents”.

The other member states within the Eurozone area also believe that the argument that the euro is overvalued holds no merit. German finance minister, Peter Steinbruck, is not worried about the strength of the currency because he “loves a strong euro”. This German concern with France’s desire to put growth ahead of the exchange rate is because of their history with runaway inflation, in regards to the Nazis being able to take power because of the mistakes of the pre-World War II Weimar Republic. Economists also refute Sarkozy’s point because they feel the strength of the euro has done good for the EU’s economy. It has boosted consumers’ purchasing power, as well as contained inflation and kept the interest rates that Sarkozy argues are too high, lower than they would have been without the euro. According to Philip Whyte, of the “Centre for European Reform”, Sarkozy’s comments are misguided because a central bank cannot target the inflation rate and the exchange rate simultaneously. Whyte notes that EU interest rates are not any higher than they historically have been and that economic growth has not been hindered. Some economists even contend that France’s exports would not be competitive enough to sell regardless.


36 Dougherty


38 Whyte, Philip “Politics, Sarkozy and the Euro” Centre For European Reform Issue

Many believe that Sarkozy’s move is as much about posturing as anything else. They feel that in pushing the ECB so hard, Sarkozy is attempting to gain popularity within France by putting the onus on the ECB to force him to balance the budget. According to The Economist, the ECB and other Eurozone members are in no mood to roll over, however.\(^3\) Doing this allows Sarkozy to place the blame for slow economic growth in France on the European Central Bank. Sarkozy’s opponents say that “the French are alone on this issue as no one buys the French outcry of the euro undermining their exports”.\(^4\) However, by forcing the ECB to punish France with a fine, which it will need to do to set a precedent against noncompliance, Sarkozy may achieve popularity in France from the euro-skeptics.

Some also contend that Sarkozy’s outcries are an attempt by France to regain some increased relevancy within Europe. Hank Uterwedde of the German-French Institute (DFI) is of the opinion that “Sarkozy’s behavior is part of the French strategy to flex its new muscle in the EU. Ever since the failure of the French referendum on the EU constitution, Paris was almost absent in Europe”.\(^5\)

Another ground on which the ECB and its backers argue against Sarkozy’s assertion that its policy is hurting France, is that most do not agree that this is actually the case. They agree with Trichet that the intended goal of price stability actually supports growth and jobs. One of the main flaws in France’s argument is that since the adoption

\(^3\) "Free Rider not Free Market." The Economist July 10, 2007 

\(^4\) "Free Rider not Free Market"

of the euro, two million jobs have actually resulted. Also, the ECB is aware of the concerns that a strong euro might make exports more expensive on the international markets. However, currently, the fundamentals in the euro area and the European economies remain solid: profits in private companies continue to be high, balance sheets in the private sector are sound, and unemployment is at the lowest level in the past two decades, as stated by Joaquin Almunia, the EU’s Economic Affairs Commissioner.42

Some economists and Sarkozy are concerned that the euro is too strong. As the euro continues to climb against the dollar, it will raise the price of the exports of the Eurozone in foreign markets. They believe that if it rises too high could result in harm to employment and economic growth. “For France, in the area of large contracts such as nuclear energy, the TGV, and aerospace are finding it harder to compete with foreign goods coming in lower costs”.43 The growth in strength of the euro would, however, have to grow 10 percent more in order to experience these ill-effects of the euro’s rise against the dollar.

**ECB’s Successes**

The first decade of the euro has been a major success after early struggles. Since its launch in 1999, the ECB has been able to maintain low levels of inflation that are unprecedented for the European Union. Also, interest rates are historically low and have

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42 "Euro-Zone Ministers Eyeing Euro Muscle and Market Volatility" *Deutsche Welle*
September 14, 2007 <http://www.dwworld.de/dw/article0,2144,2783181,00.html>.

been consistently lower than Britain or America. By adopting a single currency, and stressing price stability, the ECB and its Eurozone members have been able to maintain stable economic conditions that individual member states could not have enjoyed.

Also, some economists believe that, despite Sarkozy’s opinion that the ECB’s policies are too inflexible, the Eurozone actually benefits from the stubbornness the ECB exercises in regards to price stability. In referencing the previously mentioned U.S. subprime mortgage crisis, the Eurozone continued to experience growth as a result of the ECB’s decision not to touch the interest rate. In comparison with the United States, where cuts have led to a deteriorating economy, the Eurozone economy experienced a three month growth of 12.1 percent, which is the fastest pace on record. Kathy Lien, chief strategist of DailyFX.com, credits Trichet and the ECB for staying put and not overreacting in the face of the crisis. It is that stubbornness that she believes has allowed the euro to continue to grow where in value other currencies have not.

The euro’s growth in strength has afforded its Eurozone some definite advantages. With raw materials being listed in terms of dollars, the costs of supplies is greatly reduced by the strength of the euro relative to the dollar. This has helped to reduce the impact of oil price increases. Also, as noted by Angela Merkel, a strong euro represents a strength in Europe and the European economy. While the ECB needs to watch just how


The euro has indeed grown significantly since its introduction. The current success of the euro indicates just how far the Eurozone has come since 1999.

Along with its strength against the dollar, the euro's, and in turn, the ECB’s success can be seen in terms of pure numbers. Since the euro was introduced as banknotes in 2002, the number of banknotes in circulation has tripled. Also, along with the circulation, the total value of those banknotes has also almost doubled as well. The euro has gone from $0.80 to a current level of around $1.50. The ECB has, likewise, been able to achieve record lows in inflation and keep interest rates at 4 percent, as was previously mentioned.

When the ECB was created, price stability was set out as its main goal. In pursuing that goal, the ECB has been strongly committed to maintaining a low inflation. These numbers indicate just how successful it has been in achieving that aim. Because of this dedication, Eurozone economies individually, and the Eurozone economy, as a whole, has surged to a place where individual national currencies could not have gone on their own.

Conclusions

At the start of my research, I hypothesized that the European Central Bank could indeed succeed as the central bank of the entire Eurozone area. Throughout all my research on the subject, I saw all the concerns that were discussed as the adoption of the euro was approaching. Many economists believed early on and predicted that the euro
was doomed for failure. It was seen as being unable to handle such a diverse array of economic needs placed on it by the adopting nations. How could one central bank simultaneously respond to the economic situations of all its member states, they asked. At the time, most economists felt that in the end it could not.

Despite these concerns, the euro and the Eurozone economy have continued to grow and experience success. The ECB, while coming under attack from Nicolas Sarkozy, continues to be a steadying influence, weighing the good of the Eurozone economy over the economy of one nation. These unwavering policy beliefs and actions have allowed it to, in effect, be flexible enough to handle the needs of member states. Countries benefit from being a part of a strong and steady economy. By setting out requirements that need to be met before entrance to the Eurozone area, the ECB puts restrictions on deficit and inflation that result in growth and success if member states adhere to them. The countries collectively meeting those restrictions breed stability. I believe that through management of price stability, the ECB will continue the success that the Eurozone is currently experiencing. It will lose ground on the dollar once the dollar rights itself, but that will help ease the strain the euro’s strength has placed on imports.

The ECB is flexible enough to handle the success of the euro and individual needs because it creates a stable environment for all of the Eurozone’s member countries. If the Eurozone allows it a means of punishing violators and deterring future violations, such as France, for failing to meet the SGP requirements, the ECB can maintain its independence and successfully manage the Eurozone economy. Thus far, Portugal is the only country to have been officially punished for SGP violations. Likewise, the precedent has been set
that bigger countries will be allowed to assert more influence and get away with maintaining deficits. In 2003, France and Germany already won some concessions that allowed them some flexibility. The only way I do not see it being successful is if countries, like France, are allowed to go unpunished for violations. If the precedent is set that politicians can operate outside of the rules of the ECB, they will and suddenly the independence and effectiveness of the ECB will be gone.

After all my research, I still believe that the euro will continue to succeed because of the strong reaction to Nicolas Sarkozy’s actions early in his tenure as France’s President. Strong stances by Germany and the other large Eurozone countries help to offset the control France might be able to exert as a larger country. The isolation that France has received from its EU partners, along with a fine, if they do in fact violate the 3% of GDP deficit limit, will effectively deter other member states from pursuing such a hard line. If the ECB has the means to enforce compliance, it can effectively handle the future success of Eurozone economic growth.

The ECB was designed for maintaining stability and lessening the hurt of economic shocks to individual countries. This means that if a country can meet the convergence criteria required for entry, then the ECB can handle enlargement of the Eurozone as it did with Cyprus and Malta. My research has indicated that because of this convergence criteria, countries enter relatively stable and are, thus, not likely to experience shocks so severe by themselves that the ECB cannot account for in acting for the Eurozone collectively. The growth in the strength of the euro justifies the assertion that the ECB is effective as a central bank. It may not respond to a specific individual country’s crisis, however, if countries adhere to its restrictions and have met the criteria
of economic stability, the ECB can handle the future of the euro. Through its maintenance of price stability, I believe the European Central bank and the euro will continue to have a future and achieve sustained economic strength.
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