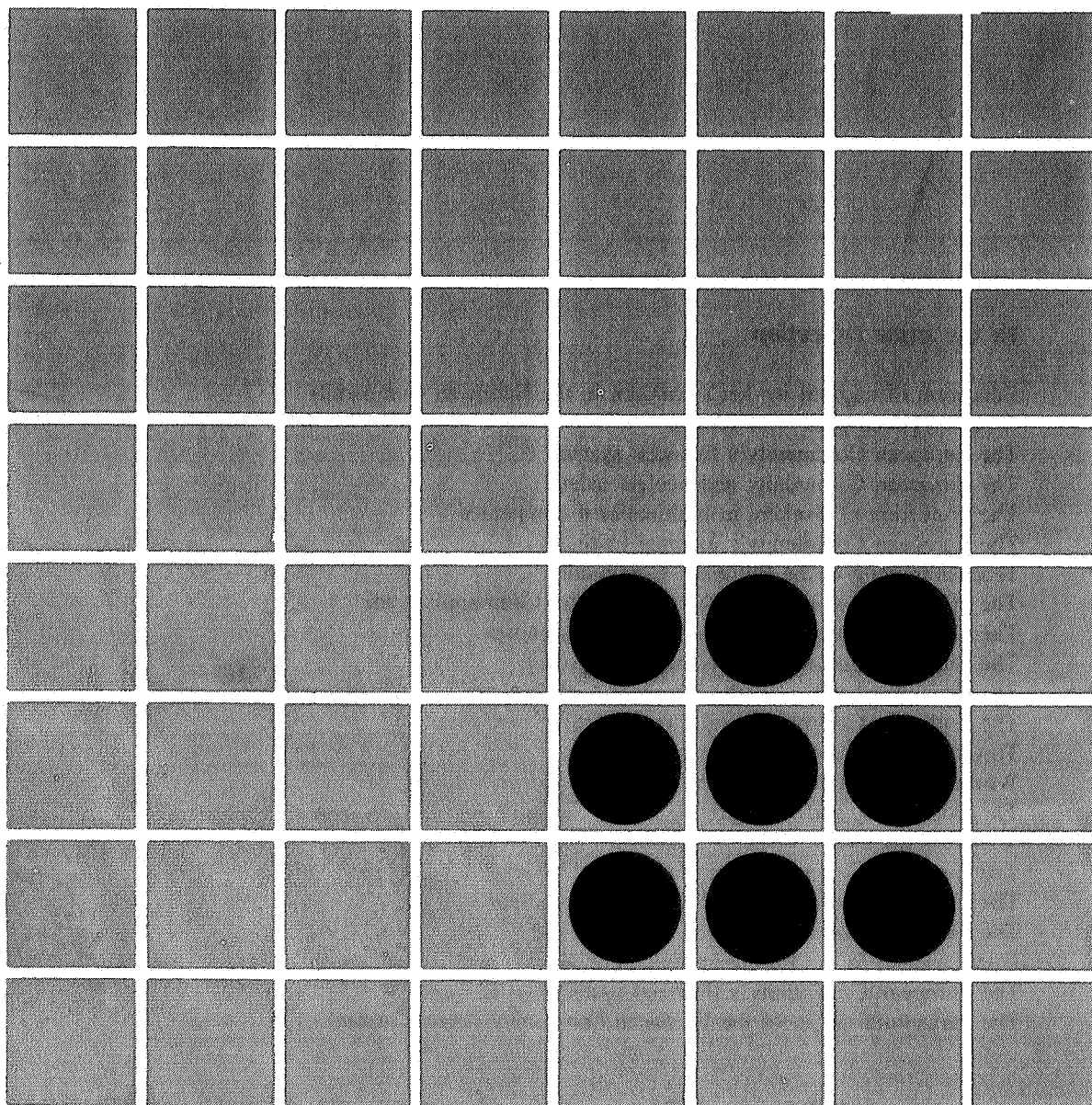


European economic and monetary union



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I — WHY DOES EUROPE NEED ECONOMIC AND MONETARY UNION?

In its most extreme form, economic and monetary union means a single economy and a single currency, with centralized economic decision-making. The architects of the European Economic Community (EEC), who drew up the founding Treaty of Rome in 1958, believed that free trade between the member countries would lead progressively to greater economic union, but they made no specific provision for its attainment. Instead they concentrated on achieving a customs union and drew up a 12-year, stage-by-stage plan for the dismantling of intra-Community customs barrier. But it soon became clear that the Community could not stop at free trade and that, for their own sakes, the Member States would have to look beyond their customs union as growing economic interdependence pointed to the need for greater economic and monetary integration.

1. Interdependence of highly industrialized economies

The customs union, achieved ahead of schedule in July 1968, was a resounding success and intra-Community trade in goods and services expanded rapidly — now accounting for half of Member States' total foreign trade as against one third in 1958. During the same period, Member States' foreign trade increased 275% in real terms and now accounts for no less than one quarter of gross Community product (ie. one quarter of the aggregate amount of all services supplied and goods produced in the nine countries). In some member countries (Ireland, Belgium, the Netherlands and Luxembourg), the share of foreign trade actually exceeds 50%, while the figure for Denmark is 33%. In the Federal Republic of Germany and the United Kingdom, the share has risen from around 20% to just under 30%, while in Italy and France the figures are around 25 and 20% respectively.

A quarter of the manufactures, farm products, and services produced by the 258 million people living in the Community are exported, and, as a result, foreign trade accounts for a quarter of the income of the Community's population. However, this crucial last 25% of their income is highly vulnerable as long as frontier posts remain in existence and as long as currency exchange rates can fluctuate sharply enough to price a country's products out of foreign markets altogether. The EEC customs union has eliminated the fear that tariff barriers between Community countries might be restored overnight against member countries' goods, perhaps depriving entire industries of their export markets. By contrast,

it has not managed to prevent excessive exchange rate fluctuations, which can have a similar, if not greater, disruptive impact on trade than customs duties. As a result, intra-Community trade is still fraught with uncertainty despite the fact that the customs union has brought about an unprecedented degree of interdependence between the Member States of what is a highly industrialized Community.

The fact that the Member States already carry out 50% of their foreign trade with one another reflects a degree of mutual reliance never before witnessed in history. Indeed, Ireland and the three Benelux countries carry out between two-thirds and three-quarters, and France, Italy, Denmark and the Federal Republic of Germany half of their trade with other member countries. The United Kingdom is the exception, transacting two-thirds of its foreign trade with non-member countries.

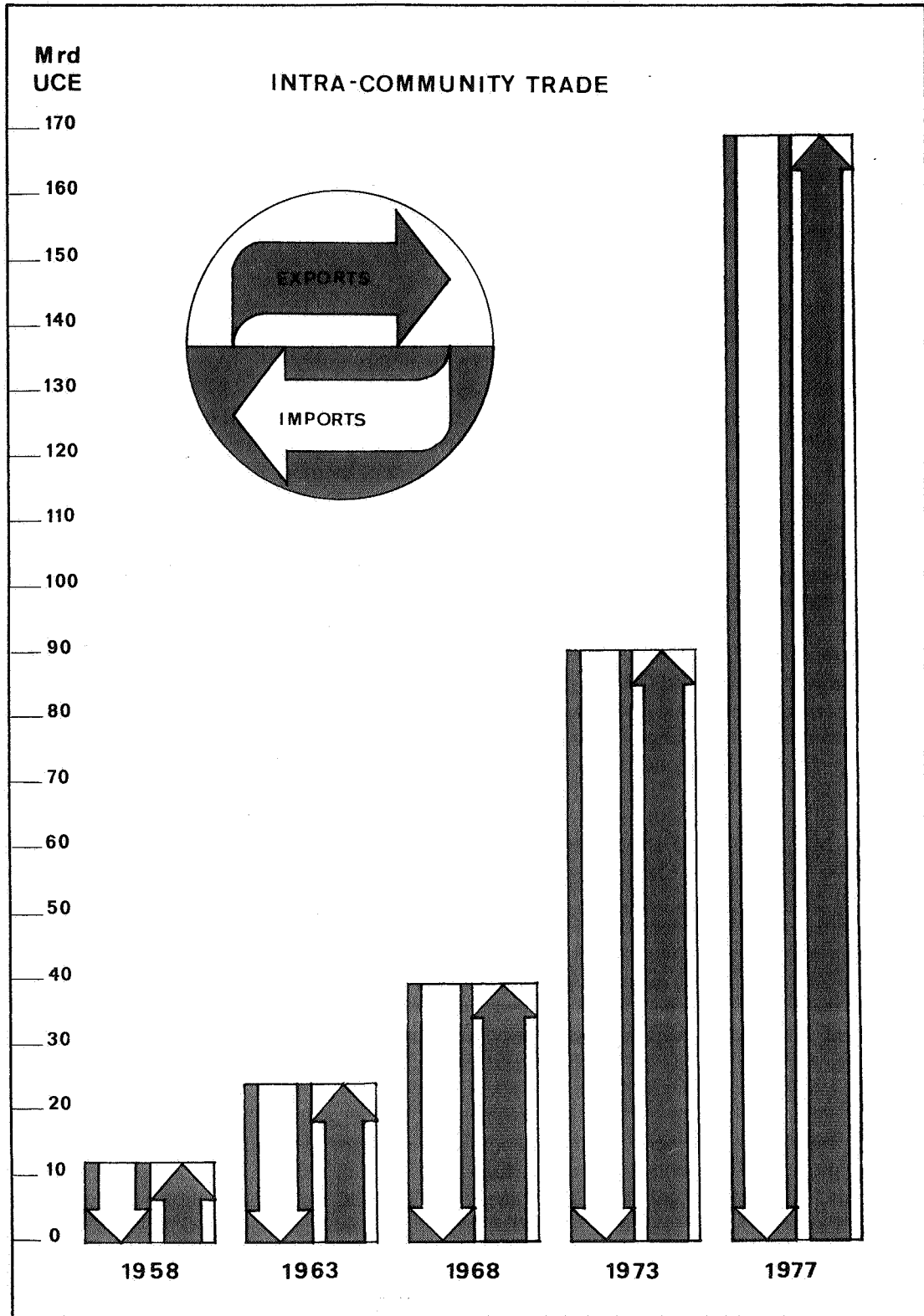
Given this high degree of interdependence, a customs union alone cannot provide the necessary long-term security: one pillar cannot suffice indefinitely to support the edifice formed by the objectives laid down in the Treaty, namely improvement and alignment of living standards and uniform development of all regions without structural imbalances and distortions to competition. To this end, what is needed is the economic union which is advocated in the Preamble to the Rome Treaty and which itself cannot be attained without monetary union. Only within such a union can the convertibility of all member countries' currencies at fixed exchange rates be guaranteed thus preventing money market fluctuations distorting competition and intra-Community trade.

The authors of the Treaty were quite content initially to urge in general terms coordination of monetary policy 'to the full extent needed for the functioning of the common market' with each Member State undertaking to 'pursue the economic policy needed to ensure the equilibrium of its overall balance of payments and to maintain confidence in its currency, while taking care to ensure a high level of employment and a stable level of prices'. In addition, each member country was to regard its exchange rate policy 'as a matter of common concern'. It was only at the summit conferences of the Heads of State or of Government held in the Hague in December 1969 and in Paris in October 1972 that the objective of creating an economic and monetary union within ten years and also of striving to achieve European Union was defined in concrete terms.

2. Securing growth and full employment

This major venture had, however, to be embarked on in the midst of a major crisis in the international monetary system by a Community that was also preparing for the accession of Denmark, the United Kingdom and Ireland. With little or no synchronization of national economies and no Community exchange rate system to ensure monetary cohesion, the currencies of the nine Member States making up the newly-enlarged Community also diverged in the wake of the successive international monetary crises.

Those Member States whose currencies were substantially revalued were compelled to adjust their economies to the higher rate, to neglect branches of the economy with lower value added and to undertake as much rationalization as possible. As a result, they now possess an efficient and modern industrial structure but for the time being there is a serious shortage of customers for their sophisticated products and services. The Member States



whose currencies lost ground during the international monetary crisis found that, on an international comparison, they had become poorer in that they had to pay more for their imports and received less for their exports. Some of them found that they could no longer earn sufficient foreign exchange to purchase the tempting goods and services their partners had to sell. Consequently, they were also unable to press ahead with investment and rationalization schemes, having instead to tighten their belts even when their partners granted them credits. The result was that strong-currency and weak-currency countries hit the trough of the recession together. They have striven — in vain — ever since to get their economies back onto a secure and steady growth path.

For the surplus countries to help pull their partners out of the recession, they need to be able to count on sustained expansion in demand at least within the Community which at the same time is not continually being wracked by monetary upheaval. Accordingly, economic and monetary policies need to be worked out in common in order to achieve growth and stability within a wider economic framework than the purely national one. Because of the Community's substantial involvement in international trade, greater growth and stability within the Community cannot only help its component member countries, but also benefit the rest of the world.

The existence of an economic and monetary union requires joint control of the money supply, that is to say of the bloodstream that feeds the circulatory flow of economic activity. It also implies joint management of the exchange rate which governs the competitiveness of Community exports and which in turn determines our economic relations with the rest of the world. Were each Member State to regulate its money supply as it saw fit, no common economic policy would be possible. The paths of our economies would be bound to diverge, and any common front shown towards the rest of the world would then certainly be more apparent than real.

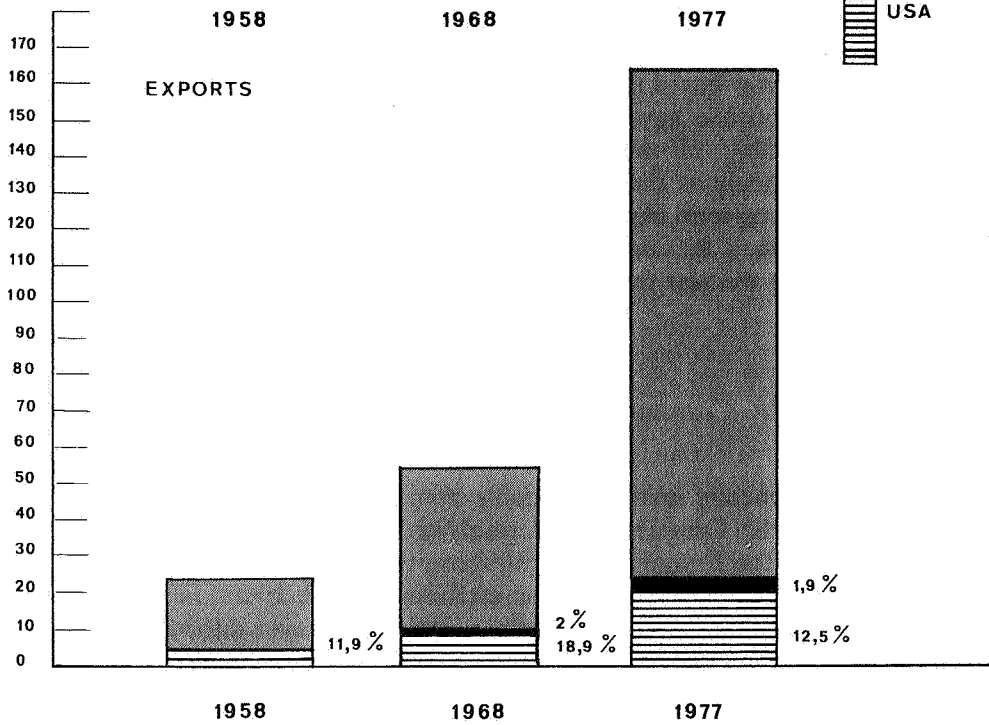
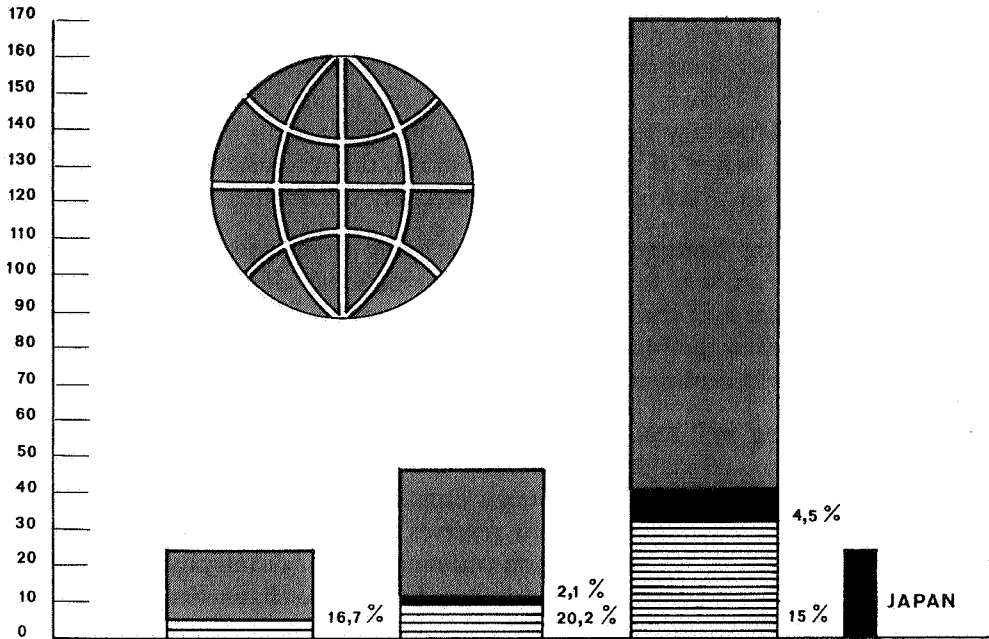
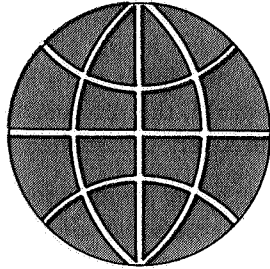
Studies by experts have shown that economic and monetary union in an advanced phase would be liable in the Community with a budget of between 5 and 7% of the combined national products and indeed, in the pre-union phase, with one of between 2 and 3% of that aggregate. A budget of this size would provide sufficient resources to finance the transfers necessary to guarantee a more consistent development of economically backward regimes and thus ensure more rapid growth for all. There would, moreover, be no need to pursue the ambitious objective of a federal state modelled on the United States, where, for historical reasons, many responsibilities have been centralized and the federal budget accounts for as much as 20% of national product.

Clearly much would depend on the economically stronger member countries being willing to pay more into the common budget than they get out of it so as to assist the weaker members. The latter, understandably, are unlikely to be enthusiastic about a Community that lacks this kind of solidarity. Accounting for just under 1% of national product, the present Community budget is still too small to allow of solidarity of this kind, especially since the bulk of the resources available has to be used, not for harmonizing structures, but for financing the common agricultural policy.

THE COMMUNITY'S IMPORTS AND EXPORTS

Mrd
UCE

IMPORTS



3. Strengthening the international monetary system

In its still incomplete form, there is another field in which the European Community is failing to play the role that the other industrialized countries and developing countries are entitled to expect of a grouping with such lofty political and economic objectives — that of external relations. The reform of the international monetary system still left the dollar as the sole world currency. Less than 4% of the world's foreign exchange reserves are held in the form of the Special Drawing Right, the neutral and jointly administered world currency of the International Monetary Fund. However, the dollar is no longer sufficiently strong to shoulder alone, on behalf of the rest of the world, the responsibilities associated with a key reserve currency in which all countries can safely denominate their assets.

On the other hand, the Community as a whole is big enough to create a second strong world currency that can help to underpin the international monetary system. The Nine constitute an entity that is of the optimum size advocated by economic theorists for a single currency area. Together the Member States could develop into one of the major currency areas in a future world economic system that has a stronger regional bias.

If there were a strong well-managed reserve currency in Europe other than the dollar, industrialized countries, oil-exporting countries and developing countries would no longer need to fear the depreciation of their foreign exchange reserves. They would be able to choose the currency in which to hold their reserves, and this would afford them a greater degree of certainty as regards the long-term planning of their development and investment programmes. Their orders would, with greater regularity, be channelled to the established industrialized countries.

The United States and Europe would be compelled to manage their currencies properly since the other countries would have a choice of reliable reserve currencies unlike under the present system of narrow-based national currencies. A policy of 'benign neglect', of which the US monetary authorities have been accused in recent years as regards the dollar, would no longer be conceivable. If the exchange rates of the major world currencies could no longer fluctuate as widely as they have done of late, this would create conditions much more favourable to long-term export business and investment decisions, thereby enhancing appreciably the prospects for continuing steady growth in a world economy free from the recessions suffered in the last few years.

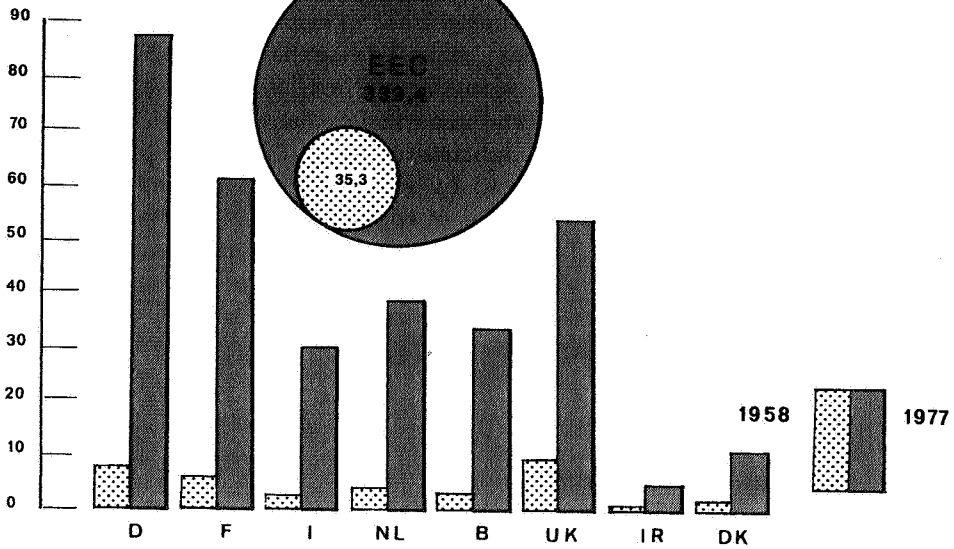
4. Safeguarding the Community's achievements to date

An economic and monetary union is desirable from the point of view of securing a steady growth path within the Community and resolving the crisis within the world monetary system. Without it, the Community's achievements to date could not be safeguarded in the long term. The general customs union established in the 1960s, including that part of it — the common market in farm products — which was most difficult to put together, would be placed in extreme jeopardy if it proves impossible to prevent Member States' currencies from developing along divergent paths. As past events have shown on more than one occasion, member countries experiencing balance of payments difficulties have had, in these circumstances, to resort to quasi-legal administrative measures to curb, or

TOTAL EC TRADE

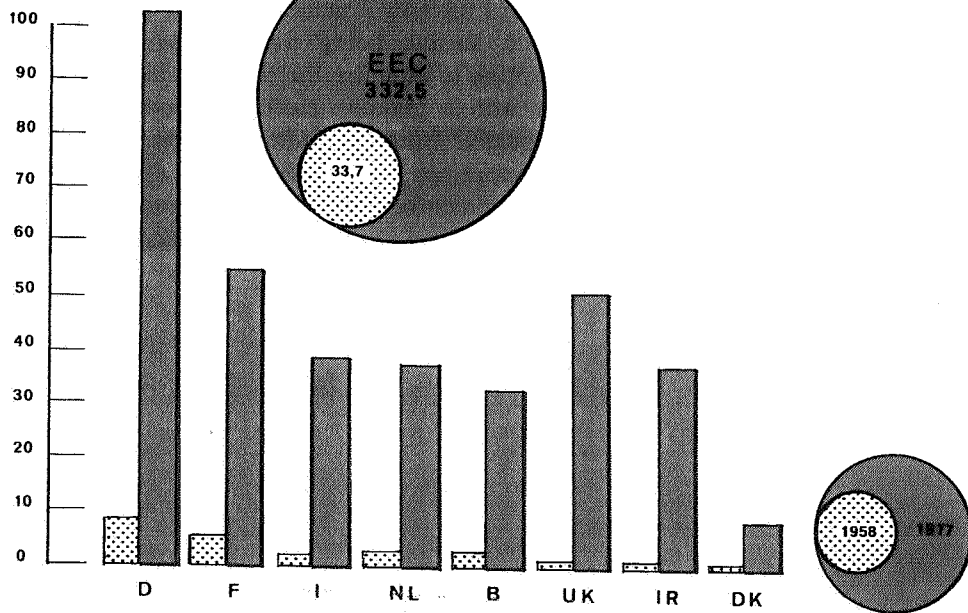
IMPORTS

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EXPORTS

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make more expensive, imports from their Community trading partners. The danger of a return to this kind of non-tariff protectionism cannot be averted unless a currency union is established within the Community.

The common market in agricultural products, which is managed on the basis of uniform prices (calculated in fixed units of account), nowadays owes its continued existence to makeshift measures such as monetary compensatory arrangements. The countries with appreciating currencies are unable to persuade their farmers readily to accept the income losses they are bound to incur in the event of revaluation vis-à-vis the unit of account. On the other hand, the countries with depreciating currencies cannot persuade their consumers readily to accept the increases in the import prices of essential foodstuffs associated with any devaluation. And so, we now find, alongside the exchange rates applied generally, special deviating increasingly over time from the normal exchange rates. This gives rise, at the dividing line between industry and agriculture — ie. the line represented by the numerous farm products that are processed by industry, ranging from tinned ham to chocolate — to distortions in competition and to complications that have to be offset by special compensatory mechanisms. The differing taxes on consumption apart, it is these mechanisms that are responsible for the fact we find ourselves not in a tax-free and duty-free economic area but in a customs union in which officials are still overworked and exporters and importers almost strangled by red tape.

5. Enlargement entails consolidation

The more countries join the Community, the more difficult it will be to hold together a customs union that has not graduated to the status of an economic and monetary union. The Community, which has set itself the task of admitting as members in the first half of the coming decade three Southern European countries (Greece, Portugal and Spain), must take the qualitative leap forward towards a monetary union if enlargement is not to result in the achievements made so far being watered down or forfeited altogether. A currency mechanism attempting to equalize the daily fluctuations of twelve currencies would have little in common with a genuine customs union and would be virtually impossible to manage. The prospective Member States hope to gain much from membership of the Community but their hopes are likely to be cruelly disappointed. In their own interests and in those of the existing member countries, the prospective members must join a fully operational Community that has set itself definite objectives and gives the countries definite objectives as well.

II — WHAT ARE THE BARRIERS TO ATTAINMENT OF ECONOMIC AND MONETARY UNION?

1. Absence of democratic structures

In its Member States' interests and in the interests of the world economy, the Community must evolve into an economic and monetary union, but this cannot be imposed on the

Community overnight by a single stroke of the pen. As past events have shown, it cannot even be achieved by way of detailed stage-by-stage plans laid down in advance.

The governments and political parties of the individual Member States still retain responsibility for the formulation of national economic policy and remain answerable to their respective electorates for the consequences, especially if these include unemployment and inflation. Before they can transfer responsibility for economic and monetary policy to European-level bodies, governments must be certain that these bodies can and will discharge these responsibilities properly. The man in the street must know for certain that his democratic rights will be safeguarded at European level too.

For this reason, direct elections to the European Parliament and a European Monetary Union are conditional upon one another. An economic and monetary union comprising states grouped together on the basis of freedom is inconceivable in the absence of direct legitimacy conferred by a body having powers of democratic control. On the other hand, a directly elected European Parliament would in the long term be relegated to a position of impotence if it had no scope for influencing the key issues of economic and monetary policy. This does not detract from the need for a European Central Bank that enjoys a sufficient degree of independence vis-à-vis the political authorities. The European Central Bank and the bodies responsible for economic policy must be established in such a way that they are able to operate at Community level as effectively as the most efficient national authorities.

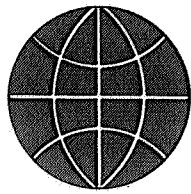
2. Marked economic disparities

In addition to gradual development of democratic structures, a further *sine qua non* for economic and monetary union is a basic consensus on the external and internal economic ends to be pursued and on the means to be employed for this purpose. Achieving such a consensus is not a straightforward matter in a Community which is marked by wide regional disparities as regards development, whose Member States have such different historical backgrounds and in which the role played by government in the economy also varies very widely from country to country. Recollecting the past, people in some countries take fright at the mere thought of unemployment while, at the same time, they take a bout of inflation fully in their stride. By contrast, people in other countries are, from experience, allergic to a rate of inflation running at more than 3 - 4%.

The countries that have already brought inflation under control are reluctant to enter into any commitments vis-à-vis the countries that are still fighting two-figure or high one-figure rates of inflation. Indeed, they are anxious lest, as part of a union, they should catch the same disease. By contrast, the countries with high rates of inflation are afraid that they might be forced too abruptly into a stable-price Community within which they would have to sacrifice their growth prospects. Their fear is that a monetary union might dash their chances of catching up economically with other countries by imposing the same pace of development for all and thus freezing existing economic disparities.

It is, however, common knowledge that high rates of inflation do not lend themselves to coordination. Nor are they — to say the least — conducive to steady growth in the long term. Therefore, there must be no slackening in the successful efforts made in recent

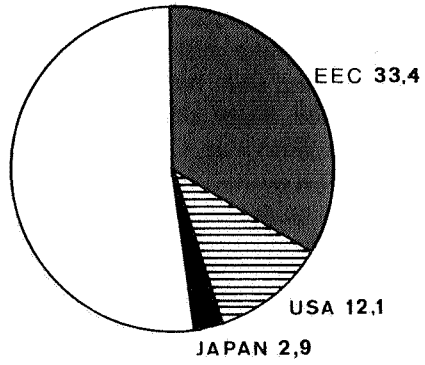
SHARE OF WORLD TRADE *



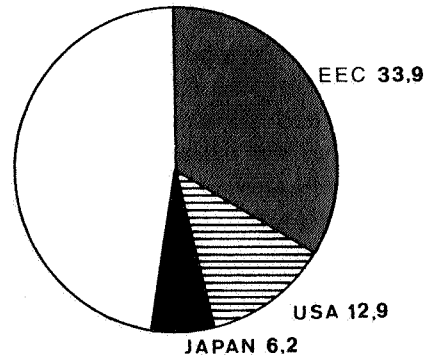
en (%)

IMPORTS

1958

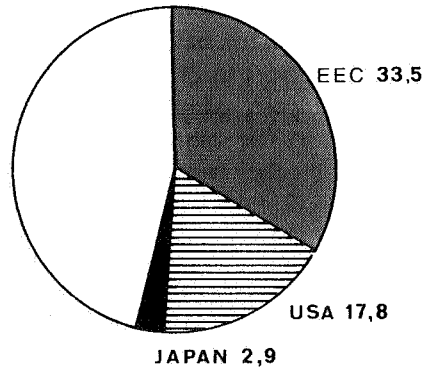


1977

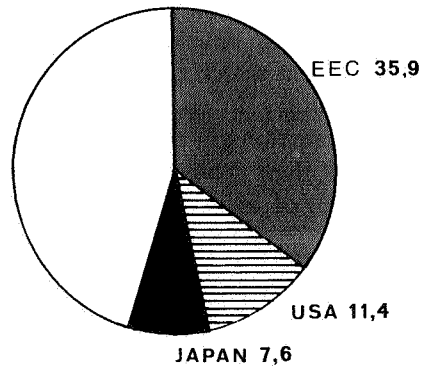


EXPORTS

1958



1977



(* including intra-Community trade)

years to bring down the rates of inflation that got out of hand during the oil crisis. The higher rates must be slowly and cautiously eased back to the average level of inflation in the stability-conscious Member States. Inflation rates can be aligned, but only downwards, on the rates recorded in the low-inflation countries. As a root cause of disease, inflation must, like any other inflammation, be attacked and cured without damaging healthy parts of the patient's body by unduly drastic action.

Once inflation has been contained and the conditions created for fostering balance of payments equilibrium, the achievement of more vigorous growth in the less developed countries will no longer be hampered by the fact that, after each promising upswing, these countries have been obliged time and time again to take deflationary action. What *will* be necessary, in these circumstances, will be for the Community to arrange the necessary transfer of resources and provide graduated investment incentives with a view to putting these countries and regions on the road to more rapid growth.

Mr Roy Jenkins, the President of the European Commission, drew attention to these interrelationships when delivering the Jean Monnet lecture to the European University Institute in Florence in October 1977. However, it was only the following year that his urgent appeal to Member States' governments to set out with determination along the road towards economic and monetary union met with a response.

3. Fears of another failure

Economists who had been asked by the European Commission in 1975 for their views on the obstacles to economic and monetary union laid the blame mainly on the Governments' lack of political will. Like showjumpers, however, Governments shy away from fences that seem too high for them. They were all the more cautious because of the failure of the first attempt made in the 1960s to achieve economic and monetary union, by way of a stage-by-stage plan. While Member States' economies could not be brought more closely into line and while growth and inflation rates diverged so widely, the Governments would not attempt to clear the major fence in front of them. They were afraid that another 'refusal' would pose a major threat to what had been achieved so far and could cost the Community a good deal of its credibility. Any new initiatives contemplated by policy-makers on the monetary front require very careful preparation and adequate safeguards ensuring support and cooperation from the 'real' economy. This is because nothing is more sensitive to inadequate improvisation than a currency.

But in April 1978, with efforts to bring Member States' inflation rates more closely into line beginning to produce effects, the President of the French Republic and the German Chancellor, at the meeting of the European Council in Copenhagen, put forward their own proposals for the establishment of a new European Monetary System (EMS) which, as we shall see, would once again embrace all Member States, with each of them playing a full part.

III — WHAT HAS ALREADY BEEN ACHIEVED?

Although the attempt to create an economic and monetary union by way of a stage-by-stage plan spanning ten years ended in failure, it would be a mistake to belittle what had been achieved even prior to launching of the European Monetary System. In the four strategic areas of monetary policy, economic policy, the efforts to build up a common capital market, and tax harmonization, substantial progress had already been made and important work carried out with a view to further development. And so the scene is set for, and the machinery is ready to launch, a new, well-prepared initiative.

1. Monetary Policy

(a) *European exchange rate system*

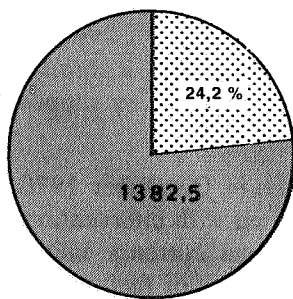
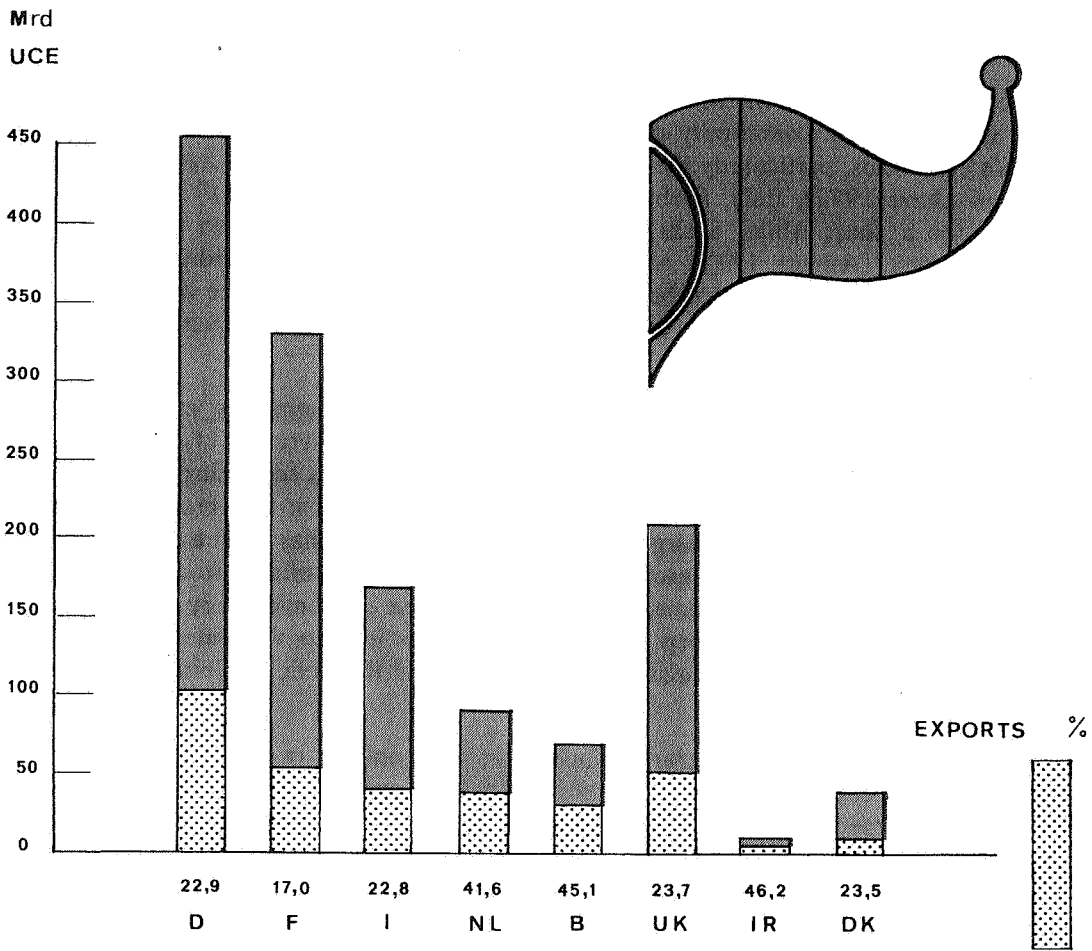
The Monetary Committee, which was set up twenty years ago, and the Committee of Governors of the Central Banks, which came into being in 1964, are the specialist bodies responsible for coordinating monetary policy within the Community. The essential component of the European exchange rate system, the currency snake, is the outcome of the first major attempt to create an economic and monetary union, launched in 1969.

At the request of the Member States' Governments, a group of experts chaired by the then Luxembourg Prime Minister and Minister for Finance, Pierre Werner, produced in 1970 a stage-by-stage plan for economic and monetary union based on a blue print previously drawn up by the European Commission.

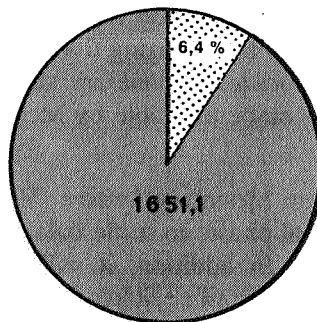
In March 1971, the Governments adopted the main short-term proposals put forward by the Group without, however, endorsing its more far-reaching longer-term political implications. The approach advocated in the Werner Plan and in the two ensuing Council Resolutions dated March 1971 and March 1972 centred on the gradual reduction of exchange rate fluctuations between Member States' currencies.

While the major world currencies were preparing in 1972/73 for the changeover to unrestricted floating, the Member States of the Community were keen to limit the margin within which their currencies were allowed to deviate from one another to 2.25%. The intention was to underpin monetary cohesion within the Community. The Member States were to be given a yardstick against which they would be able to assess their economic policies. A coordinated stabilization policy was to be pursued to ensure that the margin of only 2.25% was observed against a background of a generalized floating of currencies. Provision was made for coordinated intervention to support currencies that were temporarily in danger of being unable to keep within the lower limit of the margin of fluctuation. The central bank of a country whose currency found itself in this precarious position was to sell other currencies and purchase its own currency on the foreign exchange markets in order to hold its rate steady. The central banks in the other member countries were also committed to purchasing the threatened currency in order to support it. In the normal course of events, there was to be an unlimited obligation to intervene on the

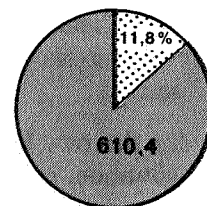
GROSS DOMESTIC PRODUCT AND EXPORTS AS % OF GDP



EEC



USA



JAPAN

exchanges. The currency credits granted to the country with the threatened currency by its partners were, as a rule, to be paid back within four to eight weeks unless, that is, they were consolidated for longer periods under the support mechanisms available. If the day-to-day fluctuations in the exchange rates of the currencies taking part in the Community exchange rate system are plotted on a graph, they produce a snake-like ribbon the width of which varies depending on the gap between the strongest and the weakest currency. Hence, the Community exchange rate system is also referred to as 'the snake'.

In practice, however, not all the Member States were able to live up to the highly ambitious objective underlying the Community exchange rate system at a time of hectic fluctuations in the world's currencies, particularly the dollar. In the course of time, the United Kingdom and Ireland (June 1972), Italy, (February 1973), and France (January 1974 and, after re-entering for a short while, again in March 1976) and the associated non-member countries, Sweden (August 1977) and Norway (December 1978), withdrew from the snake. The member countries that belonged to the snake on the eve of the changeover to the EMS were the Federal Republic of Germany, Denmark, Belgium, the Netherlands and Luxembourg.

Despite all the monetary pressures it has encountered, the Community exchange rate system has not deviated from its objectives and has ensured that these will also be adhered to within the EMS. Admittedly, the central rates of the currencies remaining in the snake have had to be adjusted on several occasions. The requirement that they must endeavour at all times to remain within the margin of fluctuation prescribed has been a great help to the countries participating in the exchange rate system in their efforts to achieve their stabilization goals. At the same time, it has made for close economic policy coordination between the countries able to keep their exchange rates in step without unduly large adjustments. This has been particularly true of the Federal Republic of Germany and the Benelux countries.

Establishment of the main monetary cooperation mechanisms in the Community — including the European Monetary Cooperation Fund, the European unit of account and the monetary support mechanisms — was attributable directly or indirectly, or linked, to the European Exchange rate system (the snake).

(b) European Monetary Cooperation Fund

The European Monetary Cooperation Fund was set up in April 1973 and since then has been concerned primarily with managing the Community exchange rate system (the snake) and the Community's short-term monetary support mechanism. It is through the Fund that the currency credits made available by Member States for currency support measures are settled.

Under the new European Monetary System (EMS) agreed in December 1978, the Fund will continue, in the initial phase, to settle balances connected with intervention and short-term monetary support. In addition, it will issue European currency units (known as 'ECU') against deposit by Member States of a given proportion of their gold and foreign exchange reserves. After two years, it is to be gradually consolidate into a genuine European Monetary Fund which will manage, on behalf of the Community, part of Member States' gold and foreign exchange reserves.

(c) Short-term monetary support and medium-term financial assistance

Close cooperation between Member States on the monetary policy front requires financing mechanisms that provide short-term support for action taken to maintain the cohesion of the European exchange rate system and that provide medium-term relief for member countries with balance of payments problems. At times of nervousness on foreign exchange markets, the exchange rates of the Member States' currencies can be kept within the desired narrow margin of fluctuation by intervention on the part of the monetary authorities. Under a system of short-term monetary support set in place as early as February 1970, the Central Banks grant one another three-month credits for the purpose of financing such support measures or helping member countries cope with temporary balance of payments deficits. These credits are renewable for a further three months.

A system of medium-term financial assistance under which foreign currency credits are granted to a country for a period of between two and five years to help it overcome balance of payments deficits was adopted in March 1971. While short-term support is granted unconditionally, medium-term balance of payments assistance is conditional upon the recipient Member State taking steps to tackle effectively the causes of its payments deficit. In December 1977, when the volume of credit available under this system was doubled, measures were also taken to ensure closer supervision of compliance with the economic policy conditions laid down in connection with the grant of credits. Credits are granted in instalments or 'tranches' and the Council announces the release of each new tranche only after it has been shown that the debtor country has, in the preceding period, complied with the economic policy conditions set. This procedure is designed to foster the adjustment process in Member States which, for balance of payments reasons, have sought assistance from their partners. Member States have not the slightest intention of operating the two support mechanisms described above in isolation from the solidarity arrangements that have been made at international level: whenever the Community's support mechanisms are to be used, account is taken of the forms of assistance that may be available from other sources, e.g. the International Monetary Fund.

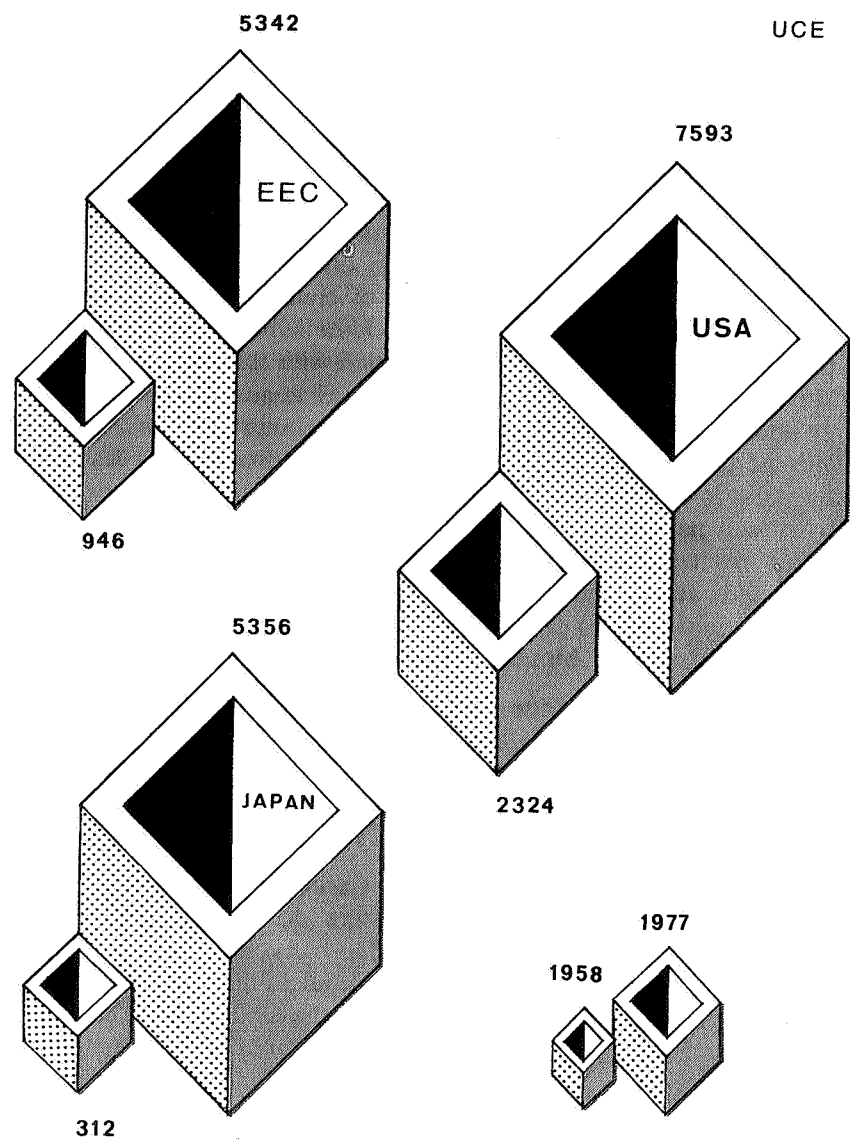
Member States' contributions to the Community support mechanisms are restricted to a specific amount. Each country is allocated quotas within which it can count on support (debtor quotas) or is itself required to provide support (creditor quotas).

A further instrument for assisting countries in balance of payments difficulties was introduced in February 1975, when, in the wake of the oil price increases, some Member States were forced to run up substantial current account deficits. Acting on a proposal from the Commission, the Council of Ministers decided to authorize the issue of Community loans on the international financial markets. Italy and Ireland received additional balance of payments assistance financed out of the yield from these loans. The Commission has also requested authorization from the Council to issue Community loans the proceeds of which will be used to tide member countries over balance of payments difficulties, even where these are no longer directly attributable to the oil price increases.

(d) European unit of account

Since its inception, the European Community has had to calculate Member States' payments to the Community budget and their reciprocal commitments and obligations by

GROSS DOMESTIC PRODUCT AT MARKET PRICES *



(* per inhabitant at current prices and exchange rates)

reference to a unit of account. At the time when exchange rates between Member States were fixed and based on a gold parity, the unit of account could be expressed by an amount fixed once and for all in terms of the national currencies. But once the leading industrialized countries decided to allow their exchange rates to fluctuate on a day-to-day basis, the Community was compelled to devise a unit of account that took account of changes in the currencies' effective values.

In April 1975, a European unit of account (EUA), made up of a composite 'basket' of the nine Member States' currencies, was introduced. Each currency was allocated a specific weighting in the basket, reflecting the economic importance of the Member State concerned. The value of the EUA — expressed in each of the Member States' currencies and in the other major international currencies on the basis of the quotations given on the official foreign exchange markets — is calculated each day by the Commission.

The Community possesses, in the shape of the EUA, a practical accounting instrument that enables it to evaluate Member States' commitments and obligations according to their real value. Slowly but surely, use of the EUA as an accounting device is being extended to an extended to an increasing number of fields. Since 1975, it has been applied in connection with the European Development Fund, set up to assist the 53 African, Caribbean and Pacific (ACP) countries that are signatories with the Community to the Lomé Convention. The European Investment Bank in Luxembourg also uses the new unit for its balance sheet and for its loan operations. In 1978, the Community drew up its own budget for the first time in EUA.

Although, at present, the EUA is first and foremost an accounting instrument, the Commission maintains interest-bearing balances expressed in EUA in banks in several Member States with a view to maintaining the value of its budget resources. The EUA is not yet used as an instrument for effecting payments. Under the new European Monetary System (EMS), agreed in December 1978, the EUA was renamed the ECU and assigned new functions. The name 'ECU' goes back to the old gold and silver coins that were in circulation in France for several hundred years.

2. Coordination of economic policy

Although currencies and the exchange rates between them determine trade relationships, they are necessarily, in their turn, a reflection of underlying economic realities. The Community endeavours to influence the exchange rates that obtain between Member States' currencies in such a way as to bring about a greater degree of convergence between national economies. Thus, monetary policy is not an end in itself but an instrument for working towards the real objective — closer alignment of national economies and removal of regional and structural disparities where the latter are incompatible with an economic union.

To further this aim, the Commission began issuing annual economic policy recommendations to Member States as early as the 1960s. Moreover, as of July 1969, a Member State contemplating important short-term economic policy decisions or measures likely to have a substantial impact on the economies of other member countries, or on the situation in the Member State concerned, has been required under a Council decision to hold prior consultations.

Since 1971, the Council has carried out a twice-yearly examination of the economic situation in the Community, based on communications from the Commission, and had drawn up short-term economic policy guidelines to be observed by the Community and by each individual Member State in the interests of harmonious economic development. Each year, the Commission presents a report on the economic situation which is adopted by the Council and is intended as a guide for Member States' economic and budgetary policy decisions.

In 1974, the objectives underlying economic policy convergence and the resulting economic policy requirements imposed on Member States were given clearer shape in a basic directive on stability, growth and full employment and in a decision concerning the convergence of economic policies. To promote closer economic policy coordination, a special Coordinating Group was set up within the Council in 1972 which brings together Commission representatives and representatives of the competent ministry in each Member State. Moreover, in 1974, the three separate committees responsible at the time for short-term economic policy, for medium-term economic policy and for budgetary policy were merged into a single committee, with sub-committees, with a view to promoting more effective coordination.

Despite these more sophisticated arrangements, the goal of improved coordination of economic policies could not be achieved during the troubled economic times that came in the wake of the oil crisis. Inflation got out of hand in 1974 and 1975 in several Member States and it was only during 1977 and 1978 that efforts made to narrow the span of inflation rates among Member States, which had ranged up to between 6% and 25%, were successful enough to halve this gap. In addition, reducing the current account disparities between the strong-currency and weak-currency member countries is proving to be a laborious process and also a painful one in that it had to be launched in 1975 at a time of declining growth rates throughout the world and had to be supported in the ensuing years when economies were recovering only at a faltering pace.

3. Structural policy

(a) Medium-term programmes (covering five years)

From 1964 onwards, the Community's medium-term and longer-term economic policy objectives have been formulated by a Medium-term Economic Policy Committee and submitted by the Commission to the Council for approval in the form of programmes. The programmes have contained not only quantitative growth targets but also qualitative structural and social policy objectives.

This has been by no means a simple matter in a Community in which some Member States placed their faith first and foremost in market forces whereas others advocated a greater degree of economic planning. Thanks to the medium-term programmes drawn up, economic forecasting techniques applied in Member States have become more comparable. Indeed, the planning work and the associated coordinating work have forged closer cross-frontier links between government departments and promoted mutual under-

standing of the different concepts and methods applied. By contrast, it has not been possible in all Member States to put fully into practice at economic policy level the objectives laid down in the medium-term programmes, and, as a result, these have been implemented only in piecemeal fashion.

(b) Regional and industrial policies

The major structural disparities between the national economies and the major regional development disparities within the individual Member States can be remedied neither by a coordinated short-term economic policy nor by medium-term programmes alone. What is needed is a genuine transfer of resources from the richer to the poorer regions of the Community.

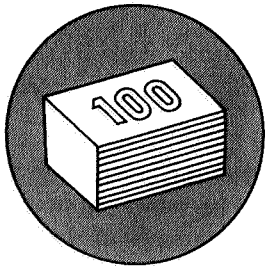
The key instrument for equalizing regional disparities is intended to be the Regional Fund, which, however, was only set up in 1974 and has since had to be content with an admittedly growing but as yet modest budget. The Fund was allotted a budget of 1 500 million units of account in its first three years of activity, from 1975 to 1977, and has a budget of 1 850 million EUA for its second three-year period of activity, from 1978 to 1980. In the Fund's early years, Community funds could normally be granted only in the form of back-up assistance for Member States' existing national development programmes. It is only in the next few years that specific measures are to be taken at Community level to improve regional structures which take greater account than in the past of the Community's objectives and needs.

Industrial policy, as well as regional policy, has an important contribution to make to structural improvement. A common market signifies change and renovation. Industries that have found themselves isolated without a future behind national frontiers must adjust to a wider, unrestricted market and encouragement must be given to the creation of new, forward-looking industries and service branches. The Community must foster the continuing adjustment process, without which uncompetitive industries would be kept artificially alive. A retreat into protectionism and the re-emergence of barriers between markets would then be unavoidable. The Community must, however, see to it that redundant workers are reabsorbed into the economic system with the help of the Social Fund and the adjustment provisions laid down in the Treaty establishing the European Coal and Steel Community. The Community has, in fact, already done a great deal to help redeploy hundreds of thousands of workers who had lost their jobs and has also helped to make life easier for workers retiring early.

(c) Financing instruments

Financing new jobs and promoting structural change requires large amounts of investment credits which, in the normal course of events, are provided by existing financial institutions and the financial institutions and the financial markets. The Community, however, must proffer its assistance and help finance the creation of new jobs at least in those areas where the Common Market is speeding up the pace of structural change and contributing to the more rapid closure of obsolete plant.

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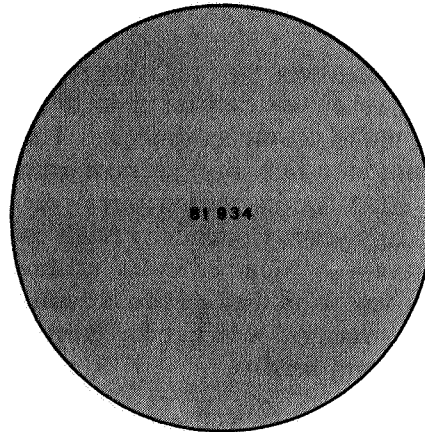
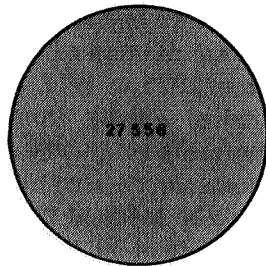
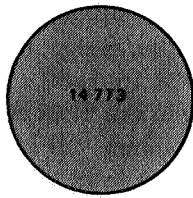


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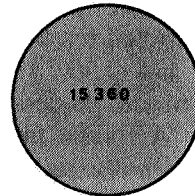
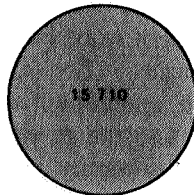
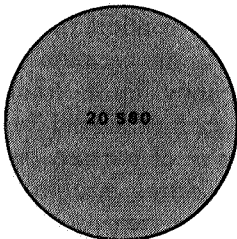
1978 *

END 1958

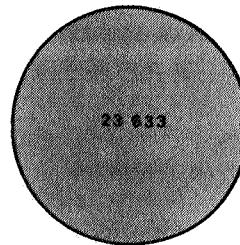
END 1968



EEC



USA



JAPAN

* JULY 1978

The European Investment Bank was set up in 1958 primarily with a view to helping to develop the Community's less favoured areas. It is designed as an instrument for financing plant modernization or conversion schemes or job-creation schemes and for providing Member States with financial assistance for joint projects of Community interest. Since its inception the EIB had granted credits of more than 10 000 million EUA and has, in recent years, stepped up its lending operations to an annual rate of around 1 500 million EUA.

Under the Treaty establishing the European Coal and Steel Community, which came into force in 1952, the then High Authority and the present Commission, as its successor, have made available to the coal and steel industry credits amounting to over 4 500 million EUA. The coal industry had to contend with major conversion difficulties in the early years, just as the steel industry also now faces a major over-capacity problem.

In 1976, the Council authorized the Commission to issue loans totalling 500 million EUA each year for the purpose of financing the construction of nuclear power stations and thereby going some way towards meeting the Community's future energy requirements.

In mid-1978, as its contribution towards combating economic stagnation and resolving the structural crises affecting several industrial sectors, the Council of Ministers authorized the Commission to float loans amounting to over 1 000 million EUA on the international financial markets. The European Investment Bank is responsible for managing the credit operations on behalf of and in conjunction with the Commission. This has provided the Community with a further — admittedly limited — source of funds to promote and facilitate structural change.

Through the Guidance and Guarantee Sections of the European Agricultural Fund, the Commission each year allocates some 1 000 million EUA to improving agricultural structures. This makes it easier for farmers to change over to modern production methods and to the kind of high-value products for which there are ready markets.

4. Free movement of capital

There can be no economic and monetary union or common market without the free movement of capital, allowing investors to move funds at will to the places where the best yields are available. In a large, free-entreprise economic entity with balanced structures maximum return on investment should reflect maximum economic utility.

The Community, however, still has a long way to go before it can be described as a common market with balanced structures. The countries with the weaker structures and currencies thus attempt to curb the outflow of domestic savings by imposing bans and controls on such movements of capital. Their currencies and economic prospects are not sufficiently sound and attractive to encourage an inflow of enough private capital from other Member States. Since it has not been possible to bring economic structures more closely into line, the liberalization of capital movements has also not proceeded much beyond the initial measures provided for in the two relevant directives adopted in 1960 and 1962. Although these directives have facilitated trade between Member States, cross-frontier payments of wages and salaries and of fees, cross-frontier payments effected in respect of services rendered, and the granting of short-term and medium-term trade

credits by prohibiting restrictions on such capital movements, the granting of financial credits for industrial investments, capital investments and cross-frontier dealings in quoted securities have still not been entirely liberalized.

Instead of forming a common capital market on which surplus savings in the richer countries and regions are transferred to the poorer countries and regions, national markets are still isolated from one another. As a result, the so-called Euromarkets, on which operations involving international foreign currency credits are transacted, have become the main channel for capital movements. On these markets, however, weak-currency countries have to borrow in hard currencies since their own vulnerable currencies are not acceptable to the market. Further progress towards liberalization of capital movements will be achieved only gradually, as progress is made in the other fields appertaining to economic and monetary union.

5. Tax harmonization

In the field of tax harmonization too, there has really been only one important milestone, namely the abolition of the cumulative turnover tax, the full burden of which fell on every product at every level of distribution and which served to restrict and distort most drastically not only free movement of goods but also competition. The cumulative turnover taxes have been replaced by value added tax systems in all Member States. Value added tax (VAT) is levied at each distribution level only on the increase in value contributed at that level and the overall burden of taxation is no longer a function of the number of distribution levels a product passes through before reaching the ultimate consumer.

But there is still a long way to go before VAT systems and rates are harmonized. The standard rate of tax in the individual Member States ranges between 10% and 23%. There are even greater disparities as regards exemptions, reduced rates for essential goods and increased rates for luxury goods. These remaining disparities and the various excise duties, particularly on spirits, tobacco and oil, continue to hamper the free movement of goods. They are the cause of the queues of lorries we see at the Community's internal frontiers and of the customs checks imposed on travellers since these tax differentials must be accounted for at frontiers by tax refunds in the exporting country and taxation in the importing country.

For ordinary travellers, the Commission has been able to introduce exemptions, at least for the quantities normally allowed through for tourists.

For revenue purposes, some member countries prefer to rely most on indirect taxes on consumption and apply correspondingly high VAT and excise duty rates, while others derive the bulk of their revenue from high direct taxes on income and wealth. These differences of emphasis are determined by deep-rooted historical and psychological considerations. They can be remedied only if economic structures are gradually brought more closely into line.

No action has yet been possible as regards harmonization of direct taxes on firms, particularly corporation tax and depreciation rules. The Commission has had to con-

centrate, first of all, on those direct taxes that constituted substantial barriers to the free movement of capital and to investment. For this reason, it is focusing its efforts on abolishing forms of tax discrimination between parent companies and subsidiaries operating in different member countries, on taxes imposed on dividends, on the special forms of withholding tax and on combating tax avoidance and evasion in so far as such efforts can be of value in helping to complete a customs union which has still not been taken on to the stage of economic and monetary union.

IV — THE NEW EUROPEAN MONETARY SYSTEM (EMS)

1. Return to monetary cohesion

Implementation of the stage-by-stage plan for creating an economic and monetary union out of the Community as it stands at present has not proved possible during the 1970s. The difficulties the individual Member States have had to contend with have shown that economic and monetary union is now neither less important nor less essential than before. With half of their imports and exports coming from or going to their Community partners and with their foreign trade accounting for one-quarter of the Community's national product, the member countries are already heavily dependent upon one another and the interpenetration of their economies is far advanced. The Community's internal trading area, the future of which is in our own hands, must now be made secure and the danger of a retreat into protectionism within Europe, which looms larger with every day of delay, removed once and for all.

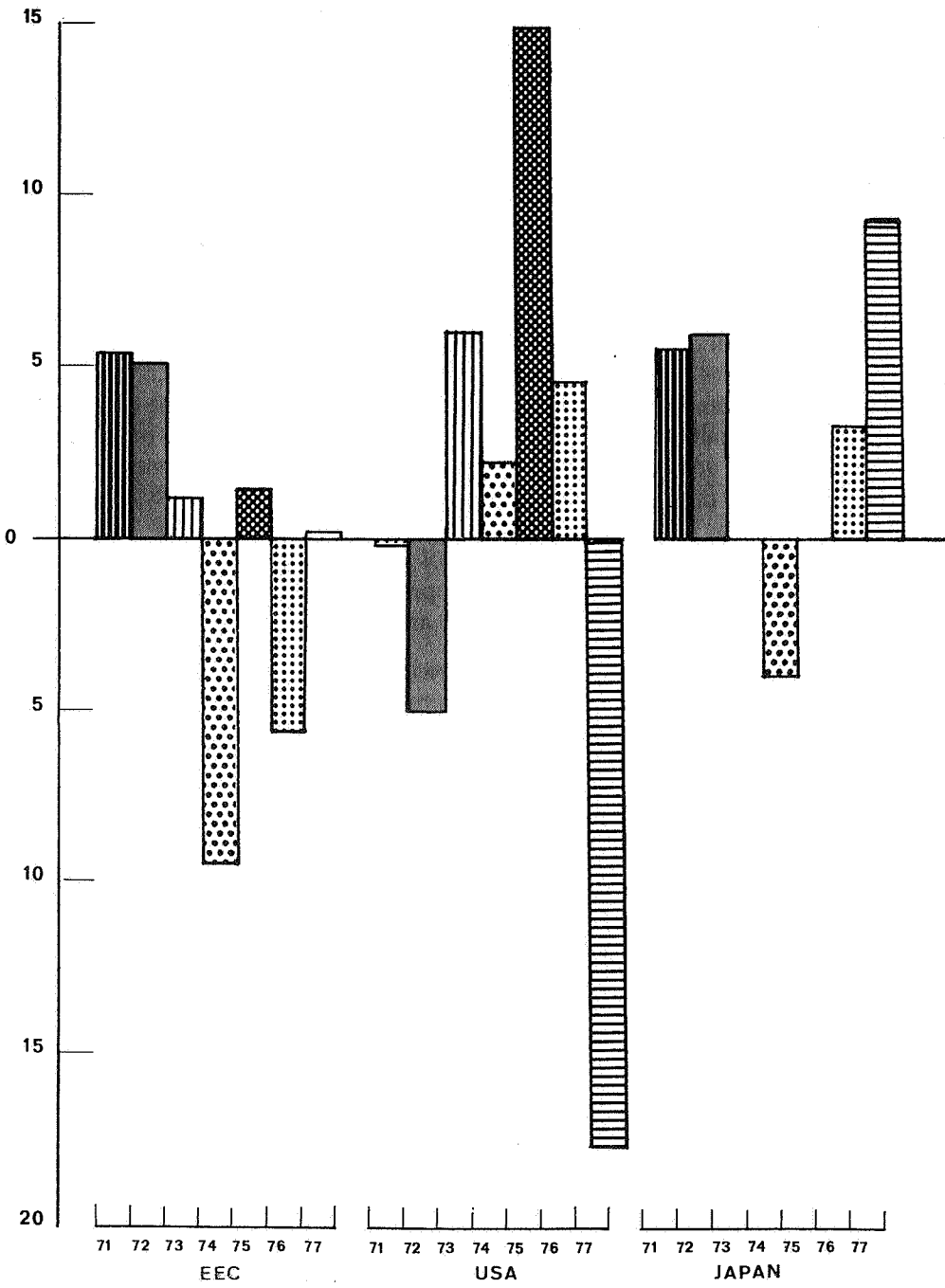
The Community must return to a path of growth and price stability. Without stability, Member States will struggle along divergent paths as inflation increasingly undermines the prosperity of some of them without the others seeing any improvement in their situation. This is because without adequate growth the weak-currency countries are unable to purchase enough goods and services from their partners to prevent the mass of unemployed expanding throughout the Community. In recent years, some member countries have had, time and time again, to cut back on the orders they placed with their partners because they were running out of the currency reserves needed to settle invoices. Inexorably, workers in other member countries lost their jobs.

Member countries could, simply by pooling part of their reserves, avert the most damaging consequences of permanent stop-go policies as a result of which several member countries are, in effect, having to live from hand to mouth.

The year 1977 brought a revival of interest in the objective of economic and monetary union — an ambition which had appeared to have been shelved. Following the watershed speech by Commission President, Roy Jenkins, in Florence, which was designed to remind Member States' Governments of the merits of a single currency, the Commission laid before the Council at the end of 1977 an action programme for the years ahead. This programme was aimed at steering the Community back onto a path of growth and stability — the prerequisites for any monetary union — by way of closer coordination of economic and monetary policies.

BALANCE OF PAYMENTS (current account)

Mrd
UCE



The year 1978 then saw the launching of a practical — albeit limited — initiative by the French President and the German Chancellor to set up a European Monetary System. All three meetings of the European Council of Heads of State or Government held in 1978 were dominated by this subject. At the April meeting in Copenhagen, the plan was discussed for the first time. At the July meeting in Bremen, basic features were approved and, at the December meeting in Brussels, the resolution was adopted in which the Heads of State or Government of all nine countries expressed their support for the new system.

The new European Monetary System must not be confused with the projected economic and monetary union, let alone with a common currency. Its immediate limited objective is to create a zone of monetary stability in Europe by closer monetary policy cooperation. It will initially be used like the European exchange rate system as an instrument for combating excessive fluctuations in exchange rates and hence for reducing a factor of uncertainty in trade and payments between Member States. In addition, through a more stable exchange rate policy, it will endeavour to create room for an economic policy geared to achieving a greater measure of internal and external stability for both deficit and surplus countries.

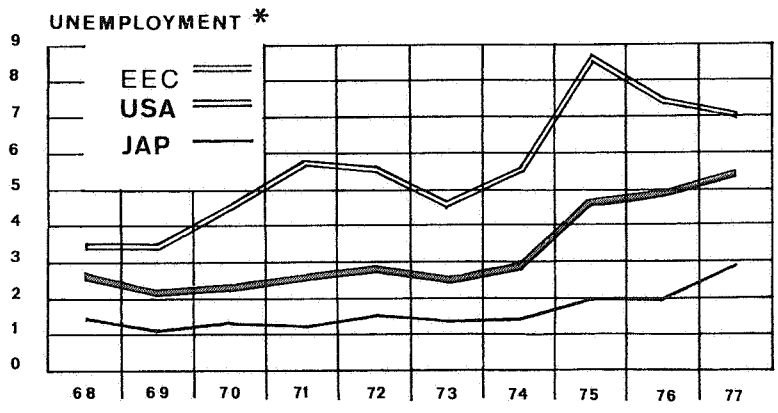
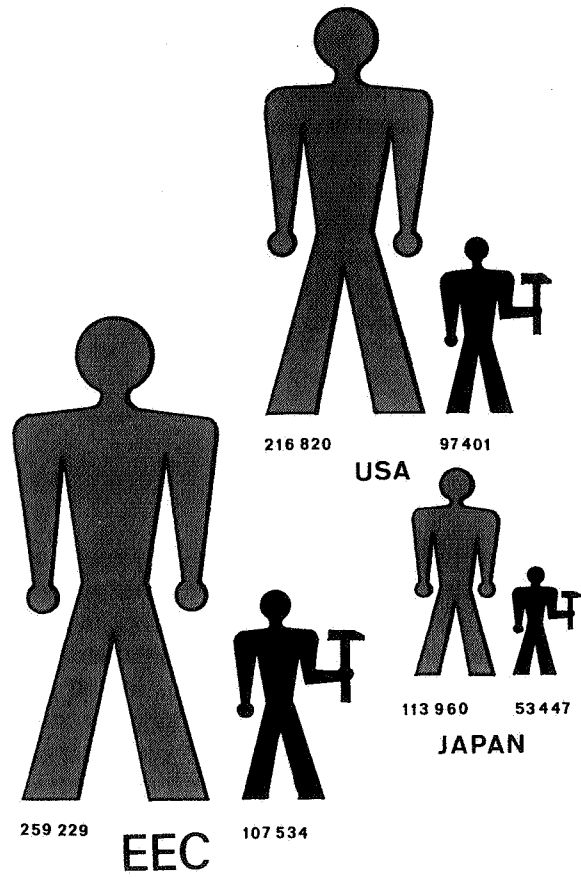
2. The ECU as the pillar of the system

The system combines well-tried practices from the currency snake and a new ECU-based procedure for keeping currencies more closely in line than previously and for averting divergences. The ECU, which lies at the centre of the European Monetary System, will be used as the denominator or numéraire for the exchange rate mechanism, as the basis for a divergence indicator, as the denominator for operations in the intervention and credit mechanisms and as a means of settlement between monetary authorities. It will thus become the new European unit of account, which is not yet a generally accepted means of payment but is intended to be used increasingly as a means of payment, initially between Member States' Central Banks and subsequently perhaps in connection with international capital movements. The ECU is a basket of the nine Member States' currencies, with the amount of each currency in the basket corresponding to the economic importance of the country in question. In this way, the weight of each currency influences the value of the ECU basket, which is calculated each day by the Commission on the basis of quotations on the relevant national foreign exchange markets. As in the snake, a grid of bilateral exchange rates has been established restricting the margin of fluctuation to 2.25% either way. Only Italy has opted to apply initially a wider margin of 6%. When a currency is threatening to leave the grid as its exchange rate fluctuates by more than 2.25% (or 6% in the case of Italy), this currency must be supported through intervention, i.e. it must be bought by the central bank responsible for the currency which has risen to the upper limit of its margin.

In addition to this conventional policy of intervention, provision has, however, been made for preventive measures where a currency deviates unduly (by more than 75% of its margin) from its average ECU rate. When this threshold of divergence is crossed, the country concerned is expected to correct the situation by taking appropriate measures which can cover intervention in various currencies, domestic economic policy measures (eg. in respect of interest rates), other economic policy measures (eg. in the field of taxation or

POPULATION AND CIVILIAN LABOUR FORCE (1977)

en 1000



(* as % of civilian labour force)

incomes policy) and, lastly, changes in the central rates themselves. Changes in the central rate must not become the rule when a country experiences difficulties. Such changes should be carried out however, where underlying economic circumstances have altered: they should not be delayed or ruled out for reasons of prestige.

The Central Banks have not yet had any experience of operating the new mechanism designed to prevent the development of any unduly wide fluctuations. For this reason, the system will be reviewed after six months. This is all the more important because one Member State, the United Kingdom, has approved, and belongs to, the new system but declined to take part in the intervention mechanism from the start.

The funds available for defensive action have been increased significantly under the new system. Moreover, central banks' currency debts arising from intervention now need only be settled after 45 days rather than the 30 days required before. At the same time short-term monetary support can now be extended for two further three-month periods instead of one, with the result that such support can now be granted for nine months in all. The amount available for short-term support has been increased to 14 000 million ECU and that for medium-term financial assistance, granted for between two and five years, to 11 000 million ECU. This means that the potential volume of credits available under the support mechanisms for defending currencies' central rates against speculation has been increased almost three-fold. It is now easier to repay currency credits since all participating Member States have agreed to deposit with the European Monetary Cooperation Fund, on loan, 20% of their gold and dollar reserves and receive in return a corresponding amount of ECU. They can use the latter to repay 50% of their debts while the remainder must be covered from national reserves.

The pooling of 20% of Member States' gold and dollar reserves is intended as an initial step towards an European Monetary Fund proper, to be set up two years after the establishment of the EMS. The reserves in this Fund, which will for an initial period remain the property of Member States' Central Banks, are to be available to the Community without any restrictions, for use as reserve assets and as a means of settlement. Once part of the currency reserves is managed jointly, the Community will also have to pursue a common foreign exchange policy towards non-member countries' currencies, in particular the dollar. In this way, the ECU will gradually help the Community to play an enlarged role in the field of international monetary policy and in the world economy.

3. The Community's contribution towards stabilizing the world economy

All the Member States have been surprised by the sharp decline in the value of the dollar, a sobering experience which impaired economic activity in the Community particularly in 1977 and which has greatly impeded recovery. The call by the President of the European Commission for a renewed and determined attempt to achieve economic and monetary union has struck a response, although the new European Monetary System is no more than a first step along the road to a genuine monetary union. It was acknowledged by the Heads of State or Government that the Community must itself develop the necessary monetary and economic policy structures to ensure that it will no longer be at the mercy of external developments over which its individual member countries have only a small degree of control.

With the first direct elections to the European Parliament, scheduled for June 1979, the Community will be endowed with a democratic structure. Steps must then be taken to ensure that the parliamentary control exercised until now at national level will not be dissipated as a result of the transfer of responsibilities to European level but will be effectively safeguarded within a wider framework.

The few years remaining before further enlargement of the Community must be used to ensure that the Community in the 1980s not only becomes a geographically larger entity but is also strengthened internally. The Community must itself develop the structures that will permit it to pursue a short-term economic policy of its own and to combat both the present unwillingness to invest and the current level of unemployment. The rest of the world expects the Community to play an active part in helping the world economy to climb out of recession. No-one can or will absolve the Nine of this responsibility.

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This booklet gives the basic facts about European economic and monetary union. It traces the history, the ideals and the aspirations of this great project up to the point when practical action was taken with the creation of a European monetary system in early 1979.