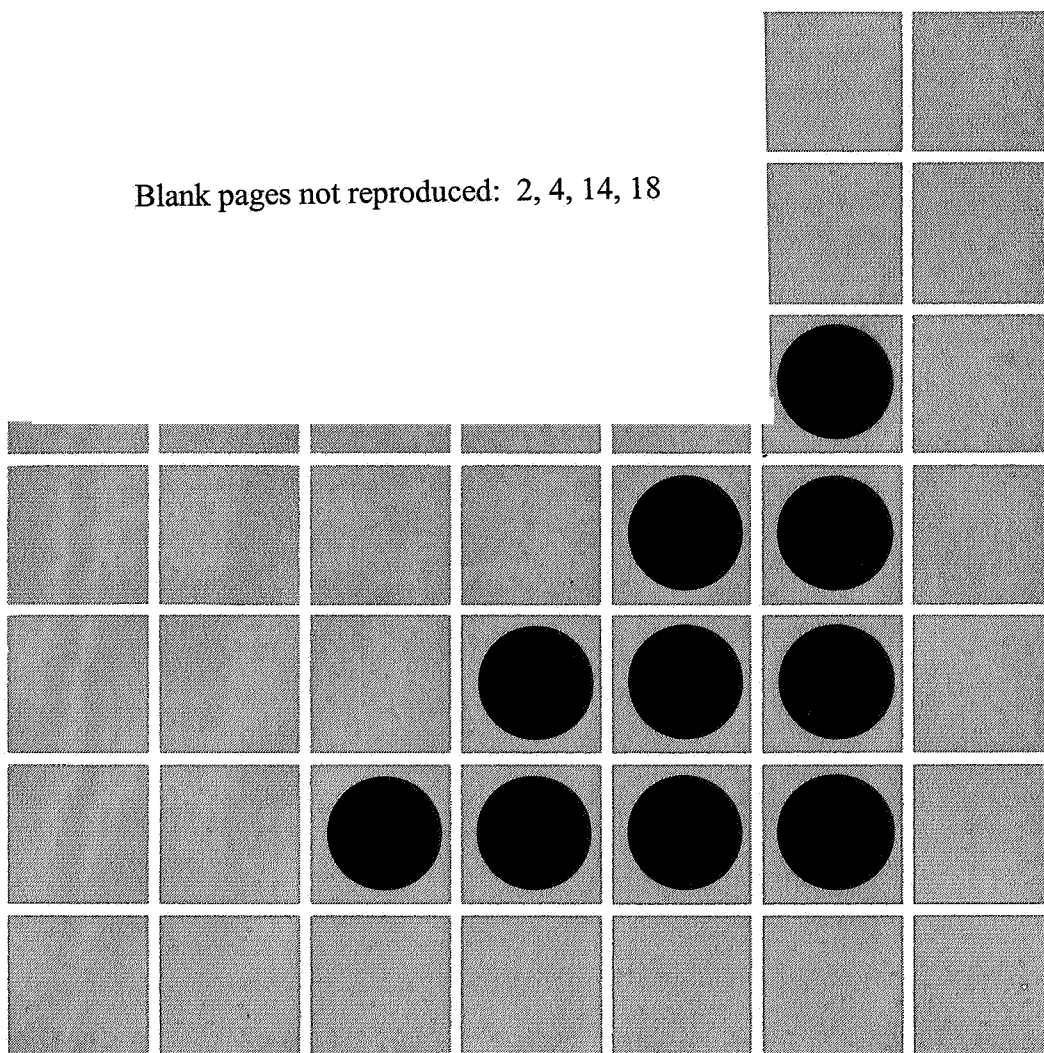


EUROPEAN ECONOMIC AND MONETARY UNION

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European economic and monetary union

Second edition

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I — Why does Europe need an economic and monetary union?

Agreements, even treaties between States, often overlook the essential point. This frequently becomes clear only when it is too late. At that stage it is difficult to repair the omission. In the mid-1950s the architects of the Treaty establishing the European Economic Community drew up a plan for dismantling intra-Community customs barriers, which was carefully staged over 12 years. In the period of uninterrupted growth of the 1960s, the target was reached ahead of schedule.

1. *Interdependence of highly industrialized economies*

The customs union has been a resounding success and intra-Community trade in goods and services has expanded rapidly: it now accounts for half of Member States' total foreign trade, as against one third in 1958. During the same period Member States' foreign trade increased threefold, and now accounts for no less than one quarter of gross Community product (i.e. of the aggregate amount of services supplied and goods produced in the Community). In some Member States (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 this figure has risen from around 20% to just under 30%, in Italy it is around 25%, while in France it is 20%.

A quarter of the manufactures, farm products and services produced by the 300 million people living in the Community are exported, so that 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. Where it is properly applied, without reliance on non-tariff barriers, the 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. But it has not managed to prevent excessive exchange-rate fluctuations, which can have as disruptive an impact on trade as customs duties can, if not more. As a result, intra-Community trade is still faced 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 more than 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, the Federal Republic of Germany and Greece half of their trade with other member countries. The United Kingdom is the exception, still transacting 60% of its foreign trade with non-member countries, but the Community share of that country's foreign trade has already increased substantially.

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 of composition. 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, with the change-over to a single currency becoming a mere formality that could be freely agreed upon.

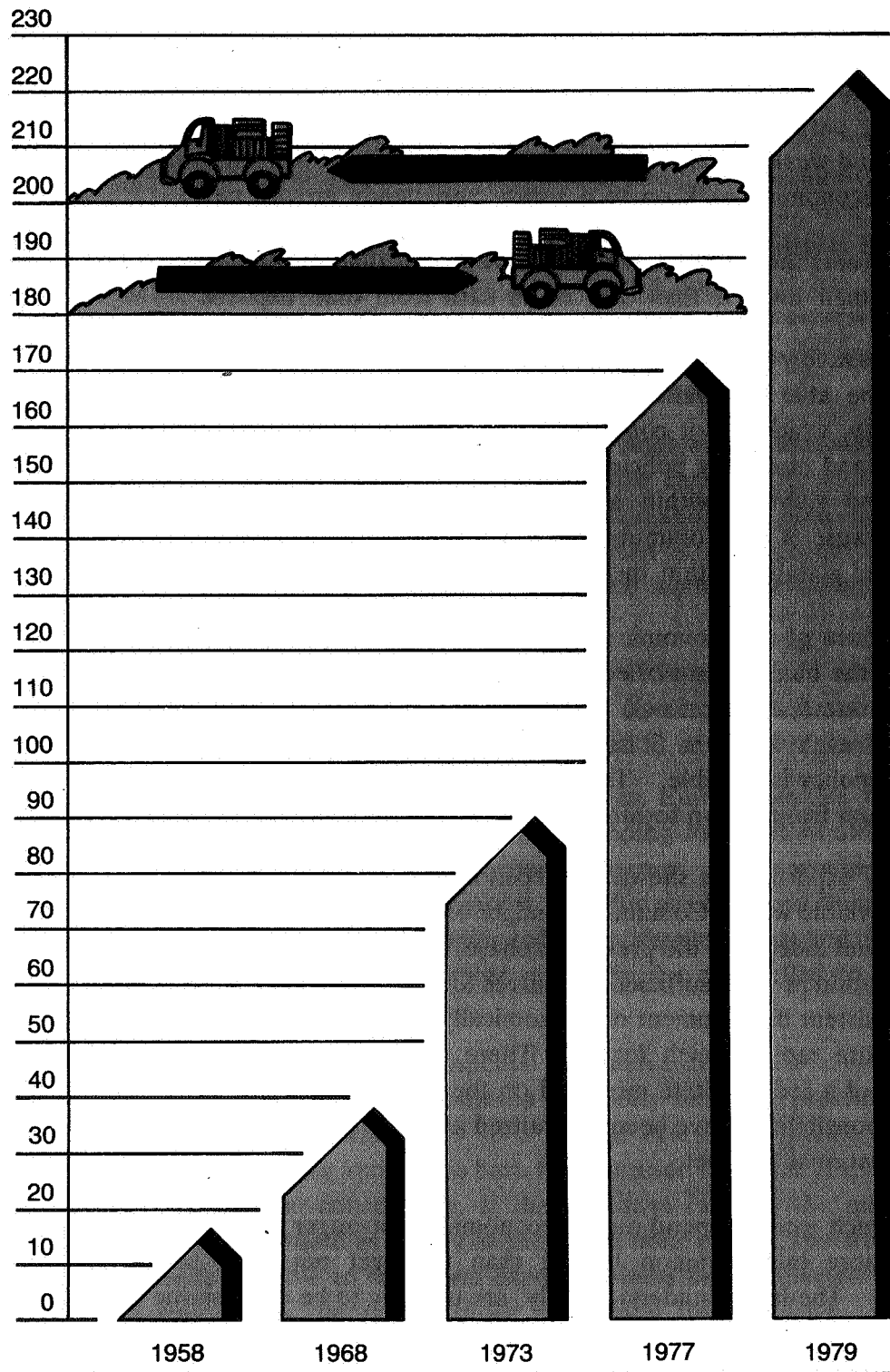
The authors of the Treaty were quite content initially to urge in general terms coordination of monetary policy 'to the full extent needed for the functioning of the common market' with each Member State undertaking to 'pursue the economic policy needed to ensure the equilibrium of its overall balance 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 Government held in The Hague in December 1969 and in Paris in October 1972 that objective of creating an economic and monetary union within 10 years and also of striving to achieve European Union was defined in concrete terms.

2. Safeguarding growth and employment

This major venture had, however, to be embarked on, between 1971 and 1973, 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 there is a shortage of customers for their sophisticated products and services.

INTRA-COMMUNITY TRADE (1 000 million ECU)



Source : Eurostat

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, and instead had to tighten their belts even when their partners granted them credits. The result was that the recession hit strong-currency and weak-currency countries alike. They have striven — in vain — ever since to get their economies back on to a secure and steady growth path.

In recent years the oil price increases have meant that all Member States have had to pay more for their imports than they could earn from their exports.

For the relatively stronger countries to help pull their partners out of the recession, they need to be able to count on a sustained expansion in demand, at least within the Community, which is not continually undermined 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 would also benefit the rest of the world.

The existence of an economic and monetary union requires joint control of the money supply — the bloodstream of economic activity. It also implies joint management of the exchange rate (i.e. of prices), which determines economic relations with the rest of the world. If each Member State regulates its money supply as it sees fit, no common economic policy is possible. The paths of our economies would be bound to diverge, and any common front shown towards the rest of the world would be more apparent than real.

Studies by experts have shown that economic and monetary union at an advanced stage would be viable with a Community 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%. A budget of this size would provide sufficient resources to finance the transfers necessary to guarantee a more consistent development of economically backward parts of the Community and thus ensure more rapid growth for all. There would 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 common budget than they get out of it so as to assist weaker members. The latter, understandably, are unlikely to be enthusiastic about a Community that lacks this kind of solidarity. Accounting for 1% of national product, the present Community budget is still too small to allow for solidarity of this kind, especially since the bulk of the resources available has to be used, not for harmonizing structures, but for maintaining balance on agricultural markets.

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 main reserve 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. Efforts in the International Monetary Fund to make surplus dollar reserves exchangeable against Special Drawing Rights have so far been unsuccessful. In practice a system of multiple reserve currencies has developed. Whether or not the monetary authorities concerned are in favour, other central banks use German marks, yen and Swiss francs as reserve currencies besides the dollar, while the importance of the pound sterling as a reserve currency has declined.

But a system balanced on one big pillar and several lesser ones will be unsteady. It is in constant danger of being shaken as reserves shift from one currency to another. Any weakness in the US economy prompts investors to unload dollars and hold more yen or German marks and Swiss francs. Conversely, if the German current account moves into deficit, marks are sold and the rate of the mark plummets against the dollar.

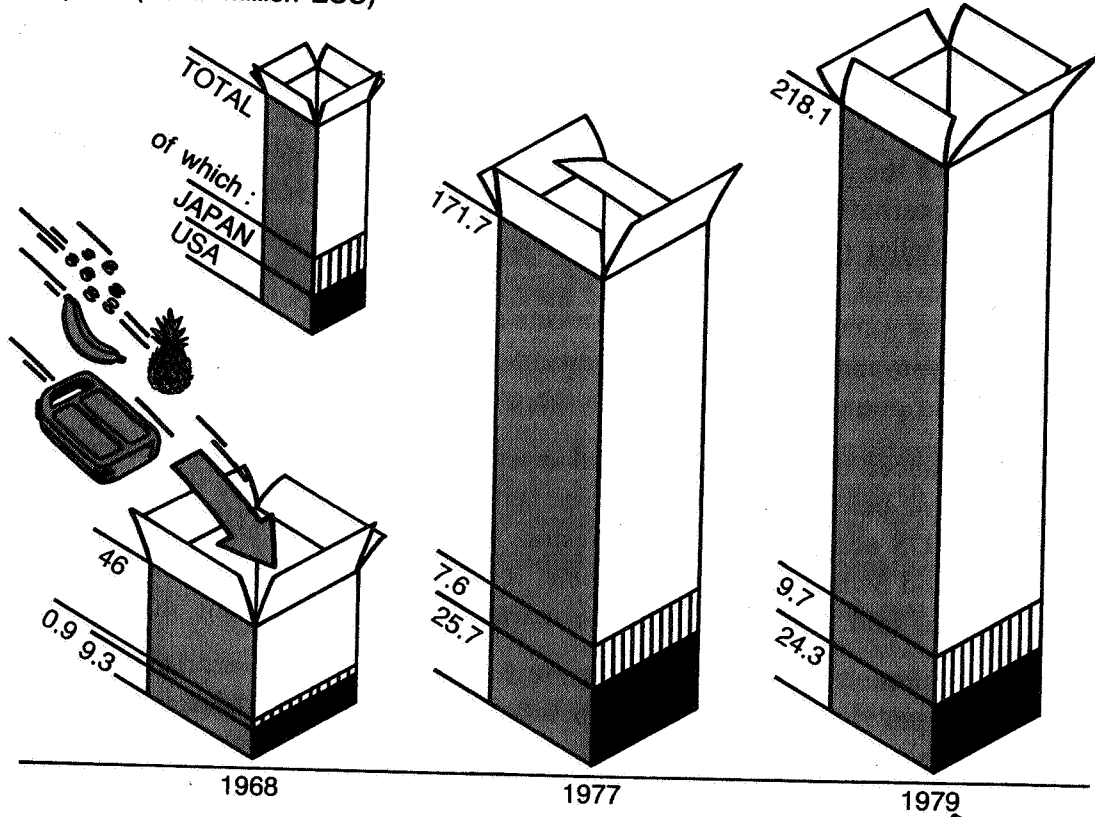
However the Community as a whole is big enough to create a second strong world currency that could underpin the international monetary system. It is of the size advocated by economic theorists for a single currency area, and could develop into one of the major currency areas in a future world economic system that has a stronger regional bias.

If there were a strong well-managed reserve currency in Europe besides 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 in the long-term planning of their development and investment programmes. Their orders would, with greater regularity, be channelled to the established industrialized countries.

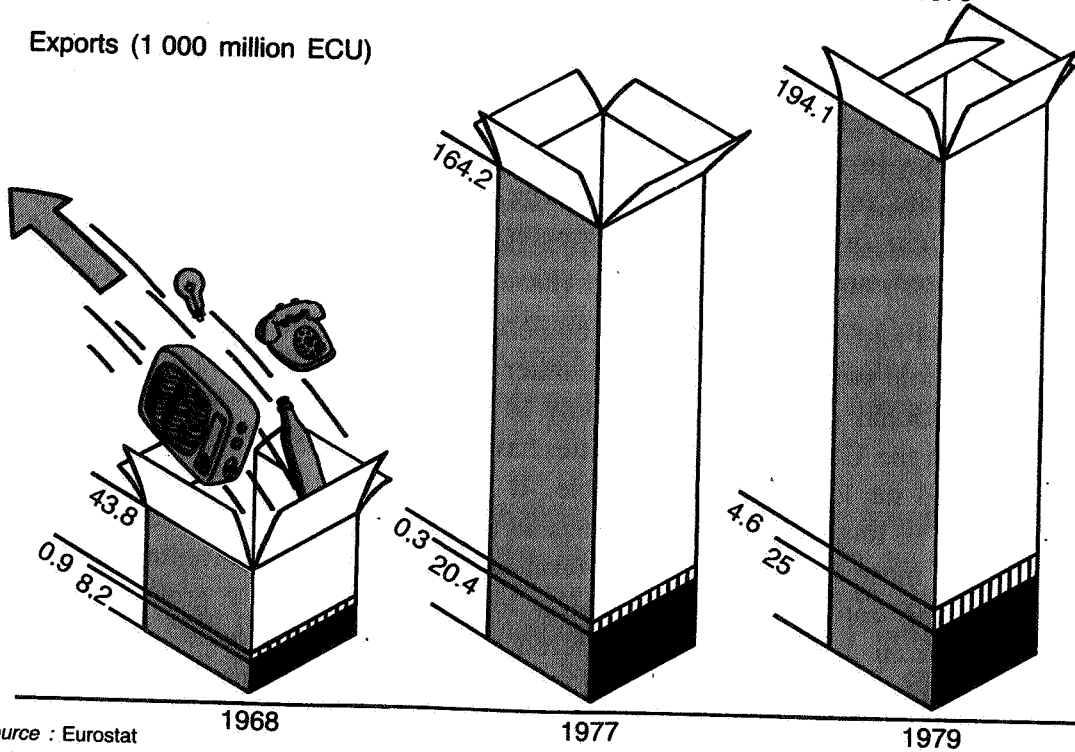
The United States and Europe would be compelled to manage their currencies with care, since countries could switch from one to the other, a possibility which the present system of narrow-based national currencies offers only to a limited extent. A policy of 'benign neglect', of which the US monetary 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 disruptions suffered in the last few years. Exchange-rate fluctuations complicate the analysis of the cost of internationally financed investment far more than do changes in interest rates, as currency values can swing as much as 25%, and even more, in a year.

THE COMMUNITY'S IMPORTS AND EXPORTS

Imports (1 000 million ECU)



Exports (1 000 million ECU)



Source : Eurostat

4. *Safeguarding the Community's achievements to date*

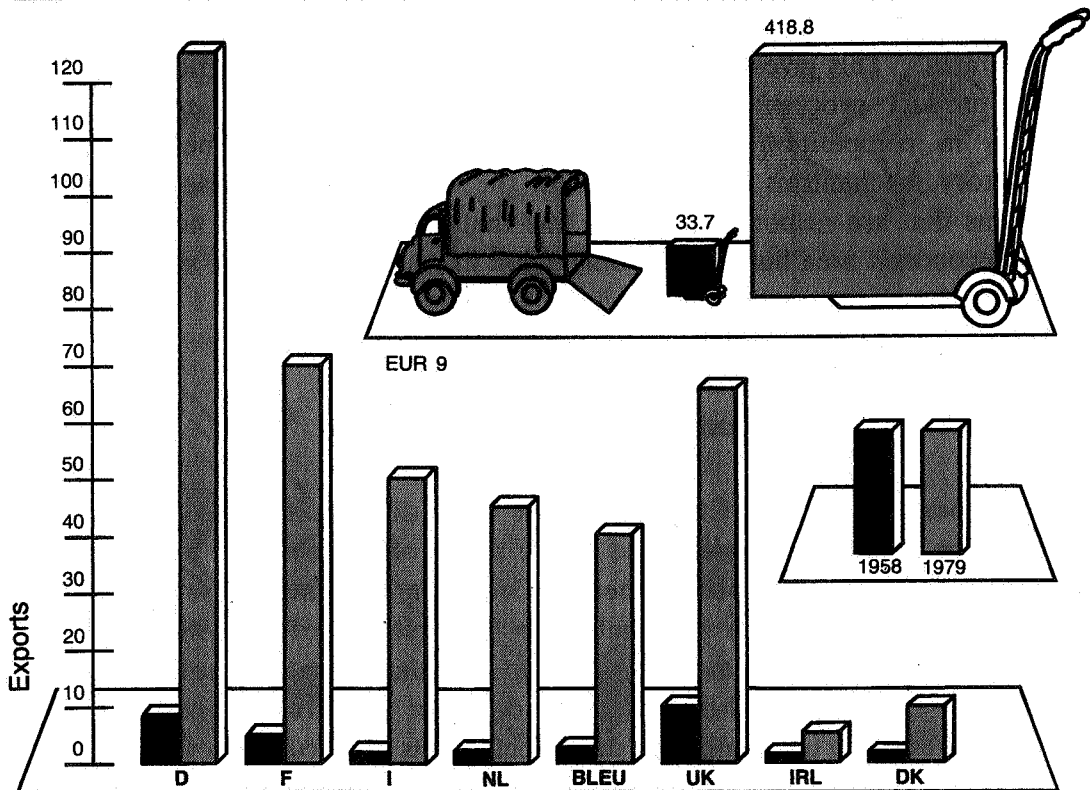
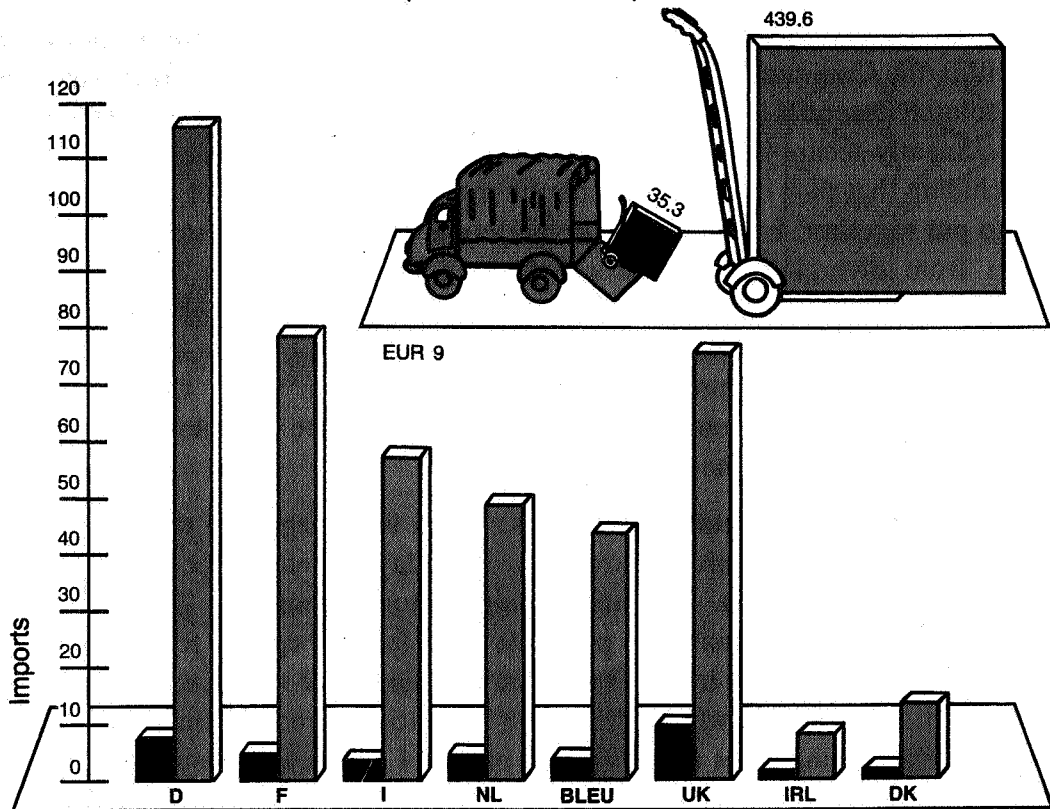
Economic and monetary union is not only desirable for laying the foundations for fresh growth within the Community and resolving the crisis within the world monetary system: it is also absolutely essential if the degree of integration already achieved in the Community is to be permanently secure in the 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, is placed in extreme jeopardy if we cannot stop Members States' currencies from diverging. As past events have shown on more than one occasion, member countries experiencing balance-of-payments difficulties then have virtually no alternative but to resort to administrative impediments just within the bounds of legality in order to curb, or make more expensive, imports from their Community trading partners. The danger of a return to protectionism cannot be dispelled 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 amounts. 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, alongside the exchange rates applied generally, special rates for farm products have come into being which diverge increasingly over time from the normal exchange rates. This gives rise, at the point where industry and agriculture meet — i.e. the farm-product processing industry, ranging from tinned ham to chocolate — to distortions in competition and to complications that have to be offset by special compensatory mechanisms. Together with the differences in excise duties, it is these mechanisms that are responsible for the fact that 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 requires 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 been joined by Greece in 1981 and has set itself the target of admitting Portugal and Spain as members in the first half of the 1980s, must make the quantum leap forward to 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 12 currencies would have little in common with a genuine customs union and would be virtually impossible to manage. The acceding countries' high expectations from membership of the Community will not be

TOTAL EC TRADE (intra-Community trade and external trade)
(1 000 million ECU)



Source : Eurostat

fulfilled by a loose customs union. In their own interests and in those of the present member countries, the Community the prospective members join must be a fully operational one that has set itself definite objectives and gives them definite objectives as well. On their side they must prepare over a transitional period to play their part in the monetary union system.

II — What are the barriers to attainment of economic and monetary union?

1. *Need for 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 union cannot be imposed overnight by a 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 depend upon each other. 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, the 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

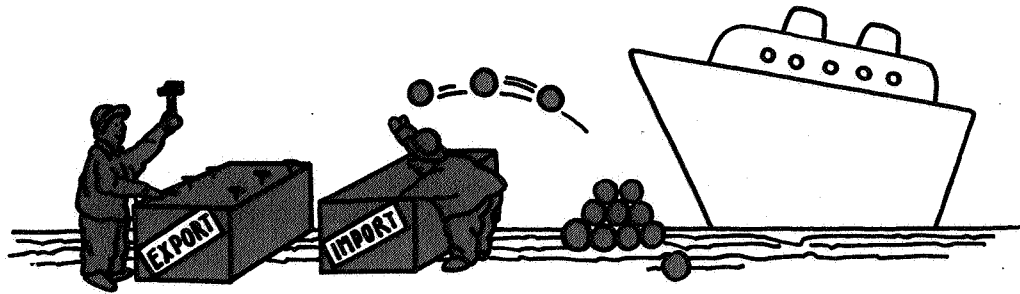
consensus is not a straightforward matter in a Community which is marked by wide regional disparities as regards development, whose Member States have such different historical backgrounds and in which the role played by government in the economy also varies very widely from country to country. Recollecting 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 4 to 5%.

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 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 centre of infection, inflation must, like any other inflammation, be attacked and cured without damaging healthy parts of the patient's body by unduly drastic action.

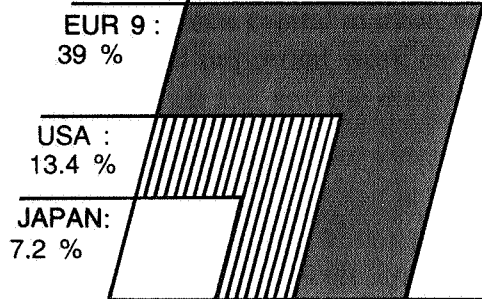
Once inflation has been contained and the conditions created for fostering balance-of-payments equilibrium, the achievement of more vigorous growth in the less developed countries will no longer be hampered by the fact that, after each promising upswing, these countries have been obliged time and time 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. It is precisely in periods of economic crisis and unemployment that the need for solidarity is greatest.

SHARE OF WORLD TRADE (including intra-Community trade)



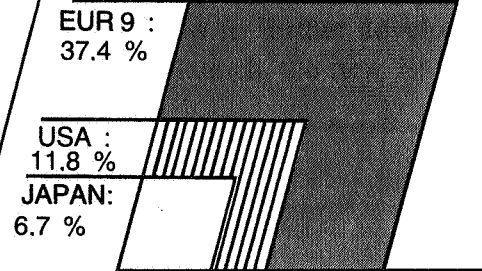
Imports (1979)

100 %



Exports (1979)

100 %



Source : Eurostat

III — What has already been achieved?

Although the attempt to create an economic and monetary union in the 1970s by way of a stage-by-stage plan spanning 10 years ended in failure, it would be a mistake to belittle what had been achieved prior to the launching of the European Monetary System (EMS). 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 was set for, and the machinery was ready to launch, the new EMS initiative on 13 March 1979.

1. *Monetary policy*

(a) *European exchange-rate system*

The Monetary Committee, which was set up in 1958, 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, was the outcome of the first major attempt to create an economic and monetary union, launched in 1969; the EMS was built on this in 1979.

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 blueprint 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 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 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 being 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.

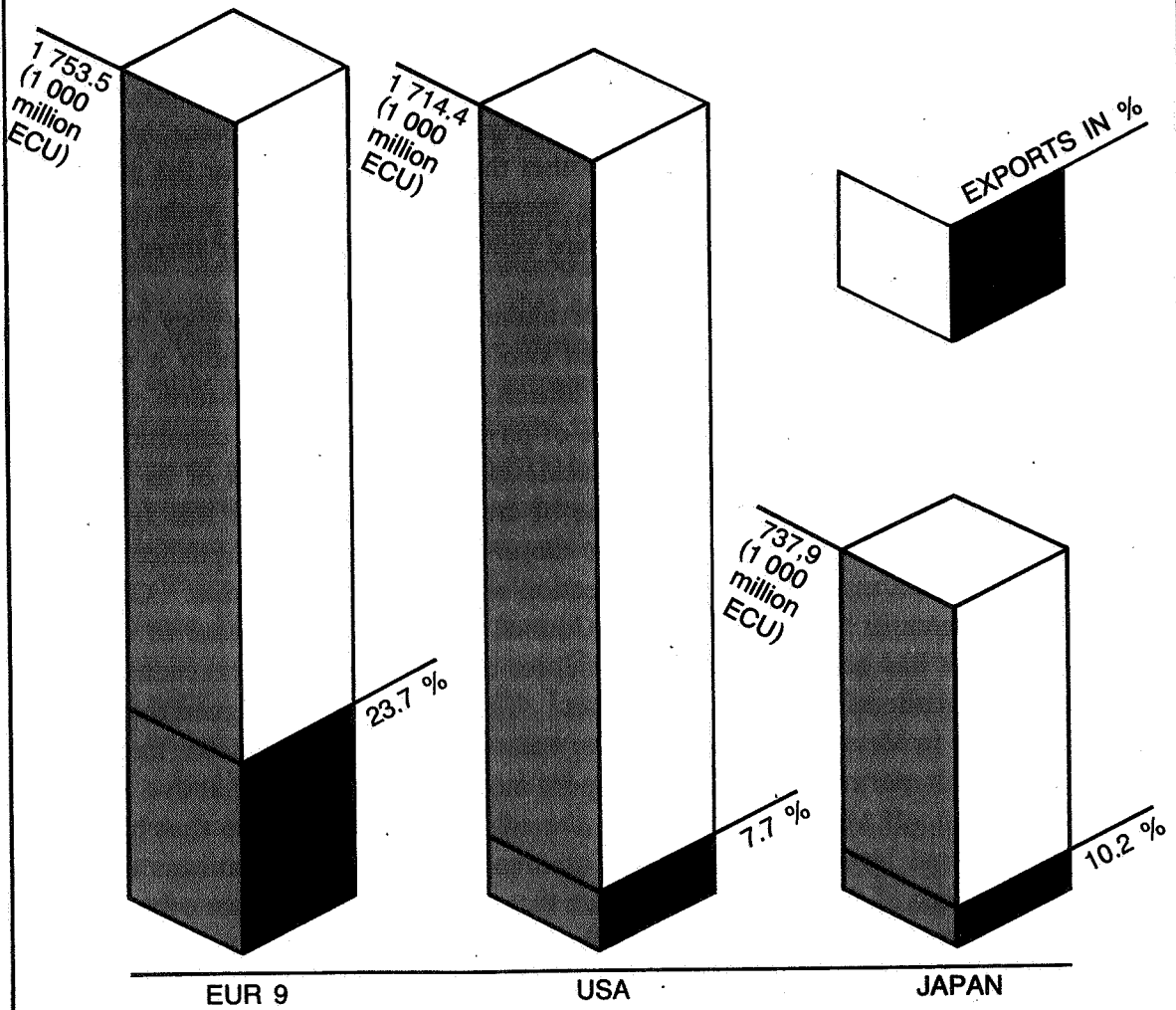
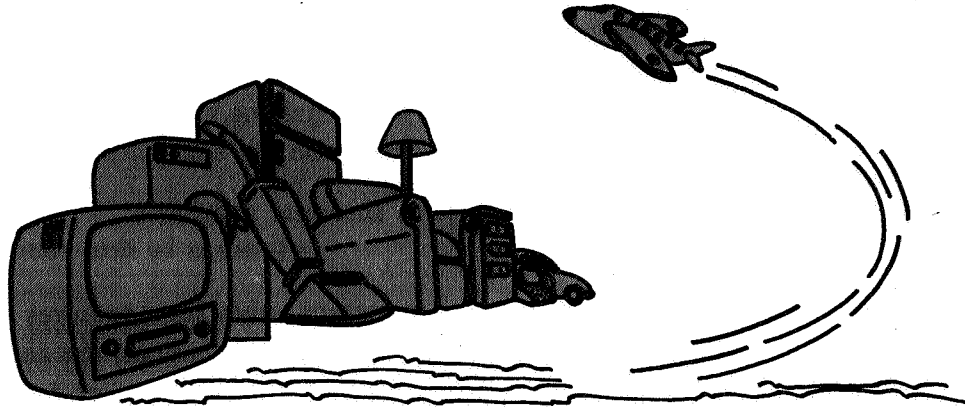
Despite all the monetary pressures it encountered, the Community exchange-rate system did not deviate from its objectives and ensured that these would also be adhered to within the EMS. Admittedly, the central rates of the currencies remaining in the snake had to be adjusted on several occasions. The requirement that they must endeavour at all times to remain within the margin of fluctuation prescribed was 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 made for close economic policy coordination between the countries able to keep their exchange rates in step without unduly large adjustments. This was 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 was concerned primarily with managing the Community exchange-rate system (the snake) and the Community's short-term monetary support mechanism.

GROSS DOMESTIC PRODUCT AT MARKET PRICES AND EXPORTS AS % OF GDP, 1979
 (per inhabitant at current prices and exchange rates)



Source : Eurostat

It is through the Fund that the currency credits made available by Member States for currency support measures were settled. Under the new European Monetary System (EMS) which came into force in March 1979, the Fund continues, in the initial phase, to settle balances connected with intervention and short-term monetary support. In addition, it issues European currency units (ECUs) against deposit by Member States of a given proportion of their gold and foreign exchange reserves. It is to be gradually consolidated 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 only 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. The two support mechanisms described above are in no way designed to cut off Member States 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. In 1976-77, Italy and Ireland received an extra 1 600 million ECU in balance-of-payments support financed from the proceeds of these loans. In 1981, again on a proposal from the Commission, the Council decided to raise the ceiling for Community loans to 6 000 million ECU. This was intended as a mark of Community solidarity at a time when all Member States were hard-hit by the second wave of oil price increases and had run up large current-account deficits.

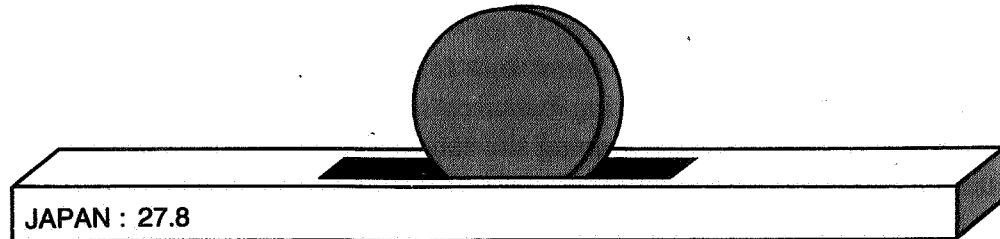
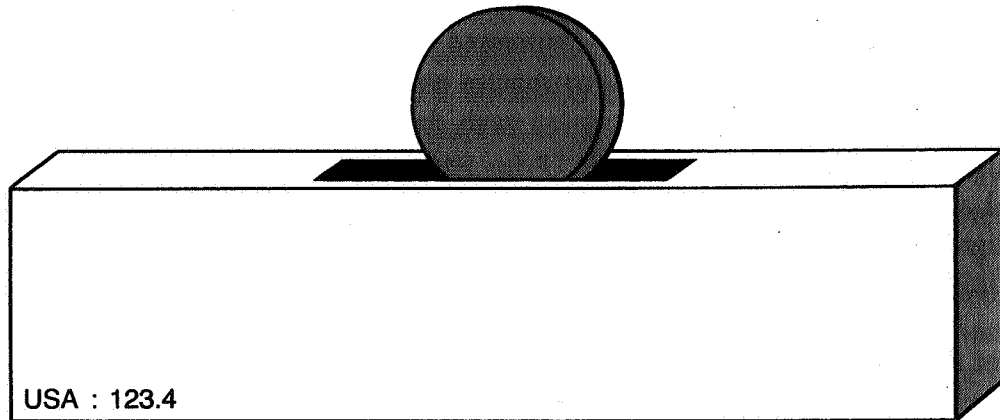
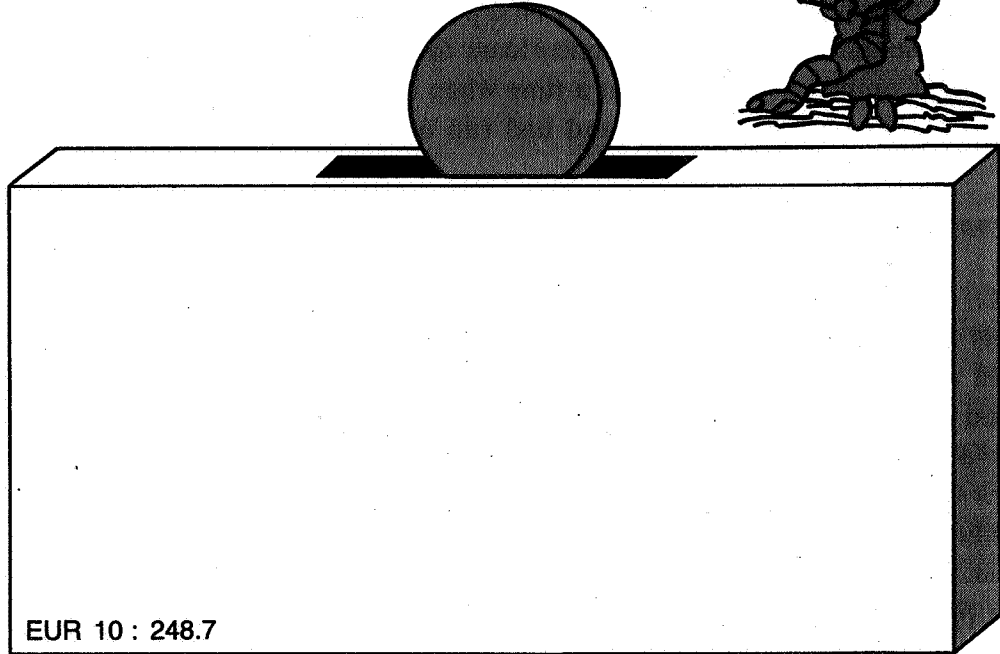
(d) European unit of account

Since its inception, the European Community has had to calculate Member States' payments to the Community budget and their reciprocal commitments and obligations by reference to a unit of account. While 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 quotations on the official foreign-exchange markets — is calculated each day by the Commission.

With this unit of account, renamed 'ECU' for EMS purposes, the Community possesses 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 increasing number of fields of Community activity. Since 1975, it has been applied in connection with the European Development Fund, set up to assist the 60 or so 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 ECU is first and foremost an accounting instrument, the Commission maintains interest-bearing balances expressed in ECU in banks in several Member States with a view to maintaining the value of its budget resources. The ECU is not yet used as an instrument for effecting payments. For the purposes of the European Monetary System, the ECU has been 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, and it is the acronym of 'European currency unit'.

OFFICIAL EXCHANGE RESERVES
(at end 1980 — 1 000 million ECU)



Source : IMF

2. Coordination of economic policy

Although currencies and the exchange rates between them determine trade patterns, they are merely a reflection of underlying economic realities. The Community endeavours to influence the exchange rates 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 elimination of regional and structural disparities that are incompatible with an economic union.

With a view to bringing economic policies more closely into line, the Commission began issuing annual economic policy recommendations to Member States as early as the 1960s. Since 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 three times each year an examination of the economic situation in the Community, based on communications from the Commission, and has drawn up short-term economic policy guidelines to be observed by the Community and by each individual Member State in the interests of more 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 foster closer economic policy coordination, a special Coordinating Group was set up at the Council in 1972 which brings together Commission representatives and representatives of the competent ministry in each Member State. 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, in the interests of effective coordination.

Despite these more sophisticated arrangements, the goal of improved coordination of economic policies could not be achieved in the wake of the oil crisis. Price escalations got out of hand in 1974 and 1975 in several Member States and it was only during 1977 and 1978 that it proved possible temporarily to halve the span of inflation rates among Member States, which at one stage had ranged between 6% and 25%. Since 1979, inflation rates have again diverged as a result of the latest oil price rises and it is proving particularly difficult to bring them closer together again.

3. Structural policy

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

Since 1964, the Community's medium-term and longer-term economic policy objectives have been formulated by a committee responsible for medium-term economic policy and

submitted by the Commission to the Council for approval, in the form of programmes. The programmes lay down for the Member States 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 understanding 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 ironing out regional disparities is intended to be the Regional Fund, which, however, was set up only in 1974 and has since had to be content with an admittedly growing but as yet modest budget. In the Fund's early years, Community funds could normally be granted only in the form of support for Member States' national development programmes. In the future, specific measures taking greater account than in the past of the Community's objectives and needs are also to be taken at Community level to improve regional structures. An amount equal to 5% of the Fund's resources and not tied to specific countries has been allocated for this purpose.

Industrial policy, as well as regional policy, has a important contribution to make to structural improvement. A common market signifies change and renewal. Industries that have found themselves isolated behind national frontiers and without a future must adjust to a wider, unrestricted market and encouragement must be given to the creation of new, forward-looking industries and services branches. The Community must foster the continuing adjustment process, provided it is carried out under conditions of fair competition. Without this process, uncompetitive industries would be kept artificially alive. A retreat into protectionism and the break-up of the single market would then be unavoidable. The Community must, however, see to it that redundant workers are reabsorbed into economic system with the help of the Social Fund and of 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 with the introduction of

early retirement schemes. However, the resources available for combating unemployment are altogether inadequate. To a large degree, reintegration of workers and unemployment benefit provision are still regarded as the concern of the national authorities.

(c) Financing instruments

Financing new jobs and promoting structural change require large amounts of investment credits, which in the normal course of events are provided by existing financial institutions and the financial markets. The Community, however, must step in to 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 the rate of closures of obsolete plant.

The European Investment Bank, a public body with legal personality, was set up in 1958, primarily to help develop the Community's less advanced areas. It is 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. By 1981, the EIB had granted credits of around 15 000 million ECU, and in recent years has stepped up its lending operations to an annual rate of over 2 000 million ECU.

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 industries credits totalling 7 000 million ECU. The coal industry had to contend with major conversion difficulties in the 1950s and 1960s, while it is now the steel industry that is facing the same problems.

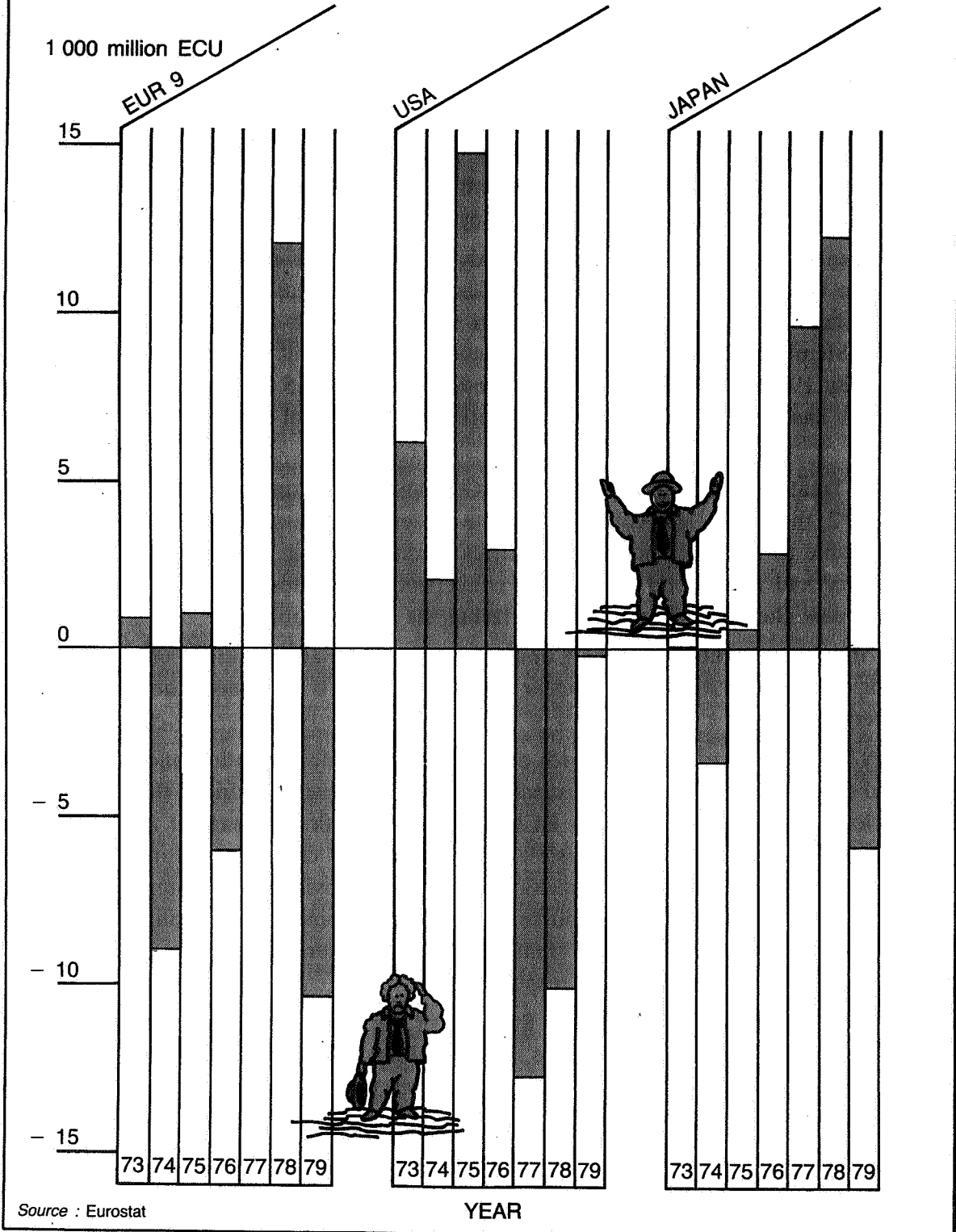
In 1976, the Council authorized the Commission to issue loans totalling 500 million ECU for financing the construction of nuclear power stations, to help meet the Community's energy requirements.

In mid-1978, as its contribution towards combating economic stagnation and resolving the structural crises affecting several industrial sectors, the Council authorized the Commission to float loans totaling 1 000 million ECU 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. In 1980, the Community granted loans and interest subsidies totalling 4 500 million ECU and 200 million ECU respectively.

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 switch to modern production methods and to the kind of high-value products for which there are ready markets.

Although the total resources that the Community can make available through its financing instruments represent only some 0.3% of Community gross national product, they have a pump-priming effect because they are directed to specific regional and sectoral measures.

BALANCE OF PAYMENTS (current account) 1 000 million ECU



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-enterprise 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. 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; but the granting of financial credits for industrial investments, capital investments and cross-frontier dealing in quoted securities may still be made subject to restrictions.

Instead of forming a common capital market on which surplus saving 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. Although the deadlock in further progress towards achieving free movement of capital was broken in 1980, in spite of the recession, by the complete removal of restrictions in the United Kingdom and by partial liberalization in France, it will finally be overcome 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 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. 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 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 26%. 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 those 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 offset at frontiers by tax refunds in the exporting country and by taxation in the importing country.

For ordinary travellers, the Commission has been able to introduce exemptions, at least for the quantities normally allowed 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 stem from deep-rooted historical and psychological factors. They can be evened out 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 rules on depreciation. The Commission had to concentrate 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 reached the stage of economic and monetary union.

IV — The new European Monetary System (EMS)

1. *Return to monetary policy cohesion*

Implementation of the stage-by-stage plan for creating an economic and monetary union out of the Community did not prove possible during the 1970s. The difficulties the individual Member States have had to contend with have shown, however, that economic and monetary union has not become less important but is even more 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 divisive protectionism within Europe, which looms larger with every day of inaction, removed once and for all.

The Community must return to a path of growth and stability. Without stability, Member States will struggle along divergent paths as inflation impoverishes some of them without the others being any better off. 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 growing throughout the Community. Time and time again in recent years, some member countries have had to cut back on the orders they placed with their partners because they did not have enough currency reserves to pay the bills. As a result, workers in other member countries lost their jobs.

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. In October 1977, the then Commission President, Roy Jenkins, reminded Member States' Governments of the merits of a single currency. At the end of 1977 the Commission laid before the Council an action programme for the years ahead. This programme was aimed at steering the Community back on to a path of growth and stability — the prerequisites for any monetary union — by way of closer coordination of economic and monetary policies.

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 year 1979 witnessed the formal introduction of the EMS, while 1980 was the year in which the system proved its worth, for the EMS central rates remained unchanged.

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 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.

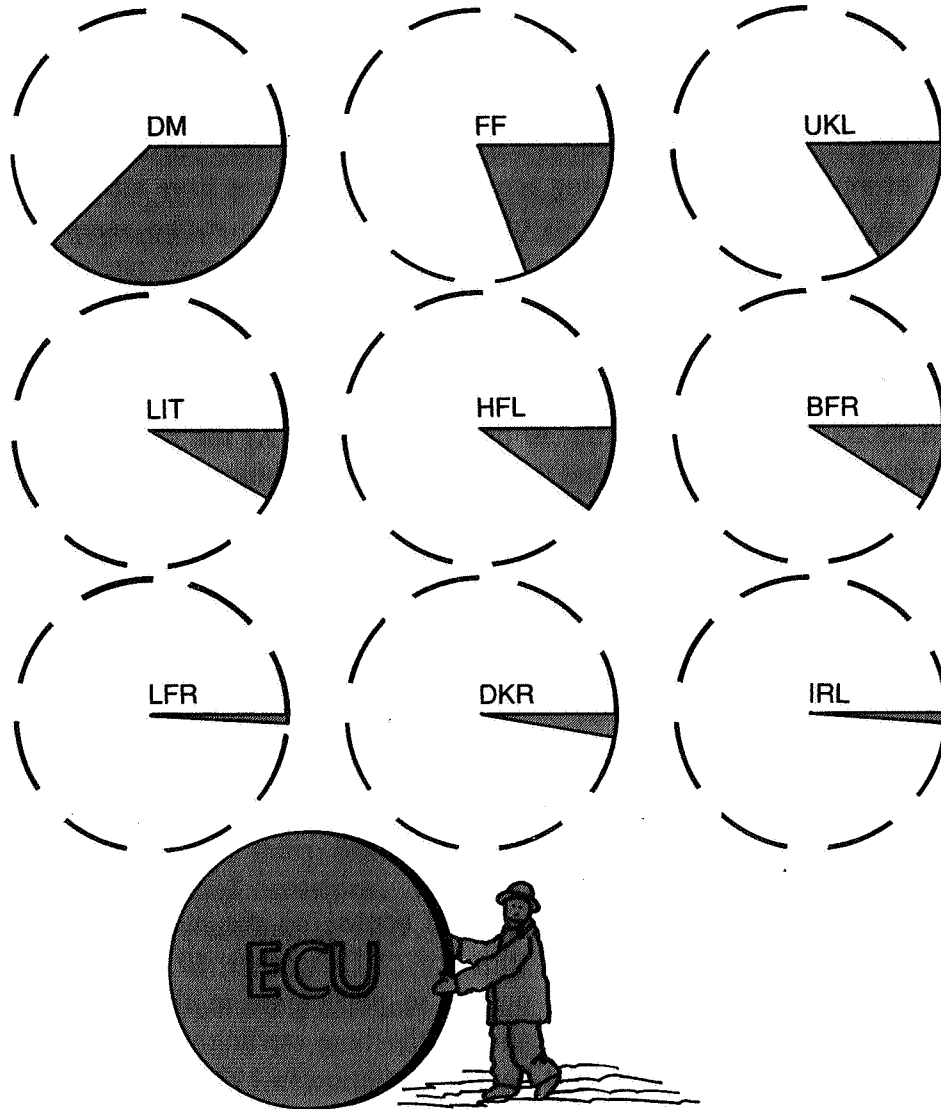
2. The ECU as the pillar of the system

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 preventing them from drifting apart. The ECU, which lies at the centre of the European Monetary System, is used as the denominator or *numéraire* for the exchange-rate mechanism, as the basis of the divergence indicator, as the denominator for operations under the intervention and credit mechanisms and as a means of settlement between monetary authorities. It is thus the new European unit of account, which is not yet a generally accepted means of payment but is intended to be used increasing as such, initially between Member States' central banks and subsequently perhaps in connection with international capital movements. The ECU is a basket of nine Member State' currencies. The intention is that the Greek drachma should be included in the ECU basket within five years of Greece's accession to the Community, i.e. before 1 January 1986. The amount of each currency in the basket corresponds 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 in danger of leaving 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 been made for preventive measures where a currency deviates unduly (by more than 75% of its margin)

WHAT IS THE ECU?



The ECU is composed of the following amounts of national currencies:

0.828	German mark (DM)	3.66	Belgian francs (BFR)
1.15	French francs (FF)	0.140	Luxembourg franc (LFR)
0.0885	pound sterling (UKL)	0.217	Danish krone (DKR)
109	Italian lire (LIT)	0.00759	Irish pound (IRL)
0.286	Dutch guilder (HFL)		

The equivalent of the ECU in a given national currency is equal to the sum of the equivalents of the above amounts in that currency. The ECU equivalents in the Member States' currencies are calculated every day and published in the *Official Journal of the European Communities*, as well as in many newspapers.

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. These comprise intervention in various currencies, domestic monetary policy measures (e.g. in respect of interest rates), other economic policy measures (e.g. in the field of taxation or incomes policy) and, lastly, changes in the central rate itself. 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. In the first two years of operation, there were only two minor adjustments to central rates, with interest rates as a rule being raised or lowered as soon as the divergence indicator was triggered.

The funds available for defensive action have been increased significantly under the new system. The central banks' currency debts arising from intervention now have to be settled after 45 days rather than after 30 days as 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 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 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.

Although the United Kingdom was in favour of setting up the new system in 1978 and endorses the European Council Resolution of 5 December 1978, which forms the foundation for the new system, it was unable to participate in the exchange rate and intervention mechanism straightaway because at the time sterling was strongly buoyed up by North Sea oil coming on stream and because inflation in 1979 and 1980 was still very high. As a result, sterling remained unsettled on the exchanges and would have disrupted the system if it had joined immediately. The United Kingdom intends to participate in the mechanism once sterling has consolidated its position.

Similarly, Greece was unable to bring the drachma into the EMS exchange rate and intervention mechanism immediately upon joining the Community on 1 January 1981. Inflation in that country, at 25% in 1980, far exceeded the Community average of 12%, which was itself much too high.

The arrangement for depositing gold and dollar reserves was the first step towards establishing a genuine European reserve fund — largely a symbolic step, since the reserves remain the property of Member States' central banks even though their corresponding value in ECU is used to finance intervention.

The dollar and gold reserves are valued at their respective market rates. After the EMS was launched, the gold price, which is determined on a narrow market, more than doubled,

and at times even tripled. As a result, the value of the reserves deposited by the Member States with the European Monetary Cooperation Fund, which had initially stood at 26 000 million ECU, roughly doubled.

Some Member States, notably Belgium, have made calls on these ECU-denominated reserves to finance intervention in support of their currencies. The short-term and medium-term credit mechanisms were not activated, one reason being that all Member States recorded a negative balance of foreign-exchange payments in 1980 and so would not have been in a position to make available any surpluses of their own to enable their partners to plug their deficits, as had frequently happened in the 1970s.

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

In its first two years of operation, the EMS exchange rate and intervention mechanism achieved everything expected of it on the monetary policy front but did not meet all expectations in the economic policy field. Since the system was set up, the exchange rates of the participating currencies have largely kept in step, apart from two downward adjustments of the Danish krone totalling 7% and a 2% upward adjustment of the mark. The mark up to March 1981 thus rose by 1.15% against the average value of the ECU, whereas the other currencies fell by 0.83%, with the exception of the Danish krone, which fell by 8.25%.

The European Monetary System displayed a remarkable degree of currency stability in an unsettled period marked by sharp fluctuations in the dollar and the yen and a switching of funds into gold on several occasions. Apart from the lira, which, if we disregard the adjustment made in the autumn of 1979, observed its wider permitted margin of 6%, the EMS currencies kept within their 2.25% margins. Sterling, which had not joined the system, was the only Community currency to experience a primarily oil-induced increase in its exchange rate which, if it had been participating in the mechanism, would have prompted a revaluation, even though as recently as 1978 sterling had been regarded, if anything, as a candidate for devaluation.

Within the EMS, Community currencies were used for the purpose of smoothing exchange-rate movements to a greater extent than in the earlier currency snake, one main reason being that three of the four major Community currencies are once again involved in the new exchange-rate mechanism. Intervention was by no means geared solely to stemming a rise in the mark: from time to time the mark had to be supported by the French franc and by the Dutch guilder when it was at the bottom of the grid.

Within the EMS too, the central banks were obliged to commit more funds to smoothing fluctuations in the dollar than to absorbing movements in their own currencies. And so through the EMS, the Community made a contribution towards stabilizing the international monetary system. Admittedly, there has as yet been no genuine coordination between the different monetary authorities' intervention policies towards the dollar: not infrequently, while some central banks have sold dollars in order to support their currencies,

others have been buying them in order to avert an excessive slide in the dollar. However, it is in the Community's interest to prevent excessive fluctuations in the dollar that push up inflation in the Community.

The EMS, which was designed to steady exchange-rate movements and thereby to bring about closer convergence of economic performances, and in particular lower rates of inflation and improved payments balances, had still to make its mark on the economic policy front. It went through a particularly difficult period when all the Member States were hard hit by the fresh wave of oil price rises. These increases triggered a fresh bout of inflation, which of course is never the same in different countries. It was only in the Federal Republic of Germany and in the Benelux countries that inflation was kept down to single figures. The other Member States, despite major efforts to contain prices, recorded double-digit inflation.

4. Step by step towards the prime objective

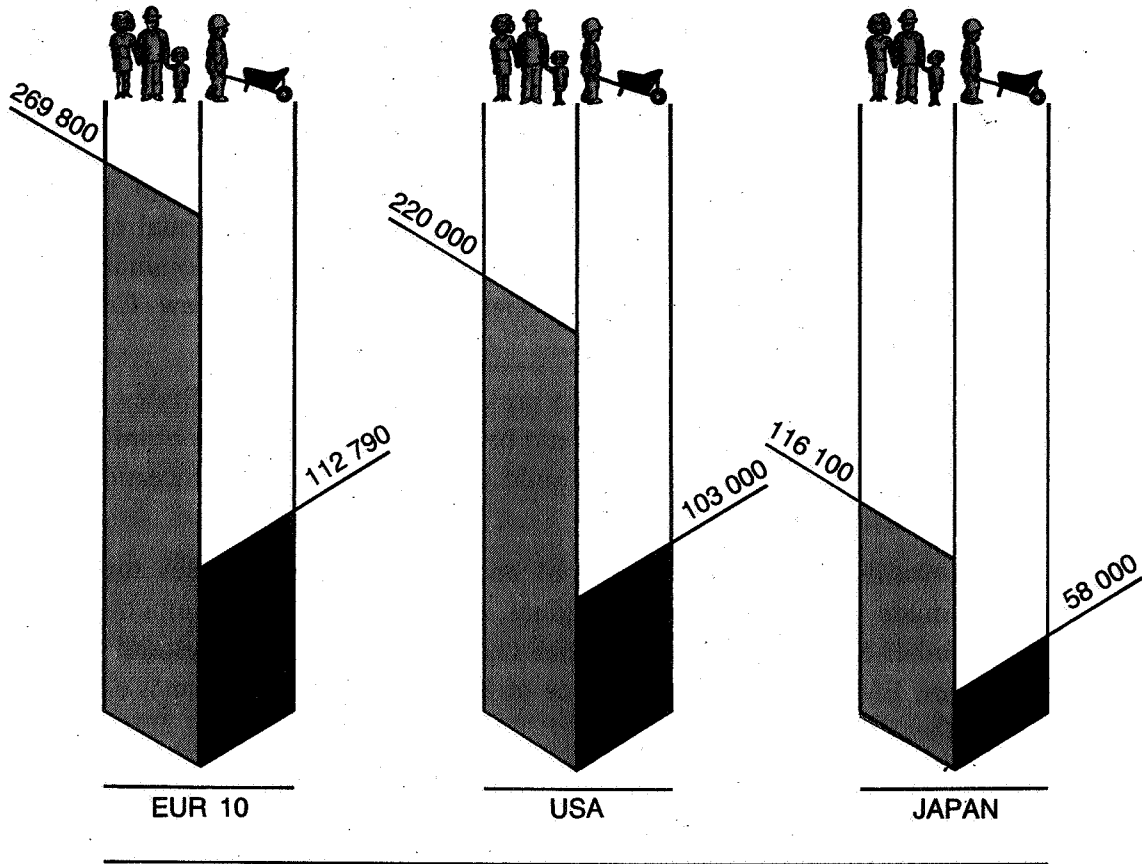
In its Resolution of 5 December 1978, the European Council announced that it was 'firmly resolved to consolidate, not later than two years after the start of the EMS scheme, into a final system the provisions and procedures thus created'. This system was to 'entail the creation of the European Monetary Fund... as well as the full utilization of the ECU as a reserve asset and a means of settlement' and was to be 'based on adequate legislation at the Community as well as the national level'.

But the Heads of State or Government had underestimated the technical, legal and political problems and difficulties of moving on to the final stage of the EMS. For instance, they did not make allowance for the fact that the creation of a body which involved the partial transfer of monetary policy responsibilities to the Community would necessitate changes in several Member States' legislation that would require ratification. Although, at its meeting in Luxembourg on 1 December 1980, the European Council reaffirmed its determination to further strengthen the EMS until transition to the institutional stage at the appropriate time, it did not set any date for that transition, but merely called upon the Commission and the Council of Ministers to continue their preparatory work.

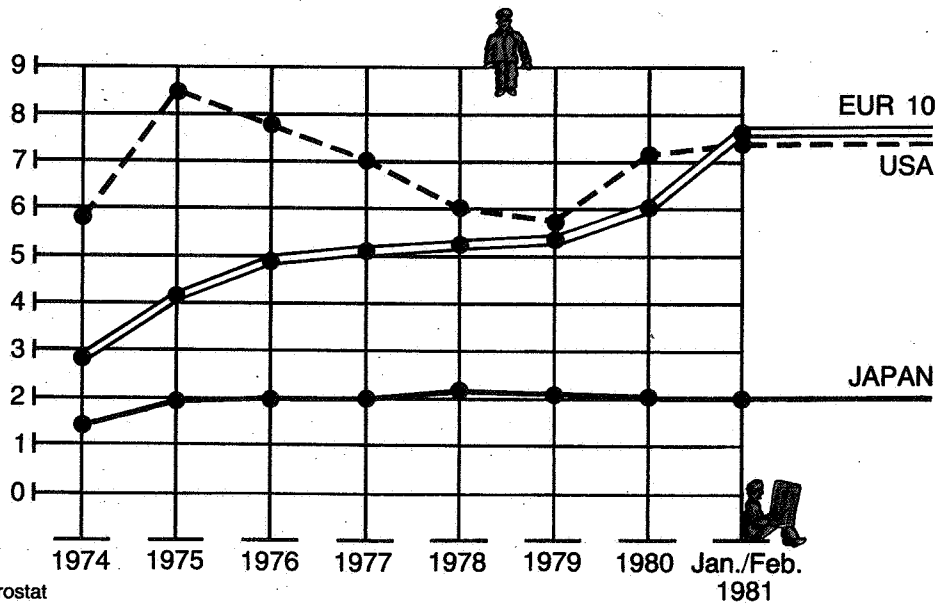
It will probably take a few more years before the Community is able to make the transition to the final stage of the EMS. In the meantime, any further steps that can be taken directly, i.e. that do not require a new legal basis or ratification at national level, should be taken. This would effectively and pragmatically pave the way for the final stage.

One direct way in which to promote the further development of the EMS is to gradually strengthen the role allotted to the ECU. This would involve, in the first place, dismantling the restrictions on the use of the ECU for settling payments between Member States' central banks, and empowering the central banks to keep part of their reserves in ECU and to use the ECU increasingly as an instrument for settling creditor or debtor balances within the Community.

POPULATION AND CIVILIAN LABOUR FORCE (1 000)



UNEMPLOYMENT (as % of civilian labour force; Greece included from January 1981)



Source : Eurostat

Consideration also ought to be given to ways and means for making the ECU more attractive. The International Monetary Fund set a useful precedent when, on 1 January 1981, it adopted measures designed to make the Special Drawing Right more attractive as a currency unit by basing it on a basket of the five major world currencies — the US dollar, the Japanese yen, the German mark, sterling and the French franc. The ECU ought to be sufficiently attractive to be used not only in transactions between central banks but also outside the central bank system, on private money and capital markets. It should be developed gradually into a currency that would also be held by investors in non-Community countries and that would attract oil producers' surpluses into the Community. It could then serve to relieve the strain on Member States' national currencies. The Community institutions themselves should consider floating ECU-denominated loans, now that the Council has authorized such operations under the New Community Instrument.

The EMS would also have to be keyed to put pressure on the Member States to reduce their inflation rates. An inflation indicator could be introduced: if the rate of inflation in a particular country climbed too sharply, this should prompt the country concerned to take more energetic corrective action.

Initial progress towards closer coordination of national monetary policies towards the dollar could be made by pooling the individual short-term credit agreements (swaps) concluded by Member States' central banks with the US federal reserve system. Greater parallelism between EMS currencies in the face of fluctuations in the dollar is essential to the cohesion of the EMS.

With a view to the final stage of the EMS, it will be important to decide in the medium term what responsibilities will need to be entrusted to the European Monetary Fund and to its administrative authorities in order to ensure that the EMS comes up to expectations in the long term. In the final stage, a European Monetary System and a European Monetary Fund must be responsible for framing the Community's internal and external monetary and exchange-rate policies. This will require detailed studies of the ways in which the present responsibilities for managing the domestic money supply and the external exchange rate can be transferred from the Member States to the Community. This task will not be made any easier by the fact that in some Member States the central banks have wide discretionary powers in the area of monetary policy while in others they are much more strictly bound by government directives.

A European Monetary System that features a European currency authority will be endorsed by all the Member States' parliaments only if it accords high priority to preserving the value of money and provides guarantees that the supply of a European currency will be at least as closely controlled and as soundly managed as the best Community currency. As things now stand, it will be no easy matter to introduce monetary harmonization. A family builds its house to last a lifetime and so it must rest on solid foundations. Similarly, the Community must address itself in earnest to the preparations for a common currency edifice with solid foundations that can withstand any upheaval.

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