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EUROPEAN CAPITAL MARKETS BETWEEN LIBERALISATION AND RESTRICTIONS

by

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I. INTRODUCTION

The founding fathers of the European Economic Community placed the abolition of obstacles to the free movement of capital among the main tasks of the new venture (art. 3), along with such fundamental aims as the elimination of trade restrictions, the establishment of a common customs tariff, the free movement of persons and services, the adoption of a common agricultural policy and the establishment of a European Investment Bank.

While many of these aims have been broadly attained, the creation of a genuinely integrated European capital market still remains a distant goal. After an initial spate of liberalising activism in the early sixties, no further progress has been recorded. On the contrary, national restrictions have been reintroduced in several countries, and there is today a marked divergence in the degree of liberalisation prevailing in the Community Member States. Instead of the development of an integrated European capital market, we have witnessed the remarkable growth of a parallel and unregulated world-wide financial market, the so-called Euromarket.

This situation is usually deplored either on almost moral grounds, with much waving of fingers at those countries who have sinned, or on narrowly legal ones, with lengthy quotations from the Treaty and other Community texts. While the failure to build an integrated European capital market is certainly lamentable, it raises questions going beyond mere indignation. Why has this goal, contrary to others, not been achieved? Is it simply by accident? Or is there a basic economic or other reason explaining it? Has the goal become obsolete, being surpassed by wider developments on a world scale, and/or being undermined by continuing national desires to preserve control over domestic markets? Or was there from the very beginning some inconsistency among the various Community goals?

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These are the questions I intend to address. To this end, I shall, as a first step, throw a spotlight on the period "where it all started": the early sixties. After that first section, the complementary second piece of analysis has to deal with the situation today, i.e. the early eighties. The comparison should bring out the change in our environment during the past two decades: the evolution in markets, institutions, theories and (maybe) policy principles pertinent to a European capital market policy. Finally, I will attempt to look ahead and to derive some policy conclusions on capital market liberalisation and restriction in the Community.

I. THE EARLY SIXTIES

1. Legal framework

Article 67 of the Treaty of Rome provides that "... Member States shall progressively abolish between themselves all restrictions on the movement of capital" ... "to the extent necessary to ensure the proper functioning of the common market ...". And the Council was called upon, in article 69, to "... issue the necessary directives for the progressive implementation" of this provision.

The Council was then remarkably rapid in its response: it adopted a first directive in 1960 and a second in 1962, graduating the freedom of capital movements according to the differing nature of the flows concerned, ranging from direct investments, to financial placements of various maturities, to purely short-term and potentially speculative flows, etc. Member States were thus unconditionally obliged to fully liberalise movements of capital directly connected with the flow of goods and services (e.g. for direct investments, investments in real estate, commercial credits), of personal capital, of securities quoted on the stock exchange (lists A and B). In another category, "conditional" liberalisation was envisaged for the issuing of bonds and for capital flows with purely financing purposes such as longer-term financing loans (list C). Liberalisation remained non-compulsory for short-term financing loans and new foreign bank accounts (list D) [1].

The basic philosophy underlying these initial successes on the road to liberalisation was clear enough. Its most comprehensive expression is to be found in the well-known report on the formation of a European capital market, drawn up in 1966 by a group of experts chaired by Professor Claudio Segré [2]. This study, which has become a Community classic in its own right, argued that a European-wide capital market would become increasingly necessary, not only to better finance economic growth, but also to stimulate the implementation of Community policies in other areas. In particular, a European capital market was considered a necessary precondition to economic and monetary union within the Community, contributing to a smooth functioning of an international monetary system based on fixed exchange rates and completely liberalised foreign exchange transactions.

These ideas, hopes and initial realisations were tacitly founded on the existence of fixed exchange rates. Such a regime,

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1) The problem of short-term capital movements and their control has occupied a central place in international economics during recent years, and has been covered extensively in economic and theoretical literature. Suffice it here to draw attention to the important distinction to be made between controls affecting long-term and short-term capital movements; this is in fact reflected in the different treatment accorded them in the first two Council directives, as well as in the IMF Articles of Agreement and in the OECD Code of liberalisation of capital movements.

2) "Le développement d'un marché européen des capitaux", Commission des Communautés européennes, Brussels, November 1966.

provided by the Bretton Woods arrangements after the end of World War II, seemed so natural a component of an envisaged common market, that nobody bothered to write it down explicitly in the Treaty. This insight is important, as the presumption of fixed exchange rates has been a potential source of early inconsistencies in the overall conception of EEC stabilisation policies. I shall return to this matter in more detail later.

2. Facts

To understand the force of conviction carried by arguments such as those of the Segré report and to realise why those initial successes were blocked in the late sixties and finally reversed in the course of the seventies, one needs to trace the factual background to those events.

The first element relates to the broad historical perspective : the lessons of the Great Depression - when many countries attempted to maintain employment through competitive devaluations and resort to exchange and trade restrictions - were deeply engraved in the minds of post-war policy makers. The Bretton Woods agreement, the Charter of the United Nations, and especially the Rome Treaty reflect a keen awareness of interdependence, a strong political will to further integration and cooperation, and a widening acceptance of the need for an agreed code of conduct in international trade and financial matters. There was a deep recognition of the self-defeating nature of "beggar-thy-neighbour" policies and of their contribution to lower global employment and welfare.

Secondly, the interpenetration of financial markets and the degree of openness of the industrial economies were much lower than they are today, so that policy makers were less fearful of uncontrollable exogenous developments impinging on their domestic autonomy. As regards the financial markets, for example, longer-run net private capital flows (over one year) within the Community totalled under

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1 billion dollars in 1960, while "classical" foreign bonds issued within the EEC amounted to only 200 million dollars (1961)[1]. The Euromarkets were, for their part, just beginning to see the light of day. On the "real" side of the picture, the major European economies were much less open than they are today: measuring openness by the ratio of total exports to GDP, in 1960 this ranged from 12 per cent in Italy (against 25 per cent today), 14 per cent in France (22 per cent) and 18 per cent in Germany (30 per cent)[2].

Thirdly and finally, the general economic climate of the late fifties and early sixties was also propitious to a process of relatively harmonious and shock-free integration. This was a period of steady, non-inflationary growth, of easy labour supply and mobility, of low and declining energy and raw material costs, of asynchronous and compensating cycles among the major industrial countries : all factors favouring a generally convergent economic performance and a reduction of per capita income disparities among the original six members of the Community. In this environment, the dismantling of capital controls seemed to lie in the mainstream of developments and to be in the natural order of things.

Having thus described the legal and the factual background to the events of the early sixties, I would like to sketch out their broader implications for economic policy, having recourse to the conventional economic wisdom prevailing in those early days after the Treaty of Rome.

3. Policy analysis

Open economy macro-economics prevailing in the early sixties focussed on "insular", i.e. basically independent national economies and governments. Between any two countries, a real and a financial relationship was suggested to hold in the case of fixed exchange rates.

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1) Source : Segré Report, op.cit., Statistical Annex, tables 13 and 15.

2) Source : Commission of the European Communities, Directorate-General for Economic and Financial Affairs - "European Economy", n° 10, November 1981, and "Economic Forecasts 1982-1983", May-June 1982.

The "real" relationship linked domestic policies to the trade balance : if a national government conducted expansive policies, the trade balance would worsen via increased domestic spending on imported goods. The "financial" relationship maintained that international capital flows react to interest rate differentials : an increase in (nominal) interest rates in a given country would raise capital inflows, thereby improving the capital account.

The analytical combination of these two relationships demonstrated how international flows of financial capital fit into national stabilisation policies. Take for example the case of a slowdown in economic activity. A policy of budgetary expansion would then stimulate the economy, while restricting monetary policy would keep domestic interest rates high enough to attract capital inflows. Overall balance of payments equilibrium would be maintained, as the trade deficit would be financed by interest-sensitive capital inflows from abroad. The result is a policy mix in which monetary policy is not directed towards domestic goals, and becomes, rather, a tool for balance of payments financing, working via the interest-sensitivity of international capital flows.

Thus, the economic wisdom of the early sixties suggested that, in a fixed exchange rate regime without capital controls, there is in principle no room for an independent national policy mix. In particular, monetary policy is constrained to be used as a tool for external stabilisation. This consequence follows from the coexistence of free capital flows and fixed exchange rates.

Both these elements were, however, built into the Treaty of Rome, as mentioned before. Free capital flows were explicitly considered as an objective. Fixed exchange rates were an implicit pillar of the Treaty. It should follow that the use of monetary policy for domestic purposes is ruled out, i.e. that national monetary policies are to be constrained by balance of payments considerations. We cannot aim simultaneously at 1) free trade, 2) capital mobility, 3) independent domestic monetary policy and 4) fixed exchange rates. The circle cannot be squared: one element has to be surrendered in order to avoid any inconsistency. The incompatibility between fixed exchange rates, free capital movements and independent national monetary policies has been referred to in economic literature as the "inconsistent trinity". To this trio we have added a fourth element, that of free trade, which is a pillar of the Rome Treaty and an aspect which cannot simply be taken for granted in our present economic environment. As Henry C. Wallich has observed, the incompatibility of these elements is "a fact well known to economists but never recognised in our institutional arrangements or avowed principles of national policy" [1].

Given the Treaty's explicit provision for the free flow of goods, services and capital, the choices open were to give up either the autonomy of domestic monetary policy or the system of fixed exchange rates. The latter option being hardly conceivable at the time, the Community's founding fathers made a definite choice in favour of the coordination of policies, overcoming the incompatibility of the various objectives by indicating that in the "inconsistent quartet" it is the autonomy of national policies which will have to yield to the exigencies of coordination, so that fixed exchange rates, free capital flows and free trade may coexist. There are a number of articles in the Treaty bearing this out: art. 145, in particular, sets the task of ensuring the "coordination of the general economic policies of the Member States" alongside "the power to take decisions" as one of the two fundamental Council tools for the attainment of the

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1) Henry C. Wallich - "The monetary crisis of 1971 - The lessons to be learned", The Per Jacobsson Foundation, 24 September 1972, Washington D.C. A similar dilemma faced the Bretton Woods negotiators. They solved it by agreeing that members of the IMF should be able to control capital transfers (except for current transactions). Already in his Proposals for an International Clearing Union, issued in 1943, Keynes had declared that no country could safely permit unwanted movements of fugitive funds, for which reason it was "widely held that control of capital movements, both inward and outward, should be a permanent feature of the post-war system". See Joseph Gold - "International capital movements under the Law of the International Monetary Fund", IMF Pamphlet Series No. 21, Washington D.C., 1977.

Treaty's objectives. The fact that in a regime of fixed exchange rates and free capital movements, economic policy is necessarily constrained by external considerations is furthermore recognised in art. 104 : "Each Member State shall pursue the economic policy needed to ensure the equilibrium of its overall balance of payments and to maintain confidence in its currency ... ".

The analytical foundations of the Treaty are therefore sound and conceptually consistent : the subsequent inconsistency and related difficulties have arisen because the principle of economic policy coordination, enounced in the Treaty, has remained precisely only a principle. Its practical implementation continues to rest on extremely loose and largely ineffective arrangements, so that coordination remains without "bite", at times degenerating into a mere exchange of information on policy actions decided upon unilaterally. That is the main short-coming and the root of the problem : the Treaty set coordination as a finality and an objective, but failed to provide for implemental norms and concrete instruments to render it a reality.

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II. THE EARLY EIGHTIES

1. Legal framework

The two Council directives of 1960 and 1962 marked the last progress so far achieved towards the liberalisation of capital movements. Since then there has in fact been a retreat. A third directive, aiming at a stepwise further liberalisation, was submitted by the Commission in 1967, but had to be withdrawn after ten years of fruitless negotiations at Council level. A decision is still pending on a more recent proposal (1979) to broaden directly the scope of the first directive (inclusion of investment fund certificates). To be sure, there have been other directives with some, albeit indirect, bearing on our subject : as bankers you are all certainly familiar with the 1973 directive on financial institutions (freedom of establishment and freedom to provide services) and with the 1977 directive relating to the taking up and pursuit of the business of credit institutions. There have also been directives on insurances, and two directives (in 1979 and 1980) on the admission of securities to official stock exchange listing and stating the particulars to be published for such admission.

These measures are of undoubted indirect significance for our subject matter, insofar as capital market integration requires a harmonisation of regulations and institutional structures. But as regards the main stage of direct capital movements liberalisation, the account remains negative. The overall degree of liberalisation is lower today than in the early sixties, and differs widely as between Community countries.

The existing imbalance in the degree of liberalisation may be briefly illustrated as follows. There are no restrictions on international flows of financial capital in the United Kingdom and (apart from marginal heritages from the past) in Germany and the Netherlands. The obstacle of additional transaction costs in the form of a two-tier foreign exchange market exists in Belgium/Luxembourg and in France.

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Direct restrictions on capital flows, which were formerly liberalised under the first two Community directives, have been imposed since 1968 in France, since 1974 in Italy, and since 1978 in Denmark and Ireland. These restrictive measures were authorised by the Commission, under recourse to the "safeguard clauses" laid down in the Treaty of Rome, whereby Member States may be authorised to take protective measures when "movements of capital lead to disturbances in the functioning of the capital market" (art. 73) or "where a Member State is in difficulties or is seriously threatened with difficulties as regards its balance of payments" (art. 108).

The Italian requirement to deposit 50 per cent of financial investment abroad in a non-interest bearing, domestic bank account is one example of a continuously existing long-term restriction; the French recourse to safeguard clauses to control various operations is another.

To do justice to the "restrictive" countries, it should be added that the various obstacles are diversified in such a way that some types of capital flows are less restricted than others. In the Italian case, for example, the deposit requirement does not apply to direct investments in EEC countries. In Denmark and Ireland, the restrictions do not apply to the acquisition of securities issued by Community institutions.

This listing of details could continue, but for our present purposes, it suffices to state the fact that the degree of liberalisation is markedly imbalanced across the Community and generally <u>less</u> than twenty years ago. We face the existence of protracted long-term controls on capital flows - controls which were originally authorised on a transitory, short-term basis only, consistent with the rationale of the "safeguard clauses".

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One may finally add two critical remarks on the legal framework within which capital movement liberalisation may be enacted in the Community.

Firstly, liberalisation of capital flows in the Community continues to depend, from a legal point of view, solely on directives issued on the basis of article 69 of the Treaty. This is to say that even today, after the end of a long 'transitional period' for the Community, the general principle of free capital flows (art. 67) does not constitute, by itself, directly binding law. This clarification has been given recently, and for the first time, by the European Court of Justice (Casati case, decision of 11 November 1981). Hence, the legal framework is one which obliges us to continue along the troublesome road of issuing directives, building European capital market intergration step by step.

This approach is, secondly, troublesome in another way. There is the serious drawback of very long internal decision lags within the Community itself. The time seems to be gone when it took the Council only a few months to approve a proposal put forward by the Commission, as was the case with the first two directives in 1960 and 1962. Today, we sometimes have to wait for years until a proposal by the Commission gets Council approval, if any (as illustrated by the table on the following page).

To the lag in the internal decision-making process, one must furthermore add - once approved by the Council - the very long implementation delays and/or grace periods granted. You are undoubtedly familiar with the considerable time it took certain Mémber States to apply the 1973 directive on the freedom of establishment and the freedom to provide services of financial institutions, risking the initiation of formal proceedings against the countries concerned.

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INTERNAL LAG OF COMMUNITY DIRECTIVES ON CAPITAL MARKETS AND RELATED ISSUES

Directive (subject)	year of		
	Commission Proposal	Council Approval	Decision Lag
1. First Directive on Article 67 of the Treaty	1960	1960	2 months
2. Second Directive on Article 67	1962	1962	7 months
3. Third Directive on Article 67	1967	withdrawn in 1977	(120 months)
4. Directive on financial institutions	1965	1973	95 months
5. Directive on international capital flows and domestic liquidity	1971	1972	9 months
6. Directive on conditions of stock exchange admission	1976	1979	38 months
7. Directive on contents of prospectus to be published	1972	1980	90 months
8. First coordination directive on financial services	1974	1977	36 months

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2. Facts

Let me now turn to the factual background to the present situation, looking in turn at the financial, real and policy phenomena of the early eighties.

(i) The EEC-scenario of detailed regulations applied to some national capital markets contrasts sharply with the existence of international financial markets which are global and mobile in scope, not subject to official regulations and ever growing in volume [1]. Against this background the continued existence of nationally regulated capital markets in the Community appears somewhat anachronistic. This impression is intensified, if we acknowledge that the very failure to build a European capital market was one of the reasons for Euromarkets to come into existence : the absence of a liberalised and integrated official capital market within the Community constituted a vacuum which was filled by private activities, with the informal construction of a free and integrated capital market outside the Community. There is some analogy here with the way in which US multinationals have been able to take advantage of the opportunities offered by the Common Market more fully and better than most European firms.

(ii) The golden period of steady, non-inflationary growth which accompanied our first liberalisation successes has been followed by one of poor growth, price and employment performance throughout the industrialised world [2].

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1) See Table in Annex for figures on the growth of these markets.

2) See Table in Annex for some indicators comparing performance in the early eighties to that achieved in the early sixties.

More importantly for the subject at hand is that the structural imbalances in the balance of payments situation of the major country groupings, and particularly the persistence of a large deficit for the non-oil developing countries, continues to mean a sustained need for financing, i.e. for compensating international capital flows, giving an essential role to international financial markets as "recycling vehicles". Let me just mention that in 1981 OECD countries raised medium and long term loans on the Euromarkets in the order of magnitude of 100 billion dollars; adding the 35 billion dollars raised by OECD countries in the form of international bond issues, one arrives at a total of 135 billion dollars which surpasses by far the current account deficit of OECD countries in the same year (29 billion dollars). This demonstrates, in general, a saving-investment dissociation at an international (global) level. Again, a large need for international capital mobility is the consequence.

To complete the list of relevant facts, let me point to a policy feature which is closely related to the financial and real features mentioned so far, and which may bring us back to a more specifically EEC dimension.

(iii) In a world of generally floating exchange rates, there exists, since March 1979, the currency area of the European Monetary System (EMS) with fixed (but adjustable) exchange rates. Obviously, there is a contrast between the EMS, which provides free convertibility of European currencies within fixed exchange rate margins, and the continued existence of nationally regulated European capital markets. In other words, while the "short end" of financial capital transactions, the money markets, are tied together and integrated by means of the EMS,the longer term end of European capital markets, comprising long-term loans as well as the issue and circulation of securities, is still segmented. The policy dimension of the EMS relates precisely

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to this contrast with the existence of regulated capital markets.

3. Policy analysis

Theoretical developments as well as factual experience have modified in an important way the analysis of "insular" economies, outlined above for the early sixties. It is now clear that in a world of capital mobility full insulation from external influences is impossible, even with floating exchange rates [1].

This conclusion is supported by the following line of reasoning. The main fundamental determinants of exchange rates, that is relative cost and price developments and balance of payments positions, operate consistently in the long-run only. In the short-run, exchange rates may be pushed in different directions, away from their fundamental equilibrium level, by rapidly changing expectations influenced by a variety of factors. Recent analysis of exchange rate determination has explained the frequent overshooting of the equilibrium level (defined by purchasing power parity or by other underlying determinants) by treating exchange rates as financial asset prices, i.e. prices which are determined in the short term by portfolio adjustments in the assets markets and are thus closely influenced by often unstable expectations [2]. Short-run changes in exchange rates are thus brought about by massive flows of short-run financial capital, generated by and transmitted via efficient international financial markets.

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1) See, for example, J. Tobin and J. Braga de Macedo - "The short-run macro-economics of floating exchange rates : an exposition", Cowles Foundation discussion paper nº 522, New Haven, April 1979.

2) For various versions of the asset market approach to exchange rate determination, see the 'Scandinavian Journal of Economics', vol. 38, nº 2, 1976.

The deviation of exchange rates from their "normal" level, i.e. their over- or undershooting, has important real effects on domestic economic activity - on domestic industries, on export and import-competing sectors. It follows from this reasoning that national authorities of widely open economies cannot afford a 'benign neglect' as regards their exchange rate.

Their reaction varies according to their possibilities : returning to our "inconsistent quartet", Community member countries have dealt with the policy dilemma it involves by adopting different combinations and yielding on one or more of the various fronts. In very general terms the situation could be described as follows : the smaller open economies, such as the Benelux countries, have sacrificed the independence of their domestic monetary policy on the altar of exchange rate stability and free capital flows. On the other hand, France and Italy have broadly aimed at insulating their domestic monetary policy and at maintaining their currencies' exchange rate via the use of capital controls (and other direct controls, such as credit ceilings). The United Kingdom did not join the EMS because, inter alia, it felt that an exchange rate commitment was incompatible with the lifting of exchange controls and the pursuit of quantitative monetary targets, to which it gave priority.

One could object that Germany, at least, has in some measure succeeded in squaring the circle : to the extent that this may be true, it is obviously due to its pivotal position in determining monetary conditions in the Community as a whole. But if one enlarges one's horizon beyond the confines of the Community, one only needs to look at developments over the last decade to realise the extent to which even Germany had, firstly, recourse to capital controls (special minimum reserve requirements, cash deposit requirements, limitations on the sale of domestic fixed-interest securities to non-residents)

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in the early seventies [1] and, in more recent times, has had to design its monetary policy in the light of external considerations; in the words of its own monetary authorities : "During the year under review (1981) the Bundesbank was unable to take as much account as in previous years of domestic economic problems (which it always kept very much in mind) in its policies, which had to be oriented more towards external requirements at times" [2]. In the present international monetary system, an effectively independent monetary policy is feasible only in what could be termed the n-th currency country, i.e. the United States.

III. LOOKING AHEAD : POLICY APPROACHES

In order to reassess European capital markets policy, the picture of a changed economic environment should now be completed with an attempt to look ahead. The comparison of the early eighties with the early sixties reveals the persistence of the old problem in a new environment : we still have to reconcile the four elements of free trade, exchange rate discipline, capital mobility and national policy autonomy. The problem, and the whole question of capital market liberalisation in the Community, has to be tackled on the basis of a consistent, and Community-oriented, organisation of all these four elements. We may think of trade, money, control and policy as constituting the four rings of what must be a coherent and organised chain, and we may distil three policy approaches which could alternatively

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1) Causing the German Expert Council to remark that "in restricting international capital movements, the Federal Republic has embarked on a path which will lead us away from a European monetary union". Quoted in N. Walter - "Capital controls and the autonomy of national demand management : the German case", in Alexander K. Swoboda, ed. - "Capital movements and their control", Geneva 1976, p. 170.

2) See "Report of the Deutsche Bundesbank for the year 1981", Frankfurt, April 1982, p.1.

bring about full consistency between the four rings of the chain. We will describe them briefly, in their pure and conceptual form, i.e. for clarity of exposition, we will intentionally ignore the existence of political difficulties and the constraints of gradualism.

1. Follow consistent macro-policies.

If each member country followed a policy line consistent with that of its partners and oriented to commonly agreed objectives, no tensions would develop in the chain. Thus "policy coordination" looks like the road of wisdom and simplicity. So much so that, starting with the Treaty, a little library of Community texts has legislated in detail the procedures by which groups, committees and councils of experts, officials, central bankers and ministers should reach ex-ante consistency, as if one policy were followed in the whole of the area. In the Commission in Brussels we spend the best of our skills and efforts to maximise the effectiveness of coordination. And it is perhaps just because of that, that we are very familiar with the formidable limits of this exercise : what appears to be the road of wisdom and simplicity is, in many ways, the road of simplification and deception.

Complete and systematic consistency of macro-policies conducted by a group of sovereign governments is extremely difficult for a variety of reasons. Each government ultimately responds to its own electorate : there is little probability, and we have evidence of this every year, that voters of different countries vote for the same policies at the same time. In addition, policy calendars do not coincide : budget proposals for a given year are presented at very different points of time in different countries; not even the definitions of a fiscal year coincide. For monetary policy difficulties are also great, as they concern not only calendar, but also choice of targets, choice of instruments, structures of the banking industry and financial intermediaries in general. Finally, policy mixes are shaped in very different ways according not only to choice but also to the institutional relationships between national central banks and Treasuries. And more reasons could be given.

Complete and systematic consistency of policies achieved without any institutional infra-structure is a dream, a beautiful and dangerous one like the anarchic dream of universal love and altruism. On the other hand, to create an international infra-structure that would force the dream into reality would raise enormous difficulties, much greater difficulties and objections than those raised by more limited institutional steps in the areas of capital market or monetary integration.

To the extent to which coordination does not work, or at best, in the words of J. J. Polak, is only "a relatively weak form of international influence on national policies" [1], we have different forms of distortions in the other rings of the chain. One of them is the development of various types of controls, possibly of capital market controls, as we have already seen. Another is, of course, the widening of economic divergences that create tensions in the EMS and threaten trade and agricultural arrangements, thus endangering the very foundations of the Community. In other words, if the policy coordination ring in our chain of four elements does not hold, at least one of the other elements is bound to come under tension and perhaps break : trade, money or controls.

To prevent such negative consequences, approaches have to be implemented which tend to strengthen policy coordination either indirectly, via capital market integration, or directly, via the completion of monetary union.

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1) See J. J. Polak - "Coordination of national economic policies", Group of Thirty Occasional Papers n° 7, New York, 1981.

2. Enforce capital market integration

The idea conforms closely to a cooperative Community spirit, and carries the logic of enforcing policy coordination in an indirect way through the institutionalisation, or organisation, of a European capital market. Detailed proposals to enact further liberalisation directives and to revitalise the legally established supervising functions of the Commission and the Monetary Committee are its basic practical ingredients.

The proposal might however meet with the objection that the integration of European capital markets has by now become an obsolete or redundant goal : financial markets throughout the world are already linked via the Euromarkets, which have repeatedly proved their worth as efficient vehicles for international capital mobility, and have in practice raised the degree of integration between different money centres. It may be argued that there are, in this sense, "market pressures" towards conformity and coordination, as observed by Lindbeck : "The internationalisation of credit markets and the integration of governments in those markets as regular lenders and borrowers, as well as the increased importance of market forces for exchange rate determination, mean that the coordination of government actions is increasingly brought about by the 'invisible hand of markets', rather than by the more visible hand of government authorities" [1].

This may be partially true, but it does not mean that the problem of government action in terms of management and surveillance can be evaded by sole reliance on market forces. This is borne out by the tendency in all major countries, over the last decade, to increase the authorities' regulatory and supervisory powers, in many cases enacting far-reaching legislation for the first time since the

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1) See "International coordination of national economic policies", in Samuel I. Katz, ed. - "US-European monetary relations", American Enterprise Institute for Public Policy Research, Washington D.C., 1977, pp. 229-230.

1930's (another crisis period), and by the attempts to increase the transparency of the international financial markets, which have tended to grow faster than the authorities' ability to supervise them.

The fact of the matter is that money and financial markets "do not manage themselves" : to the extent to which there therefore is a need for control and supervision, the question arises of determining the appropriate-space over which they should be exercised, and in this regard there is a solid case for operating them at a Community level : the EEC could in this regard be seen as constituting an optimum regulation area. This would be certainly preferable to a completely independent use of controls by individual member countries, which may work at cross purposes and invite retaliation and competitive restrictive measures. A rational use of controls based on Community cooperation and consultation would alleviate such difficulties : its intention would not be to extend the area of government regulations, but on the contrary to forestall conditions leading to a widespread expansion of restrictions.

The Treaty in fact advocates a Community approach of this type in article 70, providing for "the progressive coordination of the exchange policies of Member States in respect of the movement of capital between those states and third countries. For this purpose the Council shall issue directives, acting unanimously. It shall endeavour to attain the highest possible degree of liberalisation". This article is at the basis of the 1972 directive on regulating international capital flows and neutralising their undesirable effects on domestic liquidity [1].

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1) This directive, approved in the wake of the unsettling events following the demise of the Bretton Woods system (and to respond particularly to the formidable 1971 short-term capital inflows to Germany), provided that Member States "adopt measures immediately in order to have available, should occasion arise, the appropriate instruments for purpose of discouraging exceptionally large capital movements, in particular to and from third countries", seen to cause "serious disturbances in the monetary situation and in the economic trends in Member States", likely to "hinder the establishment by stages of an economic and monetary union".

The implementation of this strategy does however encounter the difficulty of being a very "legislation intensive" matter. There are not only extremely long decision lags within the Community, as already mentioned. More importantly, the legislative process in the EEC is paralysed, as national governments are increasingly absorbed in the control of domestic matters. They are more and more passive and immobile in building the necessary institutional arrangements to conduct systematic, and foreseeable, Community-wide policies in monetary and financial matters. Nevertheless, stagnation might be overcome, if the political will is there. Hence, this proposal is a candidate to be considered seriously. Its realisation would mean a large step towards exploiting the above-mentioned potential of the EEC as an optimum regulation area.

3. Complete monetary union

This approach is of course well-known and the one most often attempted after the end of the Bretton Woods system had deprived the Common Market of the vital monetary organisation required for its proper functioning. It is therefore not necessary, in this paper, to expound on it further. Suffice it to say that the marked attention and many studies devoted to the question of European monetary union derive from the realisation that the twin goals of free capital movements and fixed exchange rates (explicit or implicit in the Treaty) imply a single currency area and a single monetary authority. Within a single country - where there are of course free capital flows and a single exchange rate - it is clear that "the various branches of the central bank cannot pursue independent monetary policies. The Federal Reserve, whose twelve regional banks were established on the contrary assumption, learned this early in its career, and most other central banks never tried" [1].

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1) Henry C. Wallich, op. cit., p. 7.

Fully-fledged European monetary union is thus the high road to policy coordination and economic convergence, implementing these directly by replacing a number of monetary authorities with a single, central authority. Its realisation should in practice be easier than the capital market liberalisation approach : it would not be necessary to overcome a multitude of intricate, difficult obstacles and regulations. It would suffice to realise one major achievement : monetary union. Here too, its realisation would conform to an optimum concept, i.e. that of the Community as an optimum currency area.

V. CONCLUSION

In conclusion, where do we in the Community stand today as between these three approaches of : (1) directly following consistent and coordinated policies; or arriving at such policies through either (2) capital market integration or (3) monetary union ? It would seem that on all three fronts we are, to a lesser or greater degree, at a sort of halfway house between, on the one hand, purely national policy formation and, on the other, policy-making that is entirely lodged at Community level. It is a situation in which the Community is still contending with the problem posed by the "inconsistent quartet" of free trade, exchange rate discipline, free capital movements and autonomous domestic policies. Until a coherent, Community-oriented organisation of all these four elements is found, the temptation is to yeild a little on each, including even the principle of free trade, thus calling into question the very foundations of the Community. There is no point in assuming an attitude of moral or legalistic condemnation in the face of such developments and risks : the problem needs to be tackled, and in this regard there would seem to be two broad possibilities.

The first, and certainly preferable solution, would be to realise _to the full_ any one of the three alternatives examined above : either complete coordination of policies, or full capital market integration or monetary union would "square the circle" of our incompatibilities. There is no need to illustrate the considerable difficulties of arriving at the final destination along any one of these three roads : the experience of the Community to date is unfortunately an eloquent and sufficient testimony in this regard. But if the will to take the important qualitative leap which is involved were to materialise, it would seem that the way of monetary union is still the one likely to offer less "mechanical" resistance and the greater chances of success.

The second, less satisfactory but in practice more probable, alternative is that of _gradualism_. Here the transition from purely national approaches to a Community-oriented organisation is seen as a progressive shift in a spectrum, as a gradual but nevertheless on-going process. The EMS, for example, by focussing attention on convergence, may be seen as a strategic catalyst in this process of integration, enhancing the legitimacy of each participant's concern for the others' policies and inducing Member States to discuss fundamental issues sooner in time, in greater depth and in terms of more concrete policy options than in the past. Barring the great leap forward to full Community coordination or complete capital market and monetary union, we therefore appear to have no choice but to persevere on all three fronts, taking a series of steps, lengthening our stride where possible, and gaining momentum until the leap -which will then perhaps not have to be so "great" - to effective integration will be the natural and logic culmination of our efforts since the early sixties.

TABLE 1

THE EARLY SIXTIES VERSUS THE EARLY EIGHTIES : SOME INDICATORS FOR THE COMMUNITY

		1960-1965	1980-1982
1.	GDP volume growth	5.3	0.8
2.	Consumer prices	3.3	12.3
3.	Unemployment rate	2.1	7.7
4.	Net lending (+) or net borrowing (-) of general government (% of GDP)	in balance	- 4.5
5.	Real short-term interest rates	+ 0.4 (1)	+ 2.1 (1)
6.	Share of exports in GDP (%)	18.5	29.5
7.	Current account balance (% of GDP)	+ 0.3	- 0.8
8.	Cumulative change in ECU/$ rate	+ 1.3 (2)	- 28.0 (2)

(1) Average 1961-65; and 1980-April 1982.

(2) For 1960-65, change between the two yearly averages; for 1980-82, change between January 1980 and May 1982 (+ sign indicates ECU appreciation.)

Sources : Commission of the European Communities, Directorate-General for Economic and Financial Affairs - "European Economy" and "European Economy - Supplement A - Recent Economic Trends", various issues; and Commission staff internal calculations.

TABLE 2 GROWTH OF INTERNATIONAL FINANCIAL MARKETS, 1970-1981

(billions of dollars)

	1970	1975	1981
Eurocurrency market estimated size - Gross	110	460	1800 p
Net	65	250	905 p
Eurocurrency bank credits, publicly announced in period	4.7	21.0	133.4
New international bond issues	4.6	19.9	53.0

Source : Morgan Guaranty Trust, World Financial Markets, various issues

p = provisional