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Generaldirektoratet for økonomiske og finansielle anliggender

EUROPÄISCHE GEMEINSCHAFTEN
KOMMISSION
Generaldirektion Wirtschaft und Finanzen

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Direction générale des affaires économiques et financières

COMUNITÀ EUROPEE
COMMISSIONE
Direzione generale affari economici e finanziari

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STUDY GROUP ON ECONOMIC AND MONETARY UNION

European economic integration and monetary unification

PREFACE

Towards the end of 1972 the European Commission asked several experts distinguished in the field of economics, to examine the possibilities and means of achieving Economic and Monetary Union.

This Study Group has held several meetings in which officials of the Commission also took part. The meetings have given rise to profound discussions. In view of the great interest of the ideas put forward by this group it has seemed useful to make them available to the general public.

The present document consists of two parts. The first part presents a report written by three rapporteurs of the Study Group (Professor Dosser, Professor Magnifico, Professor Peeters), acting in a personal capacity. The views they have expressed here do not necessarily represent those of the institutions with which they are associated. During the preparatory stage the Reporting Group also profited of valuable contributions of Professor Neubauer. This first part commits only the three members of the Reporting Group. It reflects the work of the whole Study Group in that it summarises and synthesises the main views of the majority of the Study Group members, though not all of the members of the Study Group would agree with all of its main conclusions. Any such differences of opinion are reflected in the individual contributions of the members of the Study Group which are published in part II. These contributions have served as a basis for the discussions and for the drawing up of the report. They also permitted members of the Group to express more personal opinions on particular points.

Taking into consideration the circumstances, the monetary aspects have been especially emphasized. The Group has not considered all implications of Economic and Monetary Union, since the study aims rather to encourage further discussions than to spell out definite positions.

The Commission expresses its gratitude to all members of the group who have given considerable support to the analysis of specific problems posed by Economic and Monetary Union. However, the Commission emphasises that the publication of the results of these considerations in no way implies that the Commission is at all committed to any of the conclusions stated in the report.

COMPOSITION OF THE GROUP

Professor Dr. H.W.J. BOSMAN
Professor B. DE JOUVENEL
Professor J. DENIZET
Professor D.G.M. DOSSER
Professor Dr. H. GIERSCH
Professor G. MAGNIFICO
Professor J.E. MEADE
Professor R.A. MUNDELL
Professor Dr. W. NEUBAUER
Professor F. ONIDA
Professor T. PEETERS

REGULAR COMMISSION PARTICIPANTS IN THE GROUP'S WORK

Mr. U. MOSCA
Mr. F. BOYER DE LA GIRODAY
Mr. P. VAN DEN HEMPT
Mr. J. DE MAEYER

SECRETARIAT

Mr. J.C. MOREL
Mr. J. SCHÜLER

EUROPEAN ECONOMIC INTEGRATION
AND MONETARY UNIFICATION

- Synthesis -

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PART I

SYNTHESIS

EUROPEAN ECONOMIC INTEGRATION AND MONETARY UNIFICATION

Introduction

At the Hague Summit on 1 and 2 December, 1969 it became the ultimate declared goal to establish an Economic and Monetary Union (EMU). EMU was put forward as the next essential step in the process leading towards European economic and political integration. Underlying this move was the hope of preserving Europe as an island of stability and freeing it from outside shocks. During the following years, the apparent difficulties of the international monetary system and its recurrent crises made the need for agreement among the Community countries to step up their efforts for economic and monetary unification more urgent.

The rationale for progress toward monetary unification and economic integration, however, derives as much from internal as from external Community preoccupations. Monetary unification has always been considered as a logical and necessary step on the road towards full economic union. Repeated currency crises since 1967 only shifted the emphasis from internal preoccupations towards a more externally-oriented approach. Whereas internal Community building was the major driving force which inspired the proposals for monetary unification antedating the Werner report, it is Europe's position vis-à-vis the outside world, and the related loss of control over monetary affairs for internal stabilisation purposes, which originated the major impetus in more recent years.

Although the importance of monetary unification cannot be challenged, it is at the same time important to realize that the integration of national currencies and national monetary systems into a unified European system is only one element of the general European integration process, economic and political.

A monetary union of the Nine is by no means an objective in itself. Money should be kept as a good servant; it must be prevented from becoming a (potentially) dangerous master.

Nevertheless, one current of opinion argues that priority be given to monetary unification. Progress towards economic union (common policies with regard to business cycles, economic growth, distribution of incomes, social affairs, competition, etc.) is then considered as having only the function of safeguarding the measures orientated towards monetary union. The contrary opinion believes that priority for monetary unification might be more to the detriment of the integration of economic policy and policy objectives than to their benefit. According to this view priority should be given to economic union which is to be advanced and safeguarded by measures of monetary unification. Substantial progress towards economic union would create the necessary conditions for further development in the field of monetary union.

To the extent that an adequate understanding of the required "function of safeguarding" in either the economic or in the monetary sphere is developed, both points of view do not differ very much. Both opinions converge towards the real economic and political meaning of "the principle of parallel progress in the various fields of Economic and Monetary Union" reaffirmed at the Paris Summit.

The point to be stressed is that the postulate of parallelism is not only a political compromise between originally conflicting interests. It is rather the consequence of the interdependence of economic processes. Hence the principle of parallel policy may also be interpreted as requiring an integration policy of broad-ranging interdependent measures.

It is within this general framework that the particular measures aiming at merging the Nine towards an Economic and Monetary Union are to be judged. Whilst the political motivations underlying this process will not be elaborated on in this report, the ultimate motivation for European integration is political and perhaps it is this political determination which explains why the governments of the member states accepted (The Hague, 1969) and reaffirmed (Paris, 1972) the principle of economic integration and monetary unification, even if apparently all the consequences are not always fully understood or agreed upon. This report addresses itself to the economics of EMU and tries to contribute to the difficult task of showing how this political decision can be translated into an economically meaningful and operational scheme.

This report has not dealt with the implications of EMU for the international monetary system and vice versa. This might appear rather surprising at a moment when negociations for a reform of the international monetary system are under way. However, for the near future only transitional regulations may be expected, which will probably remain the subject of experiments and further changes. Therefore, efforts at the European level cannot start from anticipating this reform. One thing, however, is clear: as matters stand now development in monetary affairs tends towards increasing the importance of regional monetary zones. In addition, and perhaps more important, both problems are sufficiently distinct to be analyzed separately at this stage. Of course, proposals for progress of EMU can affect the rules and the working of the international monetary system but without modifying the fundamental issues at stake. Besides, it is the official position of the Community countries in the current monetary negociations that the proposals for reform should not interfere with European attempts towards EMU. This taken into consideration the Group believes that dealing with monetary unification at Community level presents also a contribution to the reform of the international monetary system.

Part I of this synthesis surveys the major issues underlying the process towards monetary unification and economic integration. Part II is devoted to the main technical problems and proposals for monetary unification including the introduction of a Common European Currency (C.E.C.) (1). Part III reviews the possibilities and necessities for action in the broad field of economic and social policies. Final remarks summarizing the major policy conclusions are set out at the and of the report.

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(1) To avoid possible confusion or too strong indentification with analogous proposals for an early introduction of a European currency it was preferred for this report to stick to the neutral and uncommitting expression of a "Common European Currency" instead of using the much more loaded name of "Europa" (or other names suggested so far).

I. The Economic of Monetary Unification and Economic Integration

Although a full assesment of the costs and benefits of monetary integration can hardly be worked out at his moment, this part of the report is focussed on the arguments for monetary unification on the one hand, and the necessary qualifications and drawbacks on the other. The first section is devoted to further comments on the need for parallelism between monetary unification and economic integration.

A. Monetary Unification as part of Economic Integration

Parallel progress towards monetary unification and economic integration is vital. It is neither a matter of compromise nor a matter of principle. The following considerations are intended to substantiate this point.

A succesful completion of monetary unification in Europe will depend on the ability of the governments of the EC-member countries to reconcile balance of payments equilibrium with full employment at stable prices during the transitional period when the process of economic and monetary integration reduces available instruments and/or the autonomy of using them. Autonomy of national economic policy objectives and the lack of homogeneity of attitudes in particular toward the trade-off between unemployment and inflation are at the origin of the familiar external adjustment problem which has been plaguing the functioning of the international monetary system for more than a decade now. It is also the central issue in the process of creating a monetary union.

The implications of monetary unification for the member countries are twofold. They will (gradually) surrender autonomy (1) in internal monetary policy, and in exchange rate policy. However, it is open for debate how much sacrifice of autonomy this may entail. The present degree of integration of world financial markets already imposes severe constraints on the freedom of individual countries. The current exchange rate arrangement with certain currencies floating individually may be considered, among other reasons, as an attempt to avoid the constraints imposed on monetary policy by integrated financial markets. However, it will hardly be a lasting solution (cf. Part II).

Monetary unification, based on the introduction of a Common European Currency along the lines presented in this report, offers the major advantage that it will help to restore at the European level the efficiency and independence of monetary policy for stabilization purposes which the national central banks have lost to a large extent without sacrificing sufficiently stable, though still adjustable, intra-Community exchange-rate relationships. However, the creation of a Common European Currency is no deus ex machina. It is important to underline that the effectiveness of the proposed scheme for monetary unification depends crucially on the creation of an adequate European decision taking process in monetary

(1) It may be useful to recall at this point that the member countries have already given up trade policy at the national level for external adjustment purpose as a result of the achievements of the Common Market so far.

matters. To the extent that this will be achieved it is not only an important contribution to monetary unification, it will constitute at the same time a great step towards economic integration and policy harmonisation.

If monetary unification is not to be separated from economic integration, there is, a fortiori no point in dealing with monetary integration policy as if the problems of a Common European Currency, exchange rate policy and capital movements (external monetary policy) could be dissociated from the problems of monetary policies withih the member states (internal monetary policies). The integration of external monetary policy is bound to fail if the integration of internal monetary policy does not progress pari passu. It is perhaps one of the major shortcoming of the current Community exchange rate arrangement (the snake) that it is not sufficiently supported by common action in the field of internal monetary policies.

If controls of capital movements according to the requirements of monetary integration were abolished whilst at the same time autonomy in national money and credit policy was maintained, the danger that divergent monetary policies might lead to serious difficulties would be amplified. The Fund for European Monetary Cooperation would be solicitated beyond its capacity and thereby be brought into discredit. Parity changes not justified by the state of economic transactions in goods and services would be provoked and conjunctural policies upset in member countries only passively involved.

The process of exchange rate unification and capital market integration implies that monetary policies of member states, external as well as internal, should be increasingly linked together. Priority should therefore be given to the process of harmonization of monetary instruments ultimately leading to an identical set of instruments. This process would be useful and necessary even in the case where national money and credit policy remains independent in the near future. As matters stand now, it is extremely difficult to assess the comparative effects of measures of monetary policy in the individual countries (1). Thus the coordination of these measures is hampered. Undoubtedly the unification of monetary instruments is rendered difficult by considerable differences in the structure of the banking sectors and in the business behaviour of banks in various countries. Nevertheless it is an important goal to develop a common set of instruments which permits :

(a) a direct regulation of bank liquidity;

(b) direct influence on market interest rates and

(c) credit ceilings as an emergency brake for restrictive monetary policy.

The creation of a common European central banking system would thus be prepared.

Meanwhile monetary authorities in the Community will have to implement a common European liquidity policy. Decisions on variations of bank liquidity and its control at the European level and not at the national level is indeed the key issue (2). This must not

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(1) Reference to Communautés européennes, Comité monétaire: La politique monétaire dans les pays de la Communauté économique européenne. Institutions et instruments, 1972.

(2) The practical implementation of this policy presupposes the production of more comprehensive European monetary statistics in which the foreign liabilities of the European banks to Community residents (the so called Euroliquidities) are included in European liquidity.

imply the adoption of a strict quantity rule for money supply, neither should it be interpreted to imply the same rate of increase in bank liquidity in each member country. The concept of a European liquidity policy could aim at setting limits (possibly nationally differentiated) for money base creation, leaving it to national authorities to utilize their discretionary power according to the commonly agreed band as well as the choice of channels and instruments through which to implement the specified goals. The point to be stressed is that these steps towards monetary integration should not be dissociated from the development of an independent common decision-taking body in monetary affairs.

Parallel progress towards economic integration and monetary unification is natural and necessary for other reasons also. Monetary unification, for instance, critically depends on the ability of member countries to preserve external balance without upsetting progress towards exchange rate unification and capital market integration. The task assigned to economic integration in this respect is to avoid chronic disequilibria between member states. Economic integration in the sense of policy coordination and harmonization is one of the ways to cope with the external adjustment problem by trying to avoid disequilibria from accurring at all. Success in economic policy integration would make intra-Community exchange-rate adjustments superfluous and monetary unification possible.

Finally, it is to be stressed that monetary unification is only instrumental in achieving certain aims better than would otherwise be possible. Monetary unification, important though it is, is subordinate to overall socio-economic policy objectives. It cannot be conceived of as feasible outside the wider context of economic union. It belongs to economic union just as other instruments of economic and social policy do. In the Paris summit communiqué it is stated that:

> "Member countries are determined to strengthen the Community by setting up an economic and monetary union as a guarantee of stability and growth ... Economic growth, which is not an end in itself, must in the first place be aimed at reducing disparities in living standards. It must improve ... the quality and level of life".

The objectives of economic integration are broader than those of monetary unification. They imply that monetary unification should be pursued in a fashion consistent with a European policy of balanced growth as a condition for improving "working conditions and conditions of life". To secure an even pattern of high employment of resources and to close the gap in living and working conditions throughout the union's territory, conscious policies at the Community level, reaching beyond the technical problem of an operational scheme for monetary unification, should become an integral part of the efforts undertaken along the road towards economic and monetary union.

It would be a rather unfortunate development if the efforts for progress of the European construction in the near future would be directed almost exclusively towards monetary unification and its related problems. This is not to deny its importance and the difficulties involved. Nevertheless, there remain outside the monetary domain a number of fields where centralized European action is worth-while and desirable because it enhances the economic welfare of the individual citizens.

Continuous action which promotes the efficient use of resources by making the best of the virtues of the market mechanism in equating social costs and values at the margin includes the abolition of different artificial government restrictions still impeding the free flow of goods, services and factors of production, not only between the European countries but also vis-à-vis the rest of the world.

Structural problems due to economics of large scale production cutting across national borders of a concentrated area like Europe also call for centralized European action. Common industrial policies and regional planning are illustrative cases. The appropriate scale for the procurement and consumption of public goods such as environmental protection or research and development efforts may well be European rather than national.

However, with the greater degree of economic integration in the Community achieved through freedom of trade and factor movements, the need for centralized coordination of overall monetary and fiscal policies for the purpose of stable economic development in member countries will also increase. These aspects are dealt with in greater detail in Part III of this report.

B. The Need for European Monetary Unification in the Framework of Economic Integration

A distinction should be drawn between the actions and the ultimate objectives to be achieved in the monetary and the economic fields. Whereas monetary unification has a clear aim and can be given a precise content, economic integration is wide-ranging and open-ended. For the latter it is impossible to define some en-point, since this itself would raise acute differences of opinion as to the degree of centralism or federalism eventually to be attained by the Community economy. The process of economic integration may be fast or slow; the declaration of parallelism between monetary and economic union (1) sets a certain minimum required pace along-side monetary unification, but over and above that, there is scope for a great deal more fruitful advance, as outlined in the previous section, if member-states have the political will.

Achievement in economic union during this decade may prove to be more difficult than in monetary union, in view of the varying degrees of fundamental changes involved in the centralization and decentralization of various economic functions. But, because of that very fact, such progress represents a more profond movement in the creation of a unified Community economy, and since it affects people's jobs, lives and environment directly, it carries tremendous importance in determining their opinion of the Community.

In both cases, however, it is important to draw a distinction between integration as a process or as a state of affairs.

Indeed, it is not too difficult to argue that monetary and economic union (the final stage) must be considered an impossibility under present circumstances. This, however, is not sufficient to claim that it is also an impossibility for the future, when conditions can be changed as the result of concrete policy action. From a policy point of view it is,

(1) Reference to Paris Summit Communiqué

therefore, only sensible to speak about European economic and monetary integration in terms of a dynamic process of change. What this process involves in the monetary and the economic fields is different. That is why this report prefers to speak about monetary unification and economic integration.

The motivations for monetary unification in the framework of economic integration derive from the need to consolidate and expand the European construction (internal reasons) and to restore control over monetary affairs in Europe (external reasons).

1. Internal reasons

The eventual realization of monetary union follows the logic of European economic integration based on the free movement of goods, services and factors of production among the member-countries. Freedom of payments for transactions connected with trade in goods and services is necessary as a complement to a customs union if in intra-Community exchange, conditions analogous to those prevailing in national markets are to be created. The free movement of capital, an essential component in the construction of a unified European market, depends ultimately on full convertibility for capital transactions. Free transfer of capital also avoids an artificial dividing line between current and capital account transactions. It excludes the possibility that capital controls interfere with the freedom of exchange of goods and services. Indeed it is an empirically-observed fact that controls on capital transactions gradually extend to current account transactions, tourists generally being among the first category to be hit together with measures to control leads and lags in payments for trade-transactions. A monetary union, characterized by complete and irrevocable convertibility and by rigidly locked intra-Community parities with no margins of fluctuations among the currencies of the union, is a guarantee for the free movement of goods, services and factors of production.

The final logic of the convertibility feature of the projected European economic and monetary union is seldom disputed. On the other hand, the question whether exchange rate unification would be helpful during the transition has been and is much more controversial. Alternative exchange rate arrangements going from floating rates to completely rigid exchange rates among member countries or a common currency, do permit, it is argued, the realization of the advantages of specialization and mass production. What matters, according to this view, is solely the abolition of obstacles to the movements of goods and factors of production, not a common currency or a permanent fixing of exchange rates.

The major trouble with this view of European economic integration is that it overlooks the internal dynamics of a process which is intended to reach beyond a customs union and the simple freeing of the movements of goods, services and factors of production. The objective is to create among the member countries conditions that will remove any bias against intra-Community trade and factor movements relative to trade and factor mobility internal to countries.

To "internalize" intra-Community trade, progress towards economic and monetary union is needed in order to spare the industrial customs union the jolts of exchange rate jumps and the implied threat for competitive efficiency. It will also contribute to preserve parts of the agricultural policy, although the latter should not be allowed to act as the tail wagging the dog. Even if the C.A.P. is overhauled, making fixed partities less important from that point of view, there are still many other important advantages, for example, efficiency gains due to the simplification of transfers, the elimination (or reduction) of exchange risks and the abolition of internal exchange controls.

Monetary unification becomes even more pressing when one turns to intra-Community liberalization of capital movements. Indeed, freedom of capital movements will bring about an equalization of interest rates on the Community's money and financial markets. This robs the national monetary authorities of one of their major instruments for domestic stabilization purposes i.e. interest rate policy. Unification of the Community money and financial markets is far from complete. Nevertheless, the de facto integration which has developed as a result of the expansion of the markets for Euro-currencies, already offers sufficient potential for destabilizing short term capital movements in anticipation of exchange rate variations and/or as a reaction to interest rate differentials.

If anti-cyclical policies through monetary control other than interest rate variations are difficult in implementation at the national level in the short run because of the degree of integration achieved, it is necessary to replace the national instrument by a community instrument. It might be objected that this is only one possibility. Another possibility to escape from the dilemma would lie in greater flexibility in exchange rates. The latter solution, it might be argued, would recreate at the national level the opportunity for an efficient and independent monetary policy.

The issue involves basically the long-standing controversy over fixed versus flexible exchange rates and the more recent formulation of that issue in terms of the economics of optimum currency areas. Whereas extreme positions in both directions do not offer practical solutions, it is admitted that during the transitional period some form of intra-Community-exchange rate flexibility, as outlined in Part II, will be necessary.

Still to be mentioned as an element of internal Community building is the fact that progress towards monetary unification offers perspectives for a convenient Europe-wide unit of account and medium of exchange. This development would strengthen, inter alia, the economic position of European banking, business, and financial firms by offering them an instrument comparable to the dollar, together with the benefits from the economics of scale and the diversification of services which only a unified European monetary and financial market and a widely-spread currency, can offer.

A common European currency would also recoup the seignoriage now accruing to US banks and tax-payers.

2. External reasons

Until recently (March 1973) developments were such that Community countries had become commercially integrated with one another, whereas monetarily they communicated mainly with, and through, the dollar. This caused sharp conflicts at a time when trade cycles were tending to diverge on the two sides of the Atlantic. Already in the second half of the fifties, Europe had regained autonomy vis-à-vis the United States in the trade cycle, but, more or less up to the end of 1972, this did not hold in the monetary and financial spheres. Several factors (including, of course, the growth of the Eurodollar market) accentuated monetary interdependence. Given the great disproportion between the United States and the fragmented European national markets interdependence was rather lopsided.

The common floating of eight European currencies (Community and non-Community ones) achieved in the agreement of March 1973, i.e., the system known as the "snake" involves among other things, an attempt to regain autonomy and to safeguard intra-Community relations against the apparent difficulties of the dollar. The recurrent crises at the beginning of 1973 and the expected consequences of the different measures taken by American authorities in order to support the dollar, rendered it impossible for European authorities to rely any longer on the so far achieved de facto role of the dollar as the main European reserve and intervention currency. However, experience has shown that the kind of common floating involved in the "snake" arrangement presents a rather fragile solution. Although it has eased the problems raised by the Eurodollar system, this arrangement has neither been elastic enough to enable all member countries of the Community to participate, nor has it spared the signatory countries the jolts of further parity-change. Therefore a fundamental solution has still to be found. This is all the more true since dollar liquidity has not yet been definitely banned. The more the dollar gains in strength due to the planned development of the American basic balance of payments, the higher is the probability that the dollar will be used again as an intra-Community currency.

Objections against monetary unification are often based on the limitations that it imposes on national sovereignty. This attitude, however, is rather inconsistent with the acceptance of the loss of sovereignty that has arisen or is expected to arrive from the Eurodollar system. Up to March 1973 the situation, where fragmented national money and capital markets largely communicated through the dollar, imposed damaging constraints on monetary policy in Europe. The fact is that not only the control of national central banks over domestic money supplies was increasingly weakened, but the European money supply had become subject to the monetary policies followed by the US authorities.

A common floating set out in the "snake" arrangement cannot be considered as a lasting solution for the Community as a whole, provision has to be made to prevent dollar liquidity from reappearing. What the Europeans need, and they need it now, is the creation of a substitute for the dollar. This rôle will have to be fulfilled by a Common European Currency tailored to suit the Community needs and which the Europeans would collectively manage for themselves.

C. Major Qualifications and Drawbacks of Monetary Unification

Although monetary unification appears to be in the logic of economic integration and is considered as a necessary further step for the European Community, its underlying dangers and possible negative implications ought to be understood clearly. Discussions and scepticism on monetary unification are focussed on possible adverse internal effects. As already stated, countries will gradually surrender autonomy in the use of policy instruments for internal and external balance. If divergences in price and cost-trends between the member countries persist, this would impose intolerable strains on their economies. Furthermore, the adjustments might take place to the detriment of the weaker regions in the Community thereby worsening the existing regional problems or leading to the formation of new ones. Together with the difficulties which might still arise from diverging business cycle developments, one has to cater for avoiding a rather negative total impact of monetary unification on the major objective of a smooth and balanced growth of the EC-economies.

1. Diverging price and cost developments

In the post-war period the task of maintaining internal and external balance has been made more difficult by the fact that the multiplication of economic and social policy objectives has outgrown the range of available effective institutions and policy instruments. This development has increased the possibility of conflicts between objectives and the adequate use of instruments. These conflicts very often resulted in a partial sacrifice of certain goals and/or in a trade-off against other goals. Because the readiness to sacrifice related objectives differs from country to country, as shown by the trade-off between the rates of growth of G.N.P., full employment and price-stability, it is not surprising that discrepancies in national price and cost-levels have developed to an extent which often requires exchange-rate adjustments.

As long as the ability to sustain the processes of economic growth in a context of monetary stability differs between member countries, monetary unification must be pursued in a way permitting smooth adjustments of economies via exchange-rate changes. If exchange-rates were rigid, countries with heavy cost-rises would register unemployment and deficits in their balance of payments. Countries with low cost-rises, on the other hand, would suffer from pronounced overemployment and increasing inflation.

Furthermore, monetary unification as worked out in particular in Part II may contribute to lifting the veil which tends to blur the differences in money-wages paid for the same work throughout the Community. To the extent that this would encourage claims for pay parity throughout the Community's territory regardless of differences in productivity, this would add to inflationary pressures and aggravate regional problems.

For all these reasons adjustements of exchange-rates cannot be excluded during the transitional period towards EMU. At the same time they point out that if these adjustlents are to be kept within a small margin, an appropriate flexibility and medium term coordination in the development of national cost-levels and prices will be indispensable. In other words, measures ought to be taken in the field of incomes-policy and/or budget policy (cf. Part III).

Divergencies in prices and costs not only require further approximation of trends between member countries. They may also give rise to particular problems in the short-run, because of divergent cyclical movements. The evidence whether there is a tendency for greater convergence in intra-Community business cycles leaves room for debate. Nevertheless, progress in the liberalization of movements of goods, services and factors of production can only be expected to bring about this convergence via increasing intra-Community economic interdependence.

During the first stage of EMU, divergences in business cycles have been more or less dealt with by means of exchange-rate fluctuations within the margins. However, if these margins were to be narrowed the success of monetary unification will also depend on how far an adequate synchronization of business cycles occurs as a result of developments in the private and public sectors, since the prospects for adjustments of divergences in member states as monetary unification proceeds, will be limited.

In Part III, fiscal policy for stabilizing business cycles are discussed. As regards monetary policy, it follows from the foregoing that monetary stabilization policy will have to be pursued mainly at Community level. With this shift of policy responsability, business cycles will have to be kept synchronized. Otherwise it would not be possible to pursue a restrictive or expansionnist monetary policy at Community level, aiming at influencing total demand, since the problem would be posed as to how to treat regions or countries experiencing a boom in relation to others suffering from a depression. And even if a policy in favour of one category of region were followed, the measures taken would hardly lead to the expected effects: low interest rates would rather tend to stimulate the boom than to moderate the depression and vice versa. It is clear that under such circumstances reliance on monetary policy as the sole or, at least, the major anticyclical instrument would lead to disappointing results. Summing up, the approach towards the final stage could and perhaps should be a more flexible one, providing selective means to cope with remaining regional cyclical divergencies, which could not be dealt with by the envisaged exchange-rate margins.

However, synchronized business cycles, although facilitating the task of a European monetary policy at the final stage of EMU, would not necessarily eliminate all difficulties. Special measures, for instance in the field of fiscal policy, still largely the responsibility of member countries, could upset Community action. An exaggerated use of policies beyond the differentiations justified by structural gaps between countries, would lead to unjustified disadvantages for obedient countries. To avoid such conflicts a sufficiently concerted short term policy would be the appropriate remedy (cf. Part III).

2. Regional and structural imbalances

Progress towards monetary unification will put heavier pressure on economically weak regions in relation to the stronger regions of the Community. In national states weak economic regions, economic sectors or social groups usually constrict considerably action available for economic measures, when steps against an excessive boom in order to stop excessive cost and price increases are desirable. It always appears attractive to remedy regional and structural unemployment by means of general demand-management policies. The limits imposed on national demand-management policies due to the progress in monetary unification can worsen this particular problem.

Factor mobility can offer a way out of this impasse, at least to a certain extent. A distinction has to be drawn between mobility of labour and of capital. As regards labour mobility, experience has shown that the movements of the labour force taking place at the present time has given rise to severe social difficulties. Housing, health, and retraining facilities are some of the major problems which have not yet found a satisfactory solution. A further increase in labour mobility in order to reduce regional and structural imbalances would lead to unacceptable costs, economic as well as social and psychological. Therefore this cannot be considered as an acceptable solution.

Capital mobility will be stimulated as convertibility is introduced and intra-Community capital controls are abolished as a result of monetary unification. Unfortunately, although capital is in general much more mobile than labour, its potential for automatic adjustments in probably as limited as that of labour migration. There is even an opinion that capital mobility responding to market incentives might, on balance, operate in a perverse way. This qualification should be born in mind when it is argued that unhampered mobility of goods and labour and free capital-movement would promote fullest efficiency in the allocation of resources, and hence would support an acceleration of real economic growth in the integrated area as a whole. It is also argued that free capital movement would increase the interaction of investments between member states and thus favour a swifter diffusion of technical innovation. According to this view it is conceivable that monetary unification will stimulate entrepreneurs to transfer capital into regions suffering from unemployment; new industries would replace old ones in decline.

These possibly favorable effects have to be balanced against the negative ones of capital movements flowing from the weaker underdeveloped to stronger industrialised areas. According to some experience, unhampered mobility of capital will attract investments to the regions which offer the highest return i.e. the regions of highest productivity and lowest relative costs. Savings will thus be drawn away from the weak regions, thereby widening the overall imbalance.

Summing up, free factor mobility may intensify the tendency for agglomeration in the already overcongested highly developed regions of the Community, even if it may lessen the interregional adjustment problem. Regional and structural policy including taxation policy, public investment and administrative measures at Community level, aiming at the creation of jobs in the depressed or underdeveloped regions, should therefore support the process of monetary unification.

II. Monetary Unification and a Common European Currency

Monetary unification in the Community has so far been pursued mainly through attempts to reduce the room for changes in intra-group exchange-rates. It was thought that the progessively stringent application of this approach would lead over a decade to the marging of the existing national currencies, and thus place monetary union definitely at the point of no return. Experience has shown, however, that in conditions of monetary disorder, both domestically and internationally, the difficulties involved in freezing exchange-rates increase at least as much as disorderly money and exchange markets re-awaken the yearning for stability. The difficulties are not only technical in nature. They have a deeper significance, in so far as they reflect conflicts attendant upon the economic, social and political changes which are taking place within and between countries. When the difficulties met are looked at in this light, an approach which attempts at suppressing them sic et simpliciter appears utterly inadequate.

In what follows, an alternative approach is illustrated, which, as anticipated in Part I, hinges upon early introduction of a Common European Currency. This approach to monetary union is in a sense more challenging than the abvious one of just locking the parities of existing currencies together. But, as it weill be shown, the Common European Currency would represent technically and economically a powerful factor of unification. This would help to reconcile, with progress towards unification, a limited measure of exchange-rate flexibility, which during the period of transition might be found to be indispensable. The introduction of the Common European Currency and the exchange-rate discipline here suggested would appear together to represent the path to monetary unification most likely to be helpful in overcoming the basic underlying difficulties.

A. Monetary Unification under Different Exchange-Rate Systems

1. Irrevocably fixed internal exchange-rates

It is usual for a monetary union to have one medium of exchange in circulation as legal tender, although there are sectors of the economy which assume and discharge obligations also by using currencies other than the domestic one. In countries which are integrated in international money and capital markets, transactions in third currencies take place also between residents. Therefore, these countries are no longer, strictly speaking, on a mono-currency standard.

It is also worth noting that in many countries, in the earlier stages of their unification process, there has been more than one type of currency notes in circulation. In general, the plurality of the banks of issue is the feature which has resisted longest the process of unification; it has survived at times also after currencies had been unified in name.

However, historical experience and the current consensus of opinion both suggest that in a fully-fledged monetary union the price of the media of exchange, in terms of one another, cannot vary over space and time. This is a condition which, of course, a mono-currency area meets by definition.

Through the immutability of price of the media of exchange, countries forming a monetary union reap important benefits. The gains may be reaped at little or no macro-economic cost if the constituent economies are fully integrated and are able to utilize fully their productive potential under roughly similar conditions of monetary stability. If the union's currencies do not, and do not need to depreciate (or appreciate) at different rates in terms of the relevant bag of goods and services, there is no need to change internal exchange-rates. Therefore, there is no cost in foregoing those changes.

It is very likely that the existing European national currencies will remain in circulation long after the completion of the monetary union, although once the transition was achieved to the final stage, intra-European exchange rates would have to be locked irrevocably together. The maintenance of a multiplicity of monetary symbols meets a deeply-rooted European emotional need. With it will survive the multiplicity of issuers, which implies that a minor measure of control over the creation and regulation of the monetary base will perhaps remain with the (peripheral) national authorities. Otherwise, the existence of the various national currencies will hardly have any economic significance.

In order to pay in a European currency different from the one held, only an arithmetical calculation will be needed. This might be simplified by fixing "rounded" exchange-rates, such as 10 or 100 units of one currency to 1 unit of another, to which people would grow accustomed because those rates would never change. The European monetary union would be truly multi-currency as people and business would receive and make payments in any of the European currencies. The area of circulation of these would no longer coincide with the national boundaries. All member currencies might, in the final stage, be declared legal tender for transactions between residents in any part of the Community.

In fact, the process of interpenetration of national currency domains should be encouraged already now. It would put more pressure on national monetary authorities to harmonize policies, and to harmonize them in the direction of monetary stability, provided one or two of the major member countries were not inflating. But the one hundred per cent locking of intra-group exchange rates will have to wait for the final stage of monetary integration.

2. Freely-floating exchange-rates

During the transitional period, fully-floating exchange-rates would be no less inappropriate than complete fixity. If there is a cause of dynamic disequilibrium at work, which at a given rate of utilization of the productive potential for the whole Community, makes costs and prices rise at slightly but persistently different speeds in the different member countries, there is no guarantee that, under freely-floating exchange-rates, rate adjustments will take place with the graduality sufficient to offset those differences in speed. Even on the more favourable assumption that price elasticities of demand for imports and for exports (produced and exported by several countries), as

well as the elasticity of export-supply are high in the short run, departures from the equilibrium rates might be more frequent and larger than needed, as a result of capital movements tending to delay, or to anticipate (by different time lengths) the adjustment. The net changes in exchange-rates, sufficient to compensate for re-iterative discrepancies in cost and price trends, would be arrived at through wide gyrations. These would in an arithmetical sense largely cancel themselves out, but in the process they would upset money and exchange-markets. They would hamper payments as well as investment planning by business catering for the needs of the Community's market as a whole. They would lead to an overgrowth of the forward exchange-markets and to their instability. At the same time, forward cover might not be forthcoming on any terms for some currencies, nor for longer maturities.

The experience available so far in the case of countries which are floating individually appears to show that decision-taking bodies and the social partners are by no means less sensitive to exchange-rate changes than to changes in reserves. However, with unlimited recours to floating rates free rein may be given for carrying out adjustments entirely by means of exchange-rate changes, especially in view in the deterioration in the use of the more conventional instruments of economic and social policy. If the opportunities for integrating the economies, which the transitional period is supposed to afford, are not to be frittered away, policy harmonization must have a share in the process of adjustment.

If free floating were to be used as a full substitute for policy-harmonization, the ability of member countries correctly to use the more conventional instruments of stabilization and growth-policies would tend to differ more and more. The pattern and the processes of allocation of resources in the economies themselves would drift further apart. Moreover, full freedom in exchange-rate matters would be inconsistent with the interdependance which exists between Community countries as a result of their strong trade integration, which it is now hoped to buttress through more pervasive economic integration. From the technical viewpoint free floating would mean the maintenance of separate national currencies, as in the past exposed to speculation. Freely-floating rates cannot be reconciled with the process of monetary and economic integration.

3. Adjustable parities

If, during the transitional period, i.e. while conditions of semi-integration of the economies obtain, exchange-rate changes cannot be wholly dispensed with, the choice lies, in actual fact, between large parity-changes, unpredictable as to their extend and timing, taking place under (restrictive) supervision on one side; on the other gradual supervised changes, aiming at offsetting cost and price discrepancies due to the different inflationary propensities of the national economics.

The former method has by an large been applied by E.C. countries and, indeed, most industrial countries in the postwar period. Experience has shown that countries have in fact behaved as if they were not under a fixed-rate constraint. Being able to ignore it, also as a result of external balance of payments aid, they lived as if in a world of floating rates, which were, in fact, not floating. Therefore, cost and price

divergencies were allowed to cumulate year after year, till they made the exchange-rate structure hopelessly unrealistic. The de facto permissiveness of the system not only delayed the adjustment of domestic policies, but also increased resistance to the variation of parities. Devaluations have generally taken place under pressure coming from creditor countries and/or markets. The reluctance of deficit countries to adjust parities did, in turn, increase the disinclination to adjust on the part of surplus countries, on which the constraint to do so is, as a rule, still weaker. This has led on many an occasion to stalemate situations, which have generated turmoil in exchange markets. Long drawn out political and diplomatic negociations have been necessary to break out of the impasse. Often the solutions adopted have been scarcely credible. The leadership which it behoves monetary authorities to exert in order to maintain orderly markets has not remained unscathed.

There are several variants by which the system can be operated and improved. The line so far chosen by the Community for the transitional period aims at improving it through a more effective process of policy harmonization, stricter mutual supervision of, and, at a later stage, Community concurrence in the decisions to change parities, and a prompter adjustment of the latter.

Scepticism in respect of the present EC policy stance seems to be justified by the absence of any new element, being built into the system itself, which might improve its operation. The improvement should come from a higher measure of political pressure and solidarity, as a <u>deus ex machina</u>. Admittedly, this has been the nature of the causative process behind many historical turning points. But, assuming that political solidarity ensured the implementation of the system in the new way envisaged, would this lead to stability and integration?

Mutual supervision and concurrence in decisions affecting parities implies that changes would be made less discretionary. In principle, this is likely to be a contribution to a more orderly and stable system. But, if the decisions to be taken involve large parity changes, would it be a sufficient condition for maintaining orderly and stable markets to make those decisions contingent upon Community agreement or the indication of some commonly recognized objective criteria and besides, how much does it matter to exporters and importers, to industrialists, to bankers, whether the change is made according to some procedure or not, <u>if</u> the size of the change can be as unpredictably large as the changes in the objective criteria themselves? It is unmeasurable uncertainty, which indefinitely large parity-changes generate, that has really disruptive effects; gives rise to massive waves of speculation that often make the expectations of parity-changes selffulfilling; and, in the end, prevents the full and irreversible liberalization of capital movements. Parity adjustments need to be regulated so as not to deprive entrepreneurs of the stable monetary framework for Community-wide, long-term planning decisions based on profitability calculations with reference to fundamental economic factors. Failing, this, the transitional period will not achieve the task for which it is conceived, and the opening and integration of the member countries economies will not advance. <u>Large</u> parity-changes between member-states ought to be banned <u>now</u>.

4. Limited internal flexibility and external floating

If there is a consensus, as indeed there is, that parity adjustments cannot be altogether dispensed with during the transitional period, one is left with one possible course of action, which consists in adjusting parities gradually, just as cost and price discrepancies are likely to arise gradually among economies which are now semi-integrated, though poised to move towards full integration. To keep the area of monetary uncertainty during the transitional period within the limits that would make it manageable for business intending to cater for the needs of the Common Market as a whole, parity-changes should only be allowed up to a preagreed size. Changes in any one yearly period should not be larger than a few percentage points. A "flexibility schedule" for parities should be agreed upon at the outset that would lay down the maximum percentage by which parities would be allowed to be changed. It would be expedient to keep those percentages within the current width of the intra-European band. They would be reduced over time in parallel with the shrinking internal band. Thus, given present margins, parity-changes of up to 2.25 per cent would be allowed in a calendar year; not more than one full change would be allowed to take place in any six months period. However, up till the end of the second stage of EMU, or possibly only midway to it (30 June 1975), exceptions to the "flexibility schedule" might be allowed either in the framework of political decisions to be taken after multilateral consultations, or by shortening the unit period for parity changes as foreseen in the "schedule" from one year to, say, six months.

Changes would, as a rule, be shared by the deficit and the surplus countries. This would be in harmony with the emerging consensus in favour of more symmetry in the adjustment process for weak and strong currency countries. It would also reduce for any single currency (deficit or surplus) deviations from the median course. Therefore, it would be less disruptive for capital movements, while obtaining the needed overall adjustment effect. In particular, it would weaken the pull on the Common European Currency by the strongest currency.

It might be objected that it is not realistic to expect member countries to renounce the right to change parities other than within these narrow limits. But the merging of the national currencies implies such a renounciation sooner or later. The whole process will be on much firmer ground if it can be carried out as a gradual exercise, rather than as a dramatic change from a condition of potentially unlimited parity-changes to one where suddenly they would no longer take place. If, during the transitional period, notwithstanding the progressive rapprochement of the economies and their institutions (including the labour unions), disequilibria should arise, which countries not bound by the programme of monetary union would correct by means of exchange rate changes, the EC countries would have instead to resort to these only to the limited extent allowed by the "flexibility schedule" originally agreed upon. They would have to complete the adjustment by using concomitantly the panoply of instruments that countries on the way to economic and monetary union must have available.

To secure a use of those instruments coherent with the commitment to the schedule of flexibility, policy harmonisation needs to be upgraded into a discipline far more effective than it obtains in the looser context of international economic cooperation. Institutional arrangements for bringing monetary authorities closer together might be envisaged as a means of fostering harmonisation.

The lack of effectiveness in policy-harmonisation would eventually cause the internal exchange-rate arrangement to break down. Policy harmonisation is, however, a necessary, not a sufficient condition. The defence of a Community exchange-rate arrangement also requires pooling the reserves in a meaningful way. In other words reserve pooling, in order to be credible, should not be reversible and should not be based on clauses which would reduce the usability of the reserves by the European Fund for Monetary Cooperation. Usability, and therefore the effectiveness of the Community pool, would be reduced by a clause which made support of a currency automatic within the quota contributed to the pool by the country issuing it, but unavailable beyond that quota. Support of currencies should not be related to the quotas, but rather to the merits of each specific case, and to the appraisal of the Community's overall monetary and payments situation.

Pooling the reserves in a meaningful way is necessary because it represents the immediate instrument for pursuing the Community's objectives in the field of exchange-rate policy. But, of course, reserve-pooling does not have to be total, not even in the sense that one would have to agree now on a schedule for complete pooling. Moreover, different methods wuold have to be used for each main category of reserve assets, Clearly, under the present constellation of economic and political circumstances, only to gold might a method be applied which would gradually lead to the de facto centralisation of the national gold stocks.

From the opposite side, it might be objected that internal flexibility of exchange-rates, even if kept within a few annual percentage points, as laid down in the pre-established schedule, is not conducive to exchange-market stability, nor to economic and finacial integration. But, as concerns the smooth working of the markets, it should be noted that in order to adjust parities, in accordance with the limited flexibility allowed, no dramatic movements in the rates of exchange would be required. In fact, no change at all of the exchange-rate might be needed on the announcement of a parity-adjustment; only the rate's position in the band would shift. Parity-changes would not be larger than the movements in exchange-rates which can take place within the band. Those movements can take place quickly, and equally quickly reserve themselves. The fact that in the scheme here proposed changes in one direction would be allowed to cumulate year after year, up to the definite achievement of EMU, would not add to the disturbances which exchange dealers have to face in their daily routine.

On the other hand, the small parity changes provided for under this scheme would be sufficient to give parities the medium-term flexibility that, in the case of economies which are only semi-integrated, is needed in order to lend credibility to the pledge to maintain and defend an exchange-rate arrangement. Entreprenears would thus be in a position to make assumptions about exchange rate-movements within a range of

uncertainty and risk that would not cripple the development of Community-wide operations.

The exchange rate arrangement here suggested would not hinder the emergence of a European monetary system, as distinct from the world monetary system. The erosion which the concept and essence of a truly international currency has undergone in recent years is one more sign that points to the formation of regional monetary areas. A meaningful common currency seems now feasible only for use within areas possessing a higher degree of socio-economic cohesion and political solidarity.

The lack of an international currency implies as a corollary, that inter-area payments adjustments will have to take place through exchange rate changes. Under an SDR standard large deficit/surplus positions cannot be allowed to develop lest the SDR itself, and therefore the soundness of the standard, should come under suspicion. Given the unwillingness of large countries, or groups of countries, to sacrifice domestic policy objectives to the external ones, when conflicts arise between the former and the latter, inter-area exchange rate changes are bound to have a primary role in payments adjustments.

A differentiated European monetary area would emerge as a result of the Community currencies together floating <u>erga extra</u>, while being internally on a limited flexibility basis. The latter would inject a needed measure of flexibility into the joint European float which, in fact , is too rigid for a group of countries that do not comprise yet an optimum monetary area; such currencies can scarcely be expected to behave as if they were one in substance as yet. Internal flexibility would tend to reduce the strains which are bound to develop in the joint float by a large group of countries that are only semi-integrated. It would make the arrangement credible; it would help to break out of the deadlock created in March 1973 when some Community currencies could not join the rigid common float.

In the light of the foregoing, a joint float erga extra <u>cum</u> limited intra-group flexibility appears to be a desirable and feasible compromise between the two extreme positions now obtaining: rigid joint floating on one side and, on the other, free floating outside any provision whatsoever for Community discipline (except as informally self-imposed by the countries concerned).

B. Creation and Role of a Common European Currency

1. The rationale for a Common European Currency

The exchange rate-arrangement proposed above would be easier to operate if a Common European Currency were available and could be used as a common intervention medium. This would be the most efficient way by which coherence, from the point of view of exchange-rates might be maintained in a multi-currency area which, for a while, will need to combine a limited degree of internal flexibility with external floating.

Untill recently the common intervention medium was the dollar. Whereas the dollar is gradually being phased out of intra-E.C. official transactions, disappointingly small progress has been made in finding an adequate substitute for it. The reasons for this are technical, economic and political.

From the technical viewpoint, it is important to note that the rise of the dollar to the position of an international currency was assisted by a formidable banking and financial infrastructure. If there is an E.C. currency which might offer comparable facilities, there are doubts as to the readiness of other E.C. countries to hold it on a large enough scale. In fact the E.C. currency which is now the most sought after as a reserve asset belongs to a country whose money and capital markets are surely inadequate to play a central role in the Community and whose authorities seem not keen to see such a role develop.

Economically, the substitution of the dollar by a national E.C. currency would not quite eliminate the conflicts which have arisen under the dollar standard, but rather transpose them into a European context. Though less sharply perhaps, conflicts would be bound to arise if a currency linked to a national economy was asked to fulfil the rôle of the European currency, as long as member country economies are not fully integrated. It would be unrealistic to assume that a national currency would be managed in such a way as to give priority to the Community's overall needs. If that could be done, it would also be appropriate to give the issuing central bank a European general management. The national currency would then be such only in name; in actual fact it would be a true Community currency. It is difficult to see how the country concerned would agree to this sort of arrangement, which would deprive it of autonomy in managing its own currency, an autonomy its partners would continue to enjoy, if only to a shrinking extent.

Finally, political and prestige considerations make most member countries disinclined to accept the rise of one of the existing national currencies to a position of primacy within the Community.

It would appear from the foregoing that for a currency to be suitable for the role of Community currency, one would have to create it ex nova.

2. Formulae for the Common European Currency

An important question which needs to be answered, when creating a Common European Currency, is how to relate it to the existing national currencies. There are of course a number of ways of doing this, as shown by way of illustration in what follows.

One possibility is that the Common European Currency comes into being as a result of the upgrading of the European Monetary Unit of Account (EMUA). In fact, the insertion of the word "monetary" seems to point to the likelihood of the EMUA being something more than an accounting notion. The EMUA, which basically repreats the formula of the unit of account used for the purposes of the C.A.P., is rather restrictive as regards both the cases of automatic changes and their scope. Being too static, and thereby open to the risk of losing contact with the national currencies, ample room has had to be left to the Council of Ministers' discretionary decisions. This, in turn, is likely to add so much uncertainty concerning the possibility of the EMUA changing, or not changing, that its widespread use especially in the private sector might be ruled out.

Furthemore, the EMUA is defined in terms of an asset, gold, concerning which the Community has a limited say, along with a number of other countries. Recent experience

has shown that gold, its use and price, can altogether break away from the control of monetary authorities. Therefore, a consensus is now emerging in official circles about the unsuitability of gold as numéraire in the international monetary system. It is unfortunate that the EMUA should have been defined in terms of gold (1).

This and other considerations militate in favour of defining the European monetary medium in terms of monetary assets, such as member countries' currencies, which are internal to the Community. The Common European Currency would be defined as a bag of currencies in which each currency would carry a weight according to a chosen parameter, such as the GNP, the foreign trade, or a combination of both. The formula might be so conceived as to have the Common European Currency reflect parity changes of a national currency, in proportion to its weight in the bag. Alternatively, the content of the bag might be defined in a way that the devaluation (revaluation) of a currency would necessarily lead, through arbitrage operations between the Common European Currency and the national currencies, in the absence of official action, to the upward (downward) adjustment of one or more other currencies. In the former case, the external value of the Common European Currency would change automatically; in the latter it would not, since the change in one currency would be offset by a change of opposite sign in one or more (other) currencies (2).

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(1) This, however, does not necessarily imply that gold cannot serve any useful purpose in the construction of the European Monetary Union. Because a large body of opinion still regards gold as a factor of monetary discipline, the issue of the Common European Currency might be linked to gold. The link should be fractional and adjustable in order to avoid building into the mechanism of creation of the European currency a constraint of the gold-standard type. As the C.E.C. circulation expanded, the link envisaged here would lead to the *de facto* centralisation of the national gold stocks.

(2) In the former case the Common European Currency is defined as follows :

$$I\ CEC = Q_{BF}BF + Q_{S}L = Q_{DM}DM + Q_{FF}FF + Q_{L}Lires + \dots$$

If the value of one of the national currencies changes, the value of the CEC changes pari passu with the weight of this currency in the bag. In the latter case a constraint is added to the previous definition. Par values of the national currencies in terms of CEC's are fixed so that the following equality is always satisfied

$$I = Q_{BF}V_{bf} + Q_{S}V_{S} + Q_{DM}V_{dm} + Q_{FF}V_{ff} + Q_{L}V_{I} + \dots$$

where (i) V_{bf} is the par value in terms of CEC's of the Belgian franc and similarly for V_{s}, V_{dm} etc., and (ii) as a result $\frac{V_{bf}}{V_{s}}$ = the par rates of exchange between the pound sterling and the Belgian franc.
If the S's are fixed any change in one of the V's must be compensated by a change of at least one of the other V's in the opposite direction.

The former formula implies that changes in the Common European Currency would equal the weighted average of changes in the national currencies: the Common European Currency would be as stable, or unstable, as that average. According to some, this is the sort of protection against exchange rate changes which is sought by the market. Therefore, a Common European Currency so defined would easily spread; it would be used for a Community-wide open market policy, as well as for issuing loans on the European financial market.

Concerning the latter formula, it is felt that forcing devaluations (revaluations) on some currencies as a result of the revaluations (devaluations) of other currencies might not be acceptable to monetary authorities. On the other hand, it should be borne in mind that because intra-EC flxibility of parities would have to be limited and would shrink over time, no large change might be inflicted on currencies, as a result of the combined application of this formula and of the flexibility schedule suggested in the previous Section. What this formula would lead to is the automatic sharing of the adjustment of parities between weak and strong currencies. This would be in keeping with the widely felt need for more symmetry in the process of adjustment.

Finally, it is worth pointing out that because the current inflationary outburst has undermind confidence in most currencies, a guarantee of stability in terms of currencies, and especially one which only afforded the average stability performance of member countries'currencies, might not be adequate to make the Common European Currency as much competitive as needed vis-à-vis the strongest currencies, and non-currency assets as well.

There are various ways for securing for the C.E.C. a better-than-average performance. One would be to increase the weight in the bag of the currencies belonging to member countries with a low propensity to inflation. Thus, the weight of those currencies would exceed that posited by the application of the parameter chosen, and do so by the amount needed to make the Common European Currency as hard as necessary. At the limit, of course, the C.E.C.'s exchange rate changes would equal those of the strongest currency: the former currency and the latter would tend to assimilate each other. This, however, is unlikely to be accepted by member countries, on both technical and political grounds.

An alternative way of securing for the C.E.C. the stability apt to make it attractive would be link it to a real, rather than monetary, parameter. In its extreme version, this formula would link in a 1 : 1 ratio the C.E.C. value and rises in (some) commodity-price index. In other words, the Common European Currency would appreciate in terms of member currencies as an E.E.C. average price index of goods rose.

It will be argued in what follows, however, that absolute stabilitu of the C.E.C. purchasing power is neither feasible, nor desirable. Instead the aim might be a somewhat better-than-average performance in terms of currencies and commodity-index formulae. More specifically, one would start from the weighted average of changes in member countries'currency parities, and then would revalue it by fraction of any increase in the commodity-price index. The fraction relevant for each given period would be decided

upon by the Council of Ministers. Thus, the formula for determining parity adjustment of the Common European Currency would be semi-automatic.

The foregoing discussion does not, of course, do justice to the many issues involved in the choice of one formula, rather than another. On the other hand, the fact should not be overlooked that the schedule of flexibility suggested in this report leaves little scope for changes in national currencies' exchange rates, and therefore restricts the potential for changes in the Common European Currency. What is essential is to move from the unit of account concept to the reality of a unit of transation. A mere unit of account would be hard put to compete with the dollar (or an E.C. national currency)/ Failing positive steps from the official side, the process of spontaneous evolution of the EMUA into a currency proper would be drawn-out, uncertain and liable to set backs. This would be hard reconcile with the urgency which is now felt for Europe's monetary unification.

3. The Common European Currency as "monnaie cambiaire"

In order to serve as an intervention currency, the Common European Currency would not and could not be just an official asset. It would need to be held and traded by market-institutions, thus allowing it to be used as an intervention currency and, further, as a transaction currency. These different functions are closely interrelated. In what follows, they are included in the special notion of a "monnaie cambiaire".

The Community central monetary authorities (including the national central banks acting as a Community body) would chart the course of the Common European Currency so as to secure for the Community as a whole the sort of payments equilibrium with the rest of the world, consistent with the balance of payments aims agreed internationally by, and for, the Community as a whole. The European Fund for Monetary Cooperation would intervene on exchange markets in dollars and any other currency, if necessary, in order to control or influence the European Currency's exchange rate. In turn, the national central banks, acting individually, would buy and sell their own currency (solely) against sales or purchases of C.E.E.

In order to help the new European currency to come into its own, a large demand for it will need to be created: this, of course, depends on the uses for which it will be eligible.

A sizeable demand will be generated by the new currency fulfilling the rôle of intervention medium: participants in the exchange market, both official and private, would need to hold working balances in the C.E.C. Transactions between the Community institutions and the national governments for the purpose of the Community's budget, of the common agricultural policy, etcetera, would of course take place in the Common European Currency. It would also be used for payments between Community institutions and private companies, and other bodies, in member countries.

Furthermore the Common European Currency ought to be used for issues and other transactions on the Community capital market. C.E.C. loans would be issued by large borrowers. To make such loans attractive to investors a clause of indexation (to the

cost of living) might be attached to them (1) even when such clauses would not be allowed for issues in national currencies. The Community financial institutions would issue C.E.C. denominated loans, thereby creating a link between the mechanism of monetary unification and the process of economic growth in the Community. Also national governments and local authorities, desirous of tapping the Community's capital market might be permitted, as unification proceeds, to issue part of their debt in the Common European Currency. They might also be authorized to issue given amounts of (medium and) short-term notes in the Common European Currency for which the European Fund offer rediscount facilities.

The banks participating in the C.E.C.-market would be required, as a regulatory device, to hold compulsory reserves in the Common European Currency, in an appropriate ratio to their C.E.C. -liabilities. Those banks would, of course, also be expected to organize a secondary market for C.E.C. denominated assets, as well as to cooperate with official bodies in order to create adequate clearing facilities.

Finally, to promote the Common European Currency on its way towards being a transaction currency the Governments might accept the new currency (in a fixed or rising ratio to their own national currency) for payments of taxes by at least some categories of taxpayers, such as affiliates of companies with the head office, or the main centre of operations, in another member country (or in a third country).

Thus, by replacing the dollar, and more specifically its euro-variant, and by taking over supplementary functions of a transaction currency, the Common European Currency would develop in the markets as a monnaie cambiaire. Participants in the C.E.C.-market would be the banks, particularly those which now engage in Euro-currency operations. They would deal in the Common European Currency with one another, with the central banks intervening in the markets for steering the exchange rate of their own currency, and with the European Fund for Monetary Cooperation. Also the participation in the C.E.C.-market of the large industrial and commercial companies, whose operations stretch beyond the national borders, might be envisaged at an early stage.

A different approach would consist in declaring the new European currency legal tender a least for some categories of transactions, defined on the basis of their (multinational European) nature, or of their size. But this would meet with resistance from even those who believe in the need of introducing a European currency at an early stage. For it is felt that to promote that currency through coercion would detract from its intrinsic desirability. The procedure ought rather be to declare the new currency legal tender, alongside the existing national currencies, after it had proved its intrinsic desirability to a restricted group of professional large-size users and it had subsequently gained acceptability nearly all the way down to wage earners and retail shoppers. After all, in developed countries the bulk of payments is done by bank cheques whereas only central bank notes (and treasury coins) are legal tender.

4. The management of the Common European Currency

In this age of unrelentless inflation and monetary disorder, the Common European Currency would stand a good chance of becoming acceptable on its own merits, if it could

be regarded as a relatively stable standard of value. A choice will have to be made, for at least as long as the Common European Currency will not be able itself to exert a decisive influence on economic trends in the Community, between absolute stability and the average instability of member countrie's currencies. Choosing the former, however desirable in itself, would very likely put a heavy strain on the new currency. It would put it on a course not representative of member countries' currencies. It might hamper its diffusion in so far as debtors would be unwilling to express their debts in a too rigid standard of value. The interests of creditors, on the other hand, would lie in the opposite direction. This conflict would hinder the smooth working of capital markets in the Community.

The conflict would be more serious if a gap between the stability performance of the Common European Currency and a weak national currency formed, which would make the latter suspect for devaluation against the C.E.C. The demand for the Common European Currency might obtain a level which would make it possible to maintain the internal limited-flexibility-schedule. All this would reduce the chances that the Common European Currency might eventually play an effective rôle in the evolution of new monetary arrangements in the Community. If, instead of adopting a formula for absolute stability for ever, it was aimed at a measure of stability clearly above the member currencies' average stability, as outlined in subsection 2, the effectiveness of the Common European Currency in fostering a better monetary performance all round would be much enhanced.

The stability performance of the European currency cannot be but the reflection largely of the combined performance of the national currencies, unless one were ready to break the proposed pattern of internal limited flexibility and joint floating *erga extra*. In that case, however, an important element of strength of the European currency would be lost, for the strict delimitation and shrinking size of the exchange risk are likely to make the Common European Currency more desirable than competing external currencies, which may bear for Community residents a potentially unlimited exchange risk.

The pattern here suggested, with regard to a more stable currency value and internal exchange rate flexibility, seems also the most suitable to secure the sort of evolution one would like to see in the relationship between the new European currency and the national currencies. During the transitional period a *smooth process of unification* should avoid sudden eruptions of currency speculation out of, and possibly back into, a Community currency, as well as massive shifts into the Common European Currency. Shifts into the latter would increase the amount of it which would be in circulation but ought to reduce *pro tanto* that of the national currency sold. Since such shifts would not reduce the overall liquidity of the economy concerned, the central bank issuing the currency exchanged for the Common European Currency would not be allowed to try to offset such shifts by means of further issues. Rather, it would have to increase the demand of its own currency for instance by raising interest rates on deposits, and other money and financial claims, in that currency.

The scheme here proposed would be likely to prevent both these inconveniences from happening, although countries would have to sacrifice to some degree their autonomy in interest rate policy, which is bound to happen in any case if progress is to be made

towards unification. But under a revised adjustable peg system, large waves of speculation would form as parity "jumps" became more and more likely. In that case, it would be true that the existence of the Common European Currency alongside the national currencies (and their interconvertibility) would make a difference from the viewpoint of currency speculation, for it would be likely to give this latter a new field of operation.

Clearly however, the technical suitability of the exchange rate set-up is not a sufficient condition for avoiding inter-currency "flights" and the need for large support of the "suspected" currencies. Effective policy harmonisation is needed, and this can only be attained if a consensus is reached concerning the unemployment-inflation trade-off at which the Community as a whole would aim. The chances that harmonisation would be accepted, would of course increase if the Community collectively could make a positive contribution to improving that trade-off.

As to free intra-group floating, which as it has been seen on several grounds is irreconciliable with the process of unification, it would also be unacceptable insofar as it would lead to the sudden dereliction of the fast depreciating currencies, and their substitution by the Common European Currency. The latter would have to be managed so as to keep in close touch with the fastest appreciating currencies, lest it be supplanted by them. An evolution of this type would hardly be acceptable, especially it would mean that only some of the national currencies would prematurely disappear from the Community's monetary scene.

These, of course, are the very reasons why it is likely that the Common European Currency being in circulation side by side with the national currencies, would exert a powerful disciplinary influence. But discipline cannot work satisfactorily and it is bound to be "contested", if it is achieved through the threat of drastic changes in the pre-existing mix of Community and national elements.

In principle, it seems safe to assume that the more gradually the use of the Common European Currency will spread, the more acceptable the process of ultimate replacement of the national currencies will be.

The speed at which the Common European Currency may be allowed to spread needs also to be controlled because its unregulated use by the private sector would lead, as in the case of the Eurodollar, to an excess creation of liquidity. Since the need for European monetary unification has been more strongly felt in order to regain from U.S. banks and Euro-banks control over domestic monetary conditions, it follows that the process of creation of the Common European Currency must be firmly in the hands of Europe's monetary authorities.

Those authorities would concur in defining and implementing a <u>harmonised European monetary policy</u> especially with regard to money supply, which however would not imply that rates of increase would be equated for all member countries. One might start by agreeing, in special circumstances, on a Community band within which rates of increase in national money supply would have to be kept. In implementing such a European monetary policy the creation of the Common European Currency and national money creation by the central banks of member countries would have to be so regulated as to meet the liquidity

needs of the Community as a whole, as well as of its large economic regions, without adding to inflationary pressures. Clearly it would not help the C.E.C. to come into its own, if it could be construed as one more engine of inflation. One of the conditions necessary to prevent this is to time and regulate the process of creation of the C.E.C. so that the latter might grow in importance pari passu with the merging of the national central banking systems into a Community one.

As to the control of C.E.C. creation by the private sector, regulations might be of a quantitative and/or qualitative nature. Without going into too much detail about the different instruments to be applied, it should be stressed that compulsory reserves would be required against C.E.C. liabilities. These would be higher or lower than reserve ratios on liabilities in national currencies, as might be needed in each specific situation. Also the use of the Common European Currency might be restricted to specified categories of (intra-European) transactions.

The rate at with the Common European Currency would spread (to larger categories of users) might also be regulated by allowing its use only for deals exceeding a given (minimum) amount. In fact, the Common European Currency might first be introduced in the private sector under the form of large-denomination C.E.C. certificates, in which banks and treasurers of big European companies would deal. Just as within countries some forms of money are legal tender only for payments up to a given amount, so the Common European Currency would be usable for transactions above a minimum amount.

Administrative controls, which would restrict the interconvertibility of the Common European Currency and the national currencies, should instead be kept at a minimum - and even that should be quickly discarded. Controls, exchange or other, which discriminate according to the residence of borrower or lender, or according to the location of the investment, hamper the process of integration of the economies during the transitional period, just when that process ought to be progressing. And they do so much more than slowly-moving currency prices especially if these make possible the maintenance of unrestricted convertibility.

Unrestricted convertibility of the Common European Currency should be aimed at, if it is to play the role of a common currency, and if it is to integrate in depth national money and capital markets, reaching intra-marginal lenders and borrowers. Those markets have worked so far as communicating markets rather than fully integrated ones. They are at present threatened with the closure of the points of communication as a result of the deteriorating usability of the dollar.

It is an essential feature of the proposals made in this report that there should be little use, if any, for intra-E.C. administrative controls in coping with payments disequilibria. In fact, as with monetary union, old-style balance-of-payments problems will be superseded by regional development problems as codetermined by regional disequilibria in the availability of financial resources, and the aim should be an allocation of those resources, both short and long term, consistent with the indications of a European policy of balanced growth. That aim cannot be achieved in markets which are moving towards integration, by means of national administrative controls which discriminate as

between E.C. residents. A Community monetary and financial system is needed, which ought to be able to correct the possible inconsistencies in respect of an "optimal" policy of growth for the Community as a whole, that might arise in the allocation of funds, within a context of full freedom of circulation through the national markets.

The proposed Common European Currency might be built as an essential part of that system. As such, its usefulness would continue also once conditions were ripe for definitely locking together intra-European exchange rates and thus merging national currencies.

III. Economic and social policies for monetary unification and economic integration

In considering the economic aspects of economic and monetary union, two approaches are possible. The first is a narrow interpretation of the parallelism discussed at the beginning of this report, so that only those non-monetary policies are proposed which must accompany monetary unification. But the potential gain, in growth and stability of member-state real national products, and in the development of Community identity and solidarity, from further co-ordinated economic and social policies, is very great indeed. Thus, over and above the minimal rate of economic integration as monetary unification progresses, vast scope is offered by many further economic and social policies.

The minimal rate of advance consists in the development of those common policies which are inescapable if intra-Community exchange rates are moving towards being locked. Some policies are clearly in this category as we have seen, e.g. means of dealing with resultant short-run and structural imbalance in regions and industries. Other policies, though highly desirable in themselves are not, e.g. environmental policies. The line is not always easy to draw. It should certainly be drawn on the liberal side, because advance in economic union has its own significance; and parallelism must not be seen only as an in-filling of crevices wrought by monetary union; it has a great positive role to play, probably more than developments in the monetary field.

A. Stabilisation policy

1. Three levels of Stabilisation Policy

There are various levels at which the attempt to achieve a steady rate of growth of G.N.P. with price stability and full employment under a balance of payment constraint has to be made: the Community cycle as a whole, member-state divergencies from that cycle, and regional divergencies from member-state norms.

The manifestation of the problem varies in each case, sometimes inflation rates, sometimes unemployment rates, sometimes outdated infrastructure or deficient public services. The cause of the problem varies similarly, from short-term demand deficiency to long-run decline of industries due to secular falls in world demand or inefficiency arising from cost increases outstripping productivity improvements.

It is customary accordingly to divide conjunctural from structural policy. This is legitimate, and is largely followed in this part of the report, insofar as the analysis of the problem is concerned. But it may not be valid from the point of view of the instruments of policy. If different instruments can be assigned to conjunctural and structural policy, the distinction can be maintained, but it becomes confusing if instruments, e.g. fiscal policy, need to be considered in a consolidated way in dealing with both types of problem, conjunctural and structural. Since there is need, especially from the fiscal point of view, for a comprehensive approach, this is why the three levels of stabilisation policy are dealt with in this section, even though regional policy is examined further in the next section.

The changing balance of importance of the three levels of conjunctural policy is a matter of debate. The question whether the Community cycle is becoming more firmly established, and member-state divergencies less significant, has already been discussed. However far this has developed at present, no doubt EMU will accentuate this transmission of inflation and depression between member-states. On the other hand, regional divergencies (from Community or member-state norms) may be accentuated by EMU, as it is developing now, as has been mentioned earlier in the report.

Of course, this development of the conjunctural problem upward and downward, away from the level of the member-state economy, conceals a difference in type of the problem: the Community cyclical problem is short-term and is dominated by prices, the regional imbalance is longer-term and dominated by employment, and the distinction between conjunctural and structural is valid. There is also a difference as to instruments appropriate and available. Monetary instruments, including parity changes (vis-à-vis outside countries), money supply and interest rate policy, remain available to the Community as EMU progresses. There are right instruments for the right problem - influencing the Community cycle.

Thus, monetary unification does provide the instruments to the Community which are necessary to deal with the development it brings about: the consolidation of a common cycle among member-states. Their use has already been covered adequately in the preceding monetary discussion.

2. Fiscal Instruments for Intra-Community Stabilisation Policy

What has not been discussed so much are the major problems of member-state stabilisation, and dealing with the possibly accentuated problem of regional disparities. Though limited availability of monetary instruments will remain during the transitional period, the emphasis must shift to budgetary instruments to deal with these aspects of stabilisation policy, and this is why these two aspects of policy need to be looked at together.

Short and medium-term changes on the expenditure side (of Community or member-state) budgets are of limited significance, as always, in view of formal commitments to programmes.

In the case of the Community budget, some flexibility may be available if a form of Community employment benefit scheme is founded, but most other elements of the budget, will not be easily adjustable for stabilisation purposes. Member-state budgets are going to be difficult to control. There is, at present, reporting of budget deficit positions by memebr-states three times a year, some supervision of these and of their financing must be allowed

to develop. But the weight is on the fiscal side, and unfortunately this runs counter to some plans for the harmonisation (meaning alignment of structures and rates) of taxes, argued on the grounds of removing distortions to trade and factor movements. In particular, the very tax most subject to alignment pressures, the V.A.T. is in the very category of general sales taxes commonly used for short-run stabilisation purposes.

Earnest consideration has to be given to this problem. Even if the removal of tax distortion to trade and production by uniformisation of taxation increases total real income, the gain is much reduced if this worsens the distribution of wealth around the Community, and neutralises the tools to correct the imbalance.

In the medium term, therefore, the Community would obtain comparatively strong monetary instruments, as part of monetary unification, whilst its direct budgetary instruments will remain small; for the member-states, conducting (with a degree of Community supervision) national and regional stabilisation policy, monetary instruments will be weak, but as compensation, fiscal flexibility, including V.A.T. rates, should be allowed to develop. As the extreme and economically more relevant version of this proposal one could envisage the institution of regional differentials (where the divergence from Community norms of income and employment may be greatest) in V.A.T. or other taxes.

3. Prices and Incomes Policy for intra-Community Stabilisation Policy

Within several member-states, use of the law and consultation to control prices and money incomes has become as important as fiscal policy.

Co-ordination of national incomes policies in a Community programme is a medium-term aim (*), but poses problems which have hardly begun to be tackled. At the very least the introduction of a permanent and efficient dialogue between the public authorities and the social partners (unions and firms) at the European level is necessary. In order to be comprehensive enough it should incorporate the global and structural policy of public authorities and boil down to coherent decisions on the development of average wage and price increases.

The basic issue lies between the economic requirement of different real income levels (in a given sector) in different parts of the Community to accord with differences in productivity levels, and the social objective of greater equalisation of standards of living in all regions. Joint incomes policies agreed with, possibly Europeanised, trade unions, are likely to tend towards the social objective, and hence worsen the disequilibria between regions of unequal productivity. The social objective may naturally take precedence, and the economic requirement be met rather by tax and social security adjustments for the weaker regions.

(*) Cf. the chapter "Incomes policy" in the Second Medium Term Economic Policy Programme and the paragraphs 102 and 133 concerning the "Dialogue with the Social partners" of the Third Medium Term Economic Policy Programme, adopted by the Council respectively in 1969 and 1971 (Official Journal L 129 of 30 May 1969 and L 49 of 1 March 1971).

This brief discussion emphasises the need for simultaneous and coordinated action to achieve balanced growth, with minimised inflation and relatively full employment, in all parts of the Community - action in the fields of taxation, public expenditure, social security and prices and incomes policies.

B. Regional and Employment Policy

The Commission has recently issued a report and has submitted several proposals to the Council in the field of regional policy (*) The Community's effort itself is to be implemented through a Regional Development Fund (**) whilst a Regional Development Committee will make surveys of and begin to harmonise Member State' regional policies. Assistance from the Fund will be decided on a case-by-case basis for larger schemes (***) and in the aggregate for smaller ones. The Commission has proposed including a sum of 500 mn U.A. in the Community budget for 1974. Sums in the area of 750 mn U.A. for 1975 and I,000 mn U.A. for 1976 will be required. As regards the mode of allocation this will depend on the expansion of production rather than use welfare payments.

1. Meaning and Definition of the Regional Problem

The regional problem itself is ambiguous and fluid. Indeed, some economists would want either to abandon the concept, subsuming the problems under labour market and instrial policy; other would re-cast it as location policy, with the income distribution content removed to other policies.

Since criteria for the distribution of regional funds depend on the determination of a region in need of aid, criteria likewise are difficult to pin down. The actual situation which policy has to influence is already fast-changing, and is likely to be increasingly so. Analytically, the regional problem is caused by the disparity in trends of factor and productivity rates, so that "highly" paid labour can no longer be employed by areas or industries with lagging productivity levels. The problem posed by EMU is that it is likely to lead to a faster convergence of factor price levels (on the capital side, by capital market integration; on the labour side, by Community wage-bargaining and wage-emulation) than it is of productivity trends. It is uncertain whether or not productivity levels will converge: geographical polarisation theories are opposed by systems lessening dependence on proximity to markets, new products lessening dependence on natural resources, etc.

But this is still to see the "regional problem" in traditional terms. We might be on the threshold of a new concept of the "regional problem" (indeed envisaged in the Commission's latest report) characterised by congestion andinfra-structure run-down and decay. And this

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(*) Reference to COM(73) 550 final, 3 May 73 - COM(73) 1170 final, 25 July 1973 - COM(73) 1171 final, 25 July 73 - COM(73) 1218 final, 25 July 73 - COM(73) 1751, 10 October 73.

(**) An Employment Fund is also being established and will have a connection with regional policy.

(***) Industrial and service investments of an amount of 10 mn U.A. or more, and infrastructure investments of an amount of 20 mn U.A. or more.

progress might also be accelerated by the industrial and social changes of EMU.

Furthermore it should be recognized that the problem of regional and structural imbalances has its particular political and social impact. The member states of the European Community have a much more intensive national life than the members of the existing federal states, e.g. the United States or Australia have. They are countries which feel their national identity strongly and are less able to tolerate economic disparities between one another than they are within the nation states.

Thus, it is going to be exceedingly difficult to define the regional problem in future years. And this presents another issue: as the regional problem become more heterodox, each member-state (or region) can make a claim for itself.

In these circumstances, a list of Community criteria is going to be difficult to define. Probably, they should be very few and very simple, perhaps put inly in terms of income and unemployment levels (*). Once multiple criteria are let in, the situation could become unmanageable. The situation to be avoided is the possibility of states and regions able to propose schemes and criteria which net out to their own benefit; Community regional and employment policy would then tend to become ineffective and confusing.

2. Community Regional Policy and Member-State Regional Policy

It has been stated, in connection with the Commission's report and its subsequent proposals that the Regional Fund will supplement rather than partly replace member-state regional spending.

This seems an undesirable situation, to be avoided if at all possible. The reasons are two-fold. Firstly, whilst the Regional Committee is to co-ordinate member-state regional aid, it will have much more difficulty in applying uniform criteria, than in the case of direct Community aid. Secondly, it is difficult to see how substantial finance can become available for the Regional Fund without a transfer of resources from member-state budgets. This does include use of loan finance through the European Investment Bank or other means. If possible this should not exclude the possibility to add to the amounts envisaged by supplementary measures. This will be taken up again in discussing the Community budget.

3. Mode of Community Regional Policy

Earlier, it was suggested that sharp, simple criteria should determine a region qualifying for aid. This appears to be in some conflict with the forceful idea that each region in need will have a particular identity and special problems, so that an assortment of aid methods might have maximum effectiveness. However, there need not be conflict; there is a two-stage process. A qualifying region is determined on income and employment grounds.

(*) The Commission has proposed using the deficit in the migration of labour force as an additional criteria. Cf. COM(73) 1751, 10 October 1973.

When qualified, its "programme support" is decided in the field according to its special needs, and consists of a special set of grants-loans to new/existing industries, retraining grants/ income support for all/selected workpeople, and finance for particular public goods and services.

So far, the mode of operation of the Community Regional Fund has pre-supposed its impact to be on the expenditure side, with finance raised by some unspecified means. But, of course, those means themselves can be an instrument of regional policy. The simplest method would be a tax with regional differentials, such as the V.A.T., or regionally differentiated payroll tax, or corporation tax. All sorts of problems are raised by such a suggestion. In the case of the V.A.T., it requires origin principle taxation and re-introduces fiscal frontiers, this time between regions. To use the corporation tax involves great difficulties over determination of where corporate profits arise, and of control. Nevertheless, the method of regionally-differentiated taxation, helps deal with the regional problem whilst also providing finance for additional action on the expenditure side.

C. Social Policy (*)

1. The Social Fund Approach

The original conception of the Social Fund was to deal with unemployment resulting from the the reorganisation of the customs union. The problem was conceived as a minor one - most reallocation would take place by autonomous changes by workers of location or job. Consequently, the size and scope of the Social Fund has always been very small.

It must become more important in the future. On the one hand, the Community must be expected to play a role in unemployment benefit schemes that it did not play before, and on the other, the unemployment problem might become more extensive. The problem of unemployment and redemployment was already a major concern when the customs union was launched; with the advent of EMU, the labour consequences of the resultant industrial re-organisation might well attain a new scale.

In dealing with this problem alone questions arise as to the required size of an enlarged Social Fund and its mode of use. It is estimated that the current annual rate of redundancy in the Nine is 3,750,000. If the outlays per head of redundant worker of the ECSN of 2.000 U.A. were applied in the Community, the implied size of the Social Fund would be impossibly large. It can be reduced by aiding only some of those made redundant, and by restricting the range of assistance given. It is generally agreed that the Community should concentrate on support for retraining, so as to give its programme a positive look. Even so, a Social Fund, envisaged but yet to be achieved, of 358 mn U.A. for 1973 (1974: 471 mn U.A.), looks very small against ECSC standards. Greater enlargement than this appears a minimum accompaniment of E.M.U., unless the burden of labour adjustment is going to be taken on regional and industrial policies.

(*) Note that "social union" was included as an element in the second stage of economic and monetary union in the Paris Summit communiqué - Reference to "Guidelines for a Social Action Programme " COM(73) 520, April 1973 also.

Whether the Social Fund is expanded to give the Community a fuller role in employment policy, or because the employment consequences of EMU are likely to require it, clearly there is no justification for its finance by a system of juste retour; those areas with the highest incidence of consequential restructuring need to receive most, pay least, the main contributors being those areas on the fortunate end of the benefits of EMU.

2. Alignment of Social Security Systems

Another great aspect of social policy lies in the possible alignment of the social security systems of the member-states. This does not necessarily have direct consequences for the Community budget, but has major implications for member-state budgets.

Whether alignment is desirable or not can be dealt with from an economic or social viewpoint. From the economic side, it is necessary to look at social security contributions by employers and by employees separately. The payment by employers is sometimes argued to be a quasi-wage. The question arises: do differences in net payments by employers and net receipts by employees in member-states interfere with the mobility and location of capital and enterprise on the one hand, and labour on the other? The answer is probably "yes" for capital, but is much more dubious for labour, as such a complex of socio-economic factors affects labour movement. The establishment of a Common Market with unimpeded factor flows therefore demands long-run alignment of employers' payments to social security. And since the slice of social security that is financed through the budget of the member-state is variable and modifies the amount directly paid by firms, it is difficult to see how differences in the division of social security finance between state and the private sector can remain, except in a sense to be mentioned later. Whilst economic arguments support the alignment of member-state budgetary participation in social security, and of employers contributions, it is rather social forces which will, in the long run, demand alignment of benefits (and hence of the final residual items in the social security accounts of employee contributions). As social and cultural integration proceeds, there will be increasing emulation effects; people with an inferior social service will view the best standard of provision in the Community with envy. Each state, as now, will be a shining example in one aspect - unemployment benefits, family allowances, pensions etc. - and form a goal for others. This "levelling-up" process is part of social innovation to be discussed later; it must be good and desirable, only the cost is daunting.

The sums involved are staggering. For example, the total cost of unemployment payments throughout the Community if provided at a uniform standard would vary from 960 mn U.A. at the lowest (Italian) standard, through 2,880 mn U.A. at an intermediate level (U.K.) to 9,480 mn U.A. at the best level (Germany). Similar results are obtained from "levelling-up" other social services.

Of course, alignment and the establishment of Community standards of provision may or may not involve direct administration by the Community - member-states could be left to finance and administer the uniformised schemes. The key difference is that operation by the Community would tend to involve a redistributive element (assuming that the Community budget were not deliberately financed to ensure juste retour), with those with currently poorer standards of provision being the gainers.

It remains disputable, of course, whether all parts of the social security system should be subject to the alignment process, even in the very long run, when some aspects are very culturally identified with particular member-states - should not member-states always be able to provide more health, more education, if willing to self-finance it? It is true that this is in conflict with social integration in the Community, but it has often been asserted that the ultimate size of a nation's "welfare" budget (financed by non-harmonised taxes) would remain discretionary.

Whilst some parts of what is normally regarded as social security has little relevance to EMU, an issue which is not much discussed in European social policy, namely housing policy, is highly relevant both to efficiency (of the labour market) and equity. Attention should be given to the harmonisation of some aspects of member-state housing policy.

3. Social Innovation

This is the widest, and in many ways, the most fascinating view, of what Community social policy should aim to do. It includes what might strictly be termed "social", and what is rather "environmental":

Social — "in-work" policies, e.g. providing training and creating jobs for minority and disadvantaged groups such as youth, women, immigrants, coloured people; improving and changingconditions of work particularly in the factory; fostering effective worker participation; etc.

Environmental* — "outside-of-work" policies, e.g. adult education; leisure and cultural facilities; community centres; urban and rural protection; etc.

A strong case exists for such an interpretation of the goals of Community social policy. It associates the Community with the best of modern democratic thinking, and has its impact among those where the Community at present inspires adverse or zero feeling. It could disassociate the Community from "old" policies, such as some forms of regional policy, which have not been conspicuously successful when practiced by member-states.

Unfortunately, as the appeal of these policies magnify, so does the cost. It is difficult to see how these could be financed directly by the Community, though perhaps the Community could urge implementation of some of them by member states, though the specific Community initiatives might not then be so clear to the people. If the Community were to implement some of them, it would probably have to be at the expense of more orthodox spending policies. It really is a crucial question whether the Community is going to duplicate member-state policies, or strike new ground in the socio-economic field.

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* There are obvious connections with regional policy, but these policies are within the scope of the social policy document of the Commission referred to.

D. Industrial Policy

1. Minimal Community Programme

There is a well-recognized list of policy heads comprising Community aims in industrial policy. These are (i) removing technical barriers to trade (ii) open tendering for public contracts and the development of Community procurement processes by Community public bodies in certain sectors (iii) writing of a European company code and harmonisation of national company law (iv) promotion of mergers and other Community assistance to small and medium-sized firms and projects (v) special aid to sectors on account of the need for reconstruction, high R & D costs, need for vast capital investment, etc. (vi) development of Community anti-trust policy and its co-ordination with member- state monopoly policies.

From this rather immense and costly programme the problem is to select those policies which are the most essential accompaniments of EMU, or which are fairly easy in terms of cost.

Work on removing technical barriers to trade, which includes harmonising standards, patents, weights and measures, etc. involves little financial cost, and certainly should be at an advanced stage of trade is being carried on in terms of a single European currency.

Open public procurement, involving goods, services and finance, fall partly under market integration, which economic union encompasses. Its achievement is mainly a matter of overcoming national protection, and should get ahead in the 70s though the establishment of Community public corporation seems farther off.

2. Longer-run Programmes

The next three elements of industrial policy all involve actual industrial re-structuring, usually into a larger, transnational scale.

It is difficult to distinguish that which is a necessary accompaniment to E.M.U., since, more than in the case of the removal of tariffs (which gave a lead on those industries to be most affected), it is very hard to forsee which industries will be most affected by the progress of E.M.U.

In general, it will be those with a strong geographical bias in certain parts of the Community, but assistance to these is a matter of regional policy.

It does seem that, at least in the second stage, industrial policy will have to be confined to the non-budgetary measures discussed above, plus that part of regional policy which has the aim of modernisation of industry.

For a long time, there may be a pressure for industrial policy, in its budgetary aspect, to be one of assisting lame-ducks, rather than having the more positive role of financing large semi-public projects of European interest, a pressure to be strongly resisted. Of course, in the main, trans-Community projects will develop anyway as private ventures, and some might argue that vast public funds should never be so used. When they are, such a project might have special provision, rather than depend on inclusion in the Community budget.

E. The Community Budget

1. Consultative and Regulatory Policies versus Budgetary Policies

A number of the policies discussed do not involve budgetary finance, but consultative procedures, and the establishment of Community law and regulation. These policies include, for example, consultation about, and co-ordination of, member-state budget deficits, regional aid efforts, company law, stock exchange regulations, competition policy. In the main, they do not involve conflict with each other, or face financing obstacles, and hence should be pushed ahead with, in a compartmentalised way, as fast as possible.

Many other policies, and often the most crucial, need financial resources, a great obstacle to their development, and are in conflict one with another, for that very reason.

A very good way of confronting the limitation of financial resources and the decisions required between the policies discussed is to consider the development of the Community budget in the second stage (to 1976) and in the stage beyond (say, to 1980).

2. Projection of Community Budget Expenditure 1976 and 1980

The commencement point is a budget in 1973 of 0.57% of Community G.N.P. (4,400 mn U.A.)*

Expenditures 1976 and 1980
(at 1973 prices)

	1976		1980-low		1980-high	
	U.A. mn	C.G.N.P. %	U.A. mn	C.G.N.P. %	U.A. mn	C.G.N.P. %
C.A.P. etc.	5,262	0.6	6,156	0.6	6,156	0.6
Social Fund) Regional Fund (Employment Fund)	3,508	0.4	14,364*	1.4*	24,624*	2.4*
Total	8,770	1.0	20,520	2.0	30,780	3.0
* Industrial Policy included						

We based our projection to 1976 (the second year of resources propres for the Six)** on the Commission's recent estimate*** of the total size of the budget of 1.0% Community G.N.P. (which target has not as yet been agreed by member-states) and by assuming a growth in C.A.P. a little above proportional-to-G.N.P. growth (C.A.P. expenditure represents 0.46% C.G.N.P. in 1973).

* Figure revised recently to 5,420 mn U.A. - An increase to 6,080 mn U.A. has been proposed for 1974.

** In general the acceding countries will fully participate in the system from January 1st 1978.

*** References to Commission's communication to Council on EMU, April 1973.

In considering the balance between the non-C.A.P. expenditures, the Commission document declares that regional and employment policies must take priority in the second stage.

The two problems which present themselves are these: (i) the small scale of resources available for non-agricultural policies, and (ii) the method of working toward largely similar purpose through three administratively separate funds.

When we come to 1980, we might postulate that the Community Budget will have continued to grow at the same rate as during 1973-1976, or at an increased rate as transitional problems of enlargement are over and Community identity is more established.

Simple alternatives for 1980 are presented in the foregoing table by budgets totalling 2.0% Community G.N.P. (the low alternative), and 4.0% Community G.N.P. (high). There is no indication at present as to the likely or desired division of the "balance" (after C.A.P.) over the various policies listed.

This is a rather unsatisfactory way, using mere projection, of establishing targets for the size of budget in the future. More satisfactory would be the approach of "costing" the various goals in regional, social and industrial policy. But here the problem is that cost of these many intentions and hopes would yield a very much greater figure, which will appear unrealistic when the financing side is considered. This crucial problem of the "gap" between policy aims in the many fields, and the apparent budgetary limitations, is one which we draw special attention to in our conclusions.

3. Financing the Community Budget

Required finance for the above budgets is fairly easy to estimate in broad terms. Revenue from the two agreed sources of C.E.T. and agricultural levies sum to 0.52% Community G.N.P. in 1973 (net, i.e. 90% of member-state actual receipts). It is not possible to forecast the trend of this % in view of structural changes to be expected during 1973 - 80, e.g. changes in world food prices, in the C.A.P. itself, completion of new trade pacts with third party countries, etc.. In general, it might be assumed that these two sources of finance will not be very dynamic, and so they will only grow in proportions to C.G.N.P. Then, they will provide for (say) a budget of o.5% C.G.N.P. throughout the period. Consequently, the "extra" finance which has to be found for our 1976 and 1980 budgets is as follows:

1976 an extra 0.5% C.G.N.P.,
1980 (low) an extra 1.5% C.G.N.P.,
1980(high) an extra 2.5% C.G.N.P.

This "extra" finance can be raised from one (or more) of several sources:

(i) V.A.T.,
(ii) corporation tax,
(iii) seignorage on a European currency issue,
(iv) short - and medium-term borrowing,
(v) direct contribution by member-states.

The requirements in terms of V.A.T. are easily calculated in broad terms. It is almost true that, with harmonised taxes along the lines of Community Directives and Commission plans, a 1.0% V.A.T. rate in the Community at large yields o.5% of the Community G.N.P. From this factor, the Community V.A.T. rate required to entirely finance the "extra" margin in all our budgets is simply deduced: *

	V.A.T. required, in addition to C.E.T. and Levies
1976	1.0% V.A.T.
1980 (low)	3.0% V.A.T.
1980 (high)	5.0% V.A.T.

If we consider finance by the corporation tax, a useful factor is that corporation tax yield in the Community is approximately equal to a 3.25% V.A.T. Its potential as a source of finance can immediately be seen by reference to the V.A.T. requirement to finance our Community budgets - it would completely finance the "extra" required for the 1980 (low) budget. Of course, it is very dubious that the whole of current corporation tax proceeds could be utilised in this way. Modified proposals consist of the payment of a company corporation tax by companies incorporated under the new Community company code. Its yield, by 1980, would of course only be some proportion of the above, dependent on the progress of the development of Community company law.

Turning to non-fiscal means of financing the Community budget, both methods mentioned involve the progress of monetary union and the development of the European currency.

The annual revenue that could be expected from seignorage (or right-of-issue) can be calculated as follows.** If the European currency became 10% of the European money sypply, and inflation and the real rate of growth are each assumed to be at 5.0% per annum, there is a revenue yield to the Community budget of o.4% of C.G.N.P. annually, as a result of the growth of Community money income. This could cover approximately one-sixth of the 1980 balances.

However, the use of this means of financing the budget is a much disputed one. Historically, the method has always been used in part and in greatly varying degree in the finance of budget expenditures by European nation-states. But the transfer of such powers to the Community would, now, give rise to acute political controversy.

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* A uniform Community V.A.T. rate system, for financing purposes, can be combined with a flexible member-state rate, for stabilisation purposes, as proposed earlier.

** If M is the total Community money supply and V (assumed value 2.5) is the ratio of total Community income to M, then M V = Community Income

$$\Delta M(V) = (0{,}05 + 0{,}05) \text{ Community Income}$$

With a fraction of 10% of the C.E.C. in the European money supply the revenue potential of the C.E.C. as a fraction of Community income is

$$\frac{0{,}1 \quad \Delta M}{\text{Community Income}} = \frac{0{,}1\ (0{,}05 + 0{,}05)}{2{,}5} = 0{,}004$$

In addition, from the economic viewpoint, the method may be inflationary (depending on numerous conditions such as the degree of replacement of seignorage earnings to American citizens through the operation of the Euro-dollar market) and insofar as it were so, the method would be in conflict with the anti-inflation policies with which the Community is currently much concerned.

The method of financing a Community budget tax-revenue deficit by short- or medium-term loans, does not essentially depend on the existence of C.E.C. (since issues could be floated by agreement with member-states in national currencies) but rather obviously ties in as a joint development in monetary union. The term-structure of such loans gives rise to complex economic and monetary effects, and requires co-ordination with member-state debt policies.

The final method of finance that is listed, direct contributions, is a return to the old system, undesirable since it involves a diminution in Community identity, and should only be regarded as a last resort if all other means fail.

4. The Community Budget and the Progress of Economic Integration

The overall conclusion is that a very large gap exists between the more extensive goals of regional, social and industrial policy, and what appears to be feasible in terms of a Community budget even at the more optimistic level of 1980. It is doubtful if even the minimal programme of regional/employment/social policies, needed to meet the dislocation produced by monetary and capital market integration, can be met.

The member-states should be asked to recognise more fully the need to make available financial resources to meet the economic and social consequences of developments in the monetary and capital fields. Since the latter is bringing real income gains, this only represents some transfer of the gains of E.M.U. to the public sector. Alternatively, if it is politically impossible for member-states to raise extra tax revenues for Community purposes, the imperative need for a growing Community budget must be met by a transfer of some current member-state budgetary resources.

Even with such a transfer, the Community budget will continue to look small, when its command of resources of 3.0% C.G.N.P. is compared with member-state budgets of 20.0 - 30.0 per cent of their G.N.P., and when compared with federal finance systems in U.S.A., Canada, Australia, etc.

Some would argue that it is not only small, but distorted, in the sense of representing policies on both the revenue and expenditure sides, which are crying out for revision. On the expenditure side the obvious candidate for re-examination is the mode of agriculture spending*. On the revenue side some would wish to see a decline in the revenue sources of agricultural levies and common external tariff, in the interests of extending the free trade concept to areas of the world outside the Community, and, in particular, increasing non-reciprocal concessions to imports from developing countries.

* A review of C.A.P. is to be made by the Commission by the end of 1973.

Thus, in the longer-run, the Community budget should not only gain substantially in size, but change significantly from its present structure.

The longer-term must see the exercise of Community policies in the three classic budgetary policies of the provision of public goods, stabilisation policy, and distribution policy, directly and explicitly. This will require a Community tax system, Community expenditures of a short and longer-term nature, and Community debt management, also short and long-term. It is also incumbent on the Community to recognise that all of these fiscal and debt policies have an impact on each of the budgetary functions, and particular policies must be examined for their detrimental effect on some groups as well as for the benefits to others.

IV. Concluding remarks

1. The development of the Common Market, characterized by the free movements of goods, services and factors of production, into a fully fledged economic and monetary union marks an important and, perhaps, decisive turning point in the building of the European Community. But there should be no delusion: the tasks and objectives still awaiting their fullfilment are by no means easier than the already difficult achievements of the past. The transition from the Common Market approach - which for sure has not yet come to an end - to the creation of an economic and monetary union, implies a shift of emphasis from market integration to an institutional integration. The former is mainly concerned with the abolition of barriers to intra-EC trade and factor movements and the implementation of common policies, particularly vis-à-vis the outside world, whereas the latter concentrates on creating the necessary set-up bound by common political responsibility, for efficient decision taking processes to work toward the common objectives and policies which form the core of EMU

A new concept of parallelism, enlarging the accepted principle of parallel progress between economic integration and monetary unification, follows from this development. Whereas up to the present most efforts have concentrated on the integration and smooth working of markets, with EMU-time has come to match a further deepening of market integration by action on the instrumental side through broad-ranging interdependent measures in the fields of economic and social policies. So rely further primarily on liberalisation measures and markets would ultimately lead to a vacuum in which national governments would have given up the independent use of policy instruments for the advancing of social and economic goals introducing common instruments and policies.

Against this background it has become questionable whether the old idea, dear to the founding fathers of European Integration, of using economic integration as a lever to pave the way for the ultimate goal of political integration still offers a valid and reliable operational base for further progress of the movements towards a united Europe. The institutional integration necessary for a succesful economic and monetary union appears to make it hardly meaningful to push ahead only in those areas where consensus can be reached and progress is still possible. In this respect the development of the Common Agricultural Policy appears as a revealing example. Therefore, this approach no longer looks convincing now that the stage of institutional integration, implied in the transition towards EMU, is reached.

This report has not dealt with the aforementioned problem explicitly. The thinking is based on the widely spread political will to achieve progress towards economic integration and monetary unification.

The point to be stressed is that the building of the Economic and Monetary Union will only succeed if simultaneous progress can be achieved over the whole range of issues that have been discussed in the preceeding parts, i.e. the comprehensiveness of the policy suggestions which have been put forward is more important than any of the individual measures proposed. Only such an approach will make it possible to deal adequately with the conflicts and trade-offs implied in the progress of European construction.

It should be recognized - more than has been the case up till now - that every Community policy has its impact on multiple objectives: monetary, economic, social and even political. In order to avoid progress in one field being followed by even bigger steps backward in other fields, the costs and benefits of every policy should be evaluated and balanced. It is in this respect that the need for parallel progress in the different fields of the European enterprise gets its fullest significance. At the same time it should be pointed out that as far as the need for harmonisation policy is concerned what matters in the first place is not necessarily a greater uniformity of instruments but a better coherence of the effects of different policy measures.

2. As a viable and credible exchange-rate system for the transitional period towards EMU, the report supports the dissociation of intra-EC exchange rate relationships from those with the rest of the world. At the same time it is recognised that for the time being, fixed intra-EC exchange rates are not compatible with the state of semi-integrated economies achieved so far. Therefore a system of limited intra-Community flexibility combined with joint-floating erga extra is proposed. The creation of a Common European Currency, defined in terms of a bag of national currencies, at an early stage is also advocated. This important step towards monetary unification would, among other things, facilitate the operation of the limitied flexibility schedule and promote the liberalization of capital movements by offering an adequate instrument for a truly European unified money and capital market.

To fulfill the functions envisaged for the Common European Currency it must be more than just an instrument for official settlements. It should also become the common intervention currency for stabilising the value of the currencies of member-states on the exchange-markets. This implies the introduction of the Common European Currency as a medium in which private transactions can be settled. For these functions it would suffice initially to restrict the use of the Common European Currency to what is called a "monnaie cambiaire". The rôle of the Common European Currency would be comparable to that of the Euro-dollar with possibly supplementary functions.

A new currency, of course, needs an issuing body and pooling of reserves. Even more important is an adequate management to prevent it from becoming another engine of inflation. A decision-taking body in monetary affairs at the European level is thus to be created concomitantly. One of its major tasks would consist in implementing a European

money supply policy, including control over national money creation.

3. The progress thus achieved in monetary unification can only be successful and operational if backed by sufficient advance in economic integration to cope with conjunctural and structural imbalances which monetary unification itself might even increase. In general, however, economic and social integration deserves to be pursued in its own right. It should not be constrained to the minimum rate of advance necessary to accompany monetary unification (and vice versa). Advance in economic union has its own significance. It is more than just an infilling of crevices wrought by monetary union.

Stabilisation policy aiming at a steady rate of growth of GNP with price stability and full employment under a balance of payment constraint becomes more complicated. Conjunctural policy has to be pursued at three different levels: Community, member-state, and regional. As compared with the member-states situation, the Community cycle problem is mainly dominated by prices, whereas the divergencies for regions with declining industries are dominated by additional employment difficulties. For the Community cycle progress towards EMU along the lines advocated in this report offers the right instruments (monetary) to deal with the problem it brings about namely the consolidation of a Community cycle. At any rate, further progress towards monetary unification through narrowing margins for exchange-rate fluctuations would require an increasing synchronization of Community cycles. The emphasis of stabilisation at the member-states level must shift to budgetary instruments. A sufficient degree of flexibility will have to come from the fiscal side. However, this runs counter to some plans for tax-harmonisation argued on the grounds of removing distortions to trade and factor movements.

Regional disparities are caused by divergent trends of factor prices and productivity rates, so that "highly" paid labour can no longer be employed by areas or industries with lagging productivity levels. It is likely that EMU will lead to a faster convergence of factor price levels than of productivity trends. This makes the need for a large scale regional policy at the Community level all the more urgent. However, matters are complicated by the difficulty in defining the regional problem, particularly as we are on the threshold of a new concept of the regional problem characterised by congestion and infrastructure run-down and decay. To avoid the situation from becoming unmanageable the list of Community criteria should be kept very short and simple and perhaps be put only in terms of income and unemployment levels.

The schedule for limited exchange-rate flexibility supported in this report as part of the transition to EMU would be greatly strenghthened if a better harmonisation of average wage and price increases could be brought about. If exchange rates are ultimately to be rigidly locked, an income policy consistent with remaining productivity differences become indispensable. Trade union co-operation will have to play a big role in this respect. As regards social policy, questions arise as to the required size of an enlarged Social Fund and its mode of use since, with the advent of EMU, the labour consequences of the resultant industrial re-organisation might well attain a new scale. Whatever the particular policies adopted in the social field, it is clear that there is no justification for its finance by a system of juste retour.

In the field of industrial policies the problem is to select those policies which are the most essential accompaniments of EMU or which are rather inexpensive in terms of cost.

4. Most of the aformentioned policy proposals, and indeed the most crucial ones, require substantial financial resources exceeding by far the current Community budget. Therefore, the Community budget should be expanded to, at least, 3% of the Community GNP by 1980. Perhaps this is the best way to illustrate the great difficulties and resistances which have to be overcome if the objective of an Economic and Monetary Union by the end of the decade is to be transformed into reality.

In general a great gap exists, at the present time, between official declarations of intent and the concrete actions undertaken to further progress on economic integration and monetary unification. It has gratly weakened the credibility of EMU. It should be recognise that the proclamation of high principles and objectives is not sufficient to guarantee their implementation in economically meaningful and viable schemes. These principles need to be followed up by common policies.

PART II

INDIVIDUAL CONTRIBUTIONS

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EUROPEAN MONETARY UNION (x)

1. Why monetary integration in Europe?

The discussions on economic and monetary union between the countries of the European Communities have been going on for several years now, and the increasingly specialized arguments could make us lose sight of the real motives which have led both to the discussions and to the first steps on the road to union. This is why it seems necessary, at the beginning of this preliminary opinion, to dwell for a moment on those original motives.

Looking at what was achieved in the Community of Six it is easy to see the motives. We can say that, since the inception of the EEC in 1957, customs union has been established; that, in various fields, efforts are also being made to coordinate and/or harmonize economic policy; and that progress will obviously not stop there but will continue along this road because it constitutes the logical continuation of what has already been achieved. This conclusion was also drawn by the Summit Conference held in The Hague in December 1969, which called for preparation of a plan for the establishment by stages of economic and monetary union. It has often enough been said that, as import duties within the Community disappear and import restrictions can no longer be applied, balance of payments policy relies increasingly on the use of monetary instruments and that this use must be coordinated so as not to be prejudicial to the common market. I would recall here that the Monetary Committee of the EEC drew attention to these consequences in its very first annual report.

At the present stage, however, the question of monetary union might be posed in entirely new terms, i.e. without taking account of previous developments in the Community. It is understandable that this idea should have arisen especially in Great Britain, which in the past few years has been confronted with the question of membership and which was then still free to reject monetary union, even though such rejection would at the same time have meant not joining the Community.

In a recent article Professor Reitsma studies the theories on optimum currency areas (1). He examined in particular the contributions by Mundell, McKinnon and Kenen but was unable to extract an attitude concerning monetary union in the EEC from them: "It would seem that the above considerations provide sufficient grounds for suggesting that the various theories on optimum currency areas are of little or no help in defining an attitude concerning a monetary union between the EEC countries. Factor mobility must certainly be considered to be insufficient in practice, and the differences in production, together with the size and openness of the economies concerned, seem to be criteria that are not reliable enough to be used as a basis for a definite exchange rate policy in the EEC area. The entry into the EEC of new members, especially the United Kingdom, makes this even more difficult" (2).

(x) This article appeared as a publication by the "Vereniging voor de Staatshuishoudkunde" (The Hague, 1972).

(1) A.J. Reitsma, "De monetaire crisis, het vraagstuk van het optimale valuta-areaal en de Europese monetaire unie", De Economist, Vol. 120, no 2, 1972, pp. 153-174.

(2) A.J. Reitsma, op. cit., p. 166.

Reitsma also took a thorough look at the theory put forward by Fleming, who considers that in a monetary union trends may easily develop which will cause the relative cost levels of the countries concerned to diverge while the exchange rate instrument will no longer be available. In particular, Fleming fears that union would entail higher unemployment than would have to be faced by each country individually.

Corden takes the same line in an essay published in the Princeton series (1), which I should like to examine somewhat more closely. Corden argues that for each country there is a Phillips curve relating the movement in costs to the level of unemployment, and that for each country there is an equilibrium position between unemployment and inflation, an equilibrium position which is determined by the political choices made by the governments and the central banks. He says: "If the optimal policy involves different rates of cost inflation, but exchange-rate relationships are in fact fixed, it becomes necessary for countries to depart from their optimal points so as to ensure a uniform rate of change in costs. Some countries will be compelled to have more unemployment than they wish, and some, more inflation" (2).

The exchange rate instrument is, however, Corden goes on to say, only meaningful if real wages and salaries can be reduced by devaluing. This will certainly not be the case in a very open economy, for then there is no money illusion, or one would wish to conclude wage contracts in foreign currency. But, according to the author, the countries of the present and future European Community are individually able to reduce real wages and salaries through exchange rates and therefore constitute what he calls "feasible currency areas", with the exception of Luxembourg and Ireland.

Monetary union finds somewhat greater favour with Corden, provided it is viewed as a continuation of customs union. Admittedly, regional unemployment can then no longer be combated by trade restrictions, but these will be replaced by subsidies, which are better suited to the purpose. However, if no regional policy has been set up by the end of the transitional period, the instrument of trade restrictions will have been jettisoned without anything having taken its place. Even the mobility of capital does not, in the final analysis, constitute a remedy for the adjustment process which a region must go through if external equilibrium has been upset. Corden's constant fear is that real wages and salaries are so rigid that this adjustment process will be accompanied by a decline in employment and production failing the possibility of resorting to the additional instrument of fluctuating exchange rates.

If one starts from his assumptions and from the assumed political choices of the public authorities, Corden's analysis is correct. These assumptions and choices do, however, call for a few comments. First of all, one must seriously question the view that money illusion in most countries of the enlarged Community can be presumed to be such that a fall in real wages and salaries brought about by a rise in the exchange rate would be accepted while a reduction due to other causes would not. The

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(1) W.M. Corden, Monetary Integration, Essays in Integration Finance, Princeton University, no 93, April 1972.
(2) W.M. Corden, op. cit., p. 9.

integration process now enables the trade unions of the various member countries to come to know each other's mentality and methods better, and this certainly need not lead to the adoption of the most short-sighted and aggressive policy conceivable; in fact, the line taken by national unions which wish to exercise restraint partly because of the unemployment that would otherwise occur is equally likely to be adopted. And if no such restraint is forthcoming it is difficult to believe that it would be brought about by a change in the exchange rate. Better understanding of economic phenomena is more likely to induce a tendency for money illusion to weaken.

Attention must, however, be drawn to the fact that various arguments put forward by Corden relate to what he calls a "pseudo exchange-rate union" and not, by any manner of means, to a "complete exchange-rate union". The latter would imply that the union has a central bank holding Community monetary reserves, and that there is also a Community policy. In a complete union, for instance, there would no longer be destabilizing speculative capital movements between Member States, in contrast to the situation in a pseudo union.

It is also necessary to comment critically on Corden's remark that elimination of the disparity between currencies would jeopardize each country's optimal point on the Phillips curve. This is certainly true, even though in what has been said before doubts have already been cast on the money illusion which would be necessary in order to stay on course via an alteration in exchange rate relationships. In my view the optimal point need not be invariable; it may shift precisely as a result of progress in integration, and this will in fact be necessary so as to arrive at a Community position in the completed union. If the individual countries' choices concerning the objectives of economic policy, and especially the mix of this policy, are maintained unchanged, there will indeed be continual distortions once the monetary frontiers have been abolished; but this would be completely incompatible with the establishment of union.

Like other people, Corden considers "that the potential deficit countries will have to depart from their optimal points rather than the potential surplus countries, so that the union will be unemployment-biased" (1), although he adds immediately that in the case of a complete union it is impossible to say what the final choice will be. This suggests that the deficit countries must make a heavier sacrifice, but it is questionable whether this will be a sacrifice for the benefit of the Community as a whole. The deficit countries may be much less important than the surplus countries, and they may realize that slightly less strain on the labour market makes it possible to achieve, among other things, comparatively much greater price stability, so that they no longer regard their change of position as a sacrifice.

In short, my objection is that Corden's analysis is too much based on the assumption that establishment of monetary union must be seen in the light of national objectives, while in actual fact such a union would be something completely new in our

(1) W.M. Corden, op. cit., p. 9.

world of national states and must be viewed as such. Provided a Community regional policy is substituted for the national policy now pursued by each country to cope with the disparity in cost trends and with structural difficulties in certain regions, there is no reason to expect that the national authorities will achieve more than the Community authority. The reverse is more likely, because in a union measures will be abandoned which merely strengthen the position of one country at the expense of another, and because economic activity, which is increasingly spreading beyond the frontiers, will no longer be hampered by a variety of national measures which, in addition, involve extra costs.

Although economic theory gives no unequivocal answer to the question of whether economic integration will ultimately bring an increase in prosperity, the experience gained so far with the European Communities already provides grounds for answering the question in the affirmative. The completion of economic and monetary union is then nothing but a logical continuation of the Community already achieved.

Moreover, economic and monetary union is of great political importance at international level; this cannot be expressed in figures but must not be disregarded when looking at the economic implications. The theory of economic policy is concerned with means that may help to achieve specific ends. Anyone who includes among the ends an increase in Europe's political weight in the world is still on economic ground.

2. Outlook in the light of the present situation

Before the Summit Conference in The Hague there had been major differences of view concerning the approach to be adopted to achieve economic and monetary union; they were commonly referred to as the dispute between the "economists" and the "monetarists". The economists gave priority to harmonization of social and economic policy, while the monetarists' prime concern was to see progress made in the fields of fixed exchange rates, free capital movements and harmonized monetary policy. The Werner Report attempted a synthesis of the two views. Conclusion E of the report reads: "Throughout the process, as progress is achieved Community instruments will be created to carry out or complete the action of the national instruments. In all fields the steps to be taken will be interdependent and will reinforce one another; in particular, the development of monetary unification will have to be combined with parallel progress towards the harmonization and finally the unification of economic policies" (1).

The Council Resolution of 22 March 1971 laying down the plan for establishing economic and monetary union likewise refers, in section IV, to "the parallelism which must be observed between the coordination of economic policies and progress in the monetary field within the Community".

These statements cannot be expected to have resolved the dispute between economists and monetarists, for when it comes to practical implementation we shall be faced time and again with the question of whether a monetary measure is justified in

(1) Werner Report, p. 26.

the light of the progress made in harmonizing economic policy. A close look at the concrete points in the resolution of 22 March 1971 shows that it is difficult to take practical action with regard to social and economic policy (here always understood to exclude monetary policy). The following are the main points listed:

1. For budgetary policy, margins must be determined within which the main items of all the public budgets must be situated; particular reference was made to variations in the size of the budgets, in the extent of the balances, and in the methods of financing or using the balances.

2. Provision was made for moves to harmonize the various types of taxation.

3. Measures must be taken in the field of regional and structural policy.

The Council is constantly being requested to draw up one or other measure but, following the delay caused by the events of 1971, this means that there can be no mention yet of any effective harmonization of social and economic policy. In addition, compulsory mutual consultation has been prescribed in many fields; the importance of such consultation should not be underestimated, because it leads to better knowledge of the situation in the partner countries, although the concrete results are not always easy to pinpoint.

In its report on the financial year 1971, the Nederlandsche Bank also drew the conclusion from the resolution of March 1971 that the only binding agreements with a practical content related to the monetary field (1).

Owing to the developments that have occurred since then, full implementation of these practical agreements has been impossible, but the measures taken in the spring of 1972 had the same aim, namely to arrive at a narrower exchange rate band between the European currencies than would derive from the relationship vis-à-vis the dollar. Moreover, both the system of short-term support and the arrangements for the mutual grant of medium-term assistance have now been put into operation. Furthermore, a European Monetary Cooperation Fund may be set up soon, and agreement has also been reached on practical measures to regulate international capital movements.

The impressiontherefore is that monetary coordination and harmonization advance more rapidly than coordination in other fields, and there are a number of reasons for this. Monetary policy is conducted by the Central Banks, whose Governors meet every month in Basle; while it requires great technical expertise, which the Central Banks are obviously not short of, it does not, in my opinion, call for major internal consultation. The effects of this policy are mainly on the banking system, which generally is organized in such a way that it is not difficult to consult. The point I am trying to make may become clear from a comparison with the problems arising under budgetary policy and taxation policy. With all their subdivisions, these policies have a much heavier impact on all areas of economic and social life. Every effect does not have the same importance from a macro-economic angle but is of great significance for

(1) Report of the Nederlandsche Bank on the financial year 1971, p. 108.

certain sectors of the national economy. In the field of budgetary and taxation policy there is also much more interference by pressure groups than in that of monetary policy, and Parliament, too, usually takes little interest in monetary matters - perhaps wrongly.

If even at national level balanced decisions in this field of official policy are so difficult to arrive at, it can be realized that harmonization in a European context comes up against still greater obstacles. On parallelism, my conclusion nevertheless is that monetary cooperation must serve as a driving force for the whole, because I fear that harmonization in the other areas will not get easily off the ground under its own steam. In other words, I feel that the conditions for the success of certain forms of monetary policy are comparatively favourable, and that the results obtained here will create a more or less compelling need for harmonization in other fields.

It may be objected that the events of the past few years have pointed towards more nationalism in the monetary field. This is difficult to deny, but one should not forget that precisely in that period the countries have been confronted with the most serious crisis in the international monetary system since the war, and it is not surprising that not all of them reacted to this challenge in the same way. As pointed out by the Commission, the situation offers a special opportunity for making fresh progress in the field of monetary harmonization, and the setting up of new institutions such as the European Fund, referred to previously, can only have a favourable impact.

One objection that may be raised to my line of reasoning is that agricultural policy, using fixed prices expressed in units of account, has failed to speed up monetary unification and that, in particular, it has not prevented the switch to floating rates and new parities. This objection is correct, but it must be borne in mind that the farm sector was not important enough for changes in exchange rate relationships to produce irreparable effects there. In many countries, however, this sector constitutes a major pressure group, so that the effects of exchange rate changes have had to be cushioned by levies and compensatory amounts.

The conclusion from this, however, must be that proclaiming fixed exchange rates does not automatically lead to the aim pursued. This is why the course followed so far, namely going for greater flexibility but narrower margins than those under the dollar standard, coupled with practical cooperation as regards intervention policy, is perhaps preferable. Monetary cooperation may then also produce results in the field of liberalization of capital movements. As already mentioned in paragraph 5, it will in this context be necessary for intra-European capital movements to be dissociated more sharply than hitherto from international capital movements. Full liberalization of capital movements, with fixed or virtually fixed exchange rates, leaves the national authorities no longer any room for a policy of their own. But where such national policy is replaced by a supra-national policy, there can also be greater liberalization of capital movements.

I should like to add a few words on the specific situation in the Netherlands. Here I refer in particular to the continuing inflation, which is stronger than in the other Member States of the European Community and seems to be impossible to combat. At the same time the guilder, together with the German mark, is one of the most highly thought-of currencies, and the Dutch monetary authorities are trying to make arrangements to stem any fresh inflows of speculative capital.

As monetary union takes shape, the position changes: there is less reason for making a distinction between the strength of currencies, and there is less scope for a sharper wage and price increase than in the other member countries because this leads more rapidly to a loss of competitiveness and an outflow of liquidity.

With wage and price increases in the Netherlands apparently impossible to check from within, and with capital imports regularly adding to liquidity, the achievement of monetary union may well be the only means of reducing inflation there to the average rate for the Community.

It would seem that these consideratioms lead to the following conclusions:

1. Economic and monetary union is desirable because an economic area without artificial frontiers drawn by history is more rational than an area with such barriers. Moreover, such union is the logical completion of what has been achieved by customs union. Lastly, economic and monetary union may lead to a united Europe which can play an important role in international politics in order to contribute towards objectives such as greater peace and security and the development of the third world.

2. The measures to achieve economic and monetary union comprise both harmonization of the instruments of social and economic policy and the joint adoption of monetary measures. The two types of measure must keep step with each other, but monetary measures may sometimes have the lead for technical reasons. This may act as a stimulus to unification in the other fields, which is much more difficult to achieve.

3. In the monetary field the time seems to have come for making a fresh start, following the frustrations of 1970 and 1971. The approach adopted to this end in the form of joint intervention policy by the Central Banks to contain the exchange rates for the European currencies within narrower margins than those applying between other non-dollar currencies is a first practical step, but this cooperation must be rapidly consolidated by setting up the European Monetary Cooperation Fund.

4. Increasingly close cooperation in the monetary field also can and must lead to a Community attitude towards the dollar. On policy vis-à-vis the dollar, there is a case for seriously considering the establishment of separate markets for commercial and financial transactions. Commercial transactions could then be handled at fixed exchange rates, or at rates varying within narrow limits, and financial transactions at completely free rates.

5. As far as can be seen at the moment, there is nothing in the plans for European monetary unification that clashes with the plans for a reform of the international monetary system.

6. With regard to sterling, continuation of the Basle arrangements, coupled with some consolidation of short-term sterling balances maintained as an investment, is sufficient to achieve a gradual rundown of its role as a reserve currency.

7. Criticism levelled at the idea of monetary union is based on unduly "national" thinking. With the exchange rate, in the long run, no longer available as an instrument, the differences in national tendencies, such as the tendency towards inflation, are bound to narrow. Closer contacts between the authorities and pressure groups will also work in this direction.

8. It is necessary that all Community institutions, including new ones, should take decisions by a majority, or possibly a qualified majority. The Commission must be represented in these institutions.

9. Increasing inflation in the Netherlands may perhaps be reduced to a more moderate rate through progress on the road to economic and monetary union.

Possible stages in the realisation of economic and monetary union

1. General remarks

Experience with the customs-union in the Common Market taught us that it is fruitful to arrange for certain steps to be taken at certain points of time, agreed upon beforehand. To reach the aim of a monetary and economic union the same pattern must be followed though the steps to be taken are less precise than in the case of the decrease in import duties some years ago.

What the Commission could and should do is to formulate proposals which are as clear as possible and to indicate afterwards in what way the Council of Ministers deviated from these proposals in taking their decisions.

The Commission should be careful not to slow down the speed of action to be taken in connection with the entry of new countries into the E.C. These countries have accepted that part of the building that has been built up to now and as far as I know also the time-schedule for the completion of the building. The Community cannot afford thinking over the whole process again and again. When, however, some gaps have still to be filled the new members have the same right as the old ones to participate in the decision. Apart from these considerations the Commission has the difficult task every time to formulate those proposals that carry the Community somewhat further on its way to a real union, but on the other hand to refrain from those proposals which everyone can see are not yet acceptable to national authorities.

2. European Monetary Fund

In the monetary field this is an important step not perhaps because of its size or its power at the moment, but because the establishment of the Fund may introduce in embryo a real centre of decision that will gather its own momentum and may be a predecessor of a European central bank. What I want to say is this: even a small Fund can have a great importance as soon as some people have to manage its ~~affairs,~~ who are more or less separate from the national authorities. Just as the Managing Director of the I.M.F. and in a lesser degree the Executive Board can play their own role in international monetary affairs, so the Management of the European Fund should play such a role in Europe. The Board of Governors should therefore at least include a non-central-bank-governor who should be the member of the Commission that has to deal with financial and monetary affairs.

At the starting-point (before 1 April) the Fund will only have to settle claims and debts arising from the intervention of central banks in each other's currencies, including the very short run credits, connected with the monthly settlement, and monetary support in the short run.

It is important , however, that in this way central banks are credited and debited in European Units of Account, from which the Europa may arise.

It is very important that the Fund should quickly be concerned with the foreign monetary policy of the Community. For that reason it is inevitable that central banks transfer a part, say at least 10 % of their gold and foreign exchange holdings into the Fund. Such a measure is a minimum requisite before we start the second stage. That will give a possibility of settling the monthly balances by transfers of Units of Account instead of by transfers of foreign exchange.

Decisions to be taken by the Board of the Fund should from the beginning be majority decisions. The difficulty that always faces the Council in reaching unanimous decisions must right from the beginning be prevented in other bodies.

3. Dollar policy

Assuming that in this way a European monetary authority were established, then this authority should as soon as possible give some guidance for a European dollar policy. In case the deficit in the basic balance of the USA continues, which is to be expected, a choice should be made between floating against the dollar, control of capital movements or a double foreign exchange market. Both control and a double market should be on a European scale. The Board should take the measures, approved by the Council and prepared by the Commission and its Directorate-General for Economic and Financial Affairs (1).

Before the introduction of a double foreign exchange market some difficult technical questions will have to be solved. One should take into account the possibility that e.g. American capital wanting to flow to Germany may/make its way via another member of the EC circumventing the high price it has to pays for D-marks. It has not been proven, however, that such a European double market is not possible.

4. Parity changes

During the second stage the possibility of parity changes will continue. I assume that the margins of fluctuation for the Euro-currencies will remain what they are now. But a European policy makes necessary not only prior consultation but judgement by an independent body. The Council of Ministers is not able to give a majority vote on the necessity for such a parity change. But the Commission is able to do so. In my opinion therefore the second stage should include something of a stipulation that no parity change will take place without the prior judgment of the Commission. The judgement will be published in the event that the parity really changes. For consent by a European authority the time is not yet ripe.

5. The Europa

It is not expected that the national states will take far-reaching decisions concerning the introduction and use of europas. When the europa has been established in the European Monetary Fund, the main banks could be allowed to buy from the Fund a small amount of Europa. They will do so in the event fo these/being a demand for europas from

(1) There would be no point in the European Fund establishing its own study-department, etc. This should be done by the Commission.

the private sector-side. Banks want to remain in equilibrium, both in general and as regards their claims and debts in europas. The Governments could then help by issuing bonds in europas. The Council of Ministers should accept a recommendation to the member Governments in this respect.

6. Final remarks

I have limited myself to some points of action that can be taken now. It is no use making various schemes of stages without knowing in what way the authorities and citizens of the member countries really are prepared to surrender a part of their national sovereignty to community bodies. It is clear that this will not happen from one day to the next , but during the second stage some progress will have to be made. Consultation in the case of budgetary and economic policy is not enough: some common opinion must arise from those consultations and must at least be morally binding for those concerned.

Because of the fact that monetary policy has less to do with pressure-groups, the policy-makers in this field can run somewhat (but not far) ahead of the others. What action can be taken in other respects depends on the situation. The proposed temporary decrease in import duties, proposed by the Commission, was a good example of prompt anti-inflationary action.

Exchange-rate policy

The German Bundesbank has in its report for 1971 declared that the gold-exchange-standard has for the time being been replace by a dollar standard. For the next years to come this will be the system on which the western world will be based, unless we take specific measures.

Among these measures I do not include a substantial reduction of the U.S. balance of payments deficit. Of course we wish such a reduction to take place, but we cannot count on such a development as it is improbable that it will occur. It is for the U.S.A.,from a technical point of view, very difficult to use the instruments of economic policy to improve the balance of payments position, it is furthermore still more difficult politically to do so, as imports and exports only play a minor role in producing and spending national income, and last but perhaps most important, the political will does not exist to solve the problem. All statements concerning an improvement of the balance of payments position must be taken too seriously. The recent devaluation of the dollar may improve somewhat the balance of payments position but will not change it fundamentally, unless the U.S. change fundamentally their commitments towards the world outside.

In the graphs, from the European business magazine Vision (15 January 1973, pages 11-12) we see the current account for most countries moving somewhat above or around zero, but for the U.S. 1972 shows a deficit of 8 billion dollars with Japan showing a surplus of about 6.5 billion dollars. The official settlements of the U.S. show a deficit of something less than 9 billion dollars.

Starting from the same development in the years to come,four possible attitudes from the European side present themselves:

1. Sticking to the dollar system.

This means that the dollar reserves of the other countries and especially of Europe will continue to grow and that there will always be a tendency to assume that the existing parities are not the right ones, so that it can only pay to continue speculation against the dollar and in favour of the DM.

If nothing were done against this speculative flow of dollars, strengthening the already existing "normal" flow, the European and especially the German authorities would be faced with a continuous creation of money.

Without maintaining that this can be regarded as the main cause of inflation, it makes the struggle against inflation still more difficult than it is already. Of course something can be done against the influence of large-scale dollar inflows on the banking system, e.g. by requiring a reserve of 100 % against foreign deposits. Experience tells us that this does not prevent outside funds continuing to flow into the country waiting for the currency to be revalued or to rise when left free. Moreover, the foreign funds can be invested in securities and then a measure like the 100 % reserve cannot be applied.

2. Floating of the European currencies

This means a rise in the value of the European currencies, and the Europa if it has been introduced. I am speaking of "European" because at this stage national solutions should be no longer applied. If there is a float, not only the D-mark should float, but the other E.E.C. currencies and probably some other European currencies as well. Of course, the strength of the European currencies is not the same and this solution would mean that some European currencies would get a higher value towards the dollar than is justified by their own position. The "snake in the tunnel mechanism" would provide that higher value as Germany, assuming that the D-mark would be the main currency in such a situation, would be obliged to buy other currencies to preserve the band of 2 1/4 %. The result would be that Germany would end up with claims on other countries which would be changed into claims on the European Fund of Monetary Cooperation.

Other countries would increase their liabilities towards the Fund. This in itself should present no special difficulties, as the claims could be used and the liabilities be compensated throughout Europe. Germany would, however, as a result of the accumulation of claims on the Fund by the Bundesbank, experience some creation of money and the other countries some destruction of money.

These amounts, as they are not the results of an inexhaustable source of finance like the creation of dollars, would be modest in comparison with the creation of money that would arise in connection with the increase of dollars in the hands of the Bundesbank. Compensating domestic measures would also be easier than in the case of a flow of dollars. The value of all European currencies would go up and business would complain of the difficulty of remaining competitive.

We must, however, not forget that trade with the U.S. is for European countries rather small in comparison with their trade with other European countries. "Mutual trade among such countries currently encompasses 2/3 to 3/4 of their total exports, as compared to about 8 % only for their exports to the United States". (R. Triffin, Basic considerations on international monetary reform, Weekly Bulletin Kredietbank, November 24, 1972, p. 473).

The increase in exports would, however, show a slower rate of growth. For countries that face a rather inflationary situation this is only favourable, but it can give some concern to countries that do not face the same rate of inflation. This is inevitable and it shows that a monetary union in Europe will force the member countries to follow more than in the past the same pattern in their business-cycle behaviour. Most countries, however, can change this pattern only within a couple of years. During that time they must rely on a certain support from the European Fund in the form of short-term assistance and if necessary from the Governments for medium-term assistance.

If the European Fund has enough foreign exchange to be able to follow a definite policy with respect to the rate of exchange between the European Unit of Account and the U.S. dollar, it can of course take into account not only the wishes of countries with a strong currency but also the needs of countries whose currency is less strong. It should follow a policy based on the economy of the community as a whole. By talking of a deliberate policy of the European Fund, I mean that the floating must not be left to the market alone. I do not see why the Fund should not influence the rate of exchange, as a part of monetary policy. So I do not see anything "dirty" in so-called "dirty floating".

3. Double foreign-exchange market

If it is preferred to stick to fixed rates of exchange at last for the current-account-items of the balance of payments, then a double market could be introduced. A European solution would mean that capital movements between member countries, as far as they are free already, remain free at the official rate of exchange, but that only non-residents of the Community will have to pay the free price for the Euro-currencies, if they would like to invest in Europe.

One problem is how to prevent an overflow from the official market to the free market, but that problem also existed in the case of double markets on a national basis, and it seems to have been solved not too badly in the case of Belgium and France. The problem arises, however, how to prevent a non-European from using the difference in the rates of exchange applicable to himself and to an inhabitant of the Community.

Suppose an American wants to invest in D-marks. The price of D-marks on the free market is already high, but the free lire is at parity. The American buys lires and will try to get from lires to D-marks at the official rate, which is applicable to inter-European capital movements. An Italian will buy D-marks at the official rate (which is permitted) and then sell his D-marks. This may be forbidden, but it will be very difficult to implement such a control. If there is no control, arbitrage will cause the lire to rise too, until there is no advantage in getting D-marks either directly or via the lire. In the meantime, a part of the profits, made by Germans if they sell D-marks to the American, will now be made by Italians, and Germany will have accumulated claims on the European Fund, whereas Italy will show increasing liabilities towards the Fund.

Because of arbitrage the adjustment will work quickly, so that the financial lire will soon be as par with the financial D-mark. Though it cannot be foreseen whether such a system will cause <u>any</u> difficulties, it may be assumed that big difficulties will not arise. The main purpose, to establish a wall between the ever growing amount of U.S. dollars and the impact of this money on Europe, will have been reached. As none of the European currencies is used as a key-currency, the same difficulties as between the U.S. and Europe will not arise between the European countries among themselves.

4. Control of capital movements

Assuming that capital movements between the member countries of the E.C. become as soon as possible reasonably free, control of capital movements between Europe and the rest of the world should be implemented by the European countries together. The should allow or disallow the same categories of payments and exert the same means of control. It must not be possible, of course, for one country to allow a certain capital import and another to forbid its or for control in one country to be more severe than in another. It is a technical matter whether this is possible and it is a political matter whether it is wanted. If it is wanted the central bank technicians should tell us what is technically possible, but it should not be assumed that it is impossible before it has been decided that it would be feasible from the political point of view.

20 February 1973.

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Documents written by Mr. J. Denizet

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Notes about European Monetary Unification

One political compromise which is respectable, like all compromises, but which leaves much to be desired from the point of view of economic logic, has for two years tended to become accepted as something obvious and commonplace within the Community. This commonplace is that monetary unity - or monetary identity as the resolution of March 1972 delicately puts it - is the completion, the gratuitous and more or less aesthetic crowing of economic unity. This view is perhaps politically adroit as it has been accepted by those who sincerely desire monetary unification and by those who harbour much suspicion towards it; but it is totally mistaken. It is mistaken to an extent which even the supporters of monetary unity no longer perceive. In fact, monetary unity is not just a pleasing detail which can be added to completed economic unification or to political unification in full stride; it is strictly indispensable, hic et nunc, for the maintenance of the degree of integration already attained. If immediate progress is not accomplished in monetary unification all the rest will collapse. It is like a surgical operation in which the surgeon has done the main part but has failed to stitch the patient up again.

I. The logic of integration

1. The aboliton of customs frontiers, freedom of movement and establishment and total freedom for capital movements (which is necessary for putting these first two matters into practice) require monetary unification. Thus, freedom of capital movements brings about an equalisation of the monetary and capital markets of the Community (this is already unification of the Community monetary and capital market). Since national monetary policies work through action exerted on rates of interest [irrespective of whether this action is intended (classical) or undergone (Friedmann)], they become impossible. It is clear that this is already the case. Recent economic history, that of Germany from January to April 1971, that of France a few weeks ago and that, I suppose, of all the countries of the Community, proves it to the hilt. The complaints of the central banks and governments are explicit enough with regard to this.

It has become impossible on the national scale to implement short-term economic policies by the expedient of monetary control and rates of interest. The Community would then be in great peril if the national instrument, which has disappeared owing to the degree of integration already obtained were not replaced by something else: the use of a Community instrument. Monetary policy must again be possible; but, in an area without frontiers it is only still possible if it is of a Community nature, not just planned in common but decided jointly and technically implemented by means of a Community organisation. The nationals will not be deprived of anything; their independence in this field has already disappeared. They will be given something.

2. The second matter with regard to which the people of the Six are to-day unprovided is an independent balance of payments policy. When you cannot carry through an autonomous monetary policy, when, in its short-terms aspects, autonomous budget any policy is faced with the absence of frontiers within the Community (i.e. its

effects are immediately dispersed throughout the Community area and proportionately it loses its force of national impact), when you can no longer set up customs duties within the Community, when you can no longer control or manipulate prices (owing to the free movement of goods) or wages (owing to the free movement of workers) and when you can no longer put controls on capital movements, then you are disarmed in the face of a deficit in the balance of payments.

There again the disappearance of the national instruments (which is inherent in integration and which you cannot go back on except by going back on integration) requires Community instruments. While waiting for these instruments to become operative, in the meantime every number nation must be able to draw on the Community reserve of currency.

The means of adjustment between member nations are of necessity in a community the same as those which come into play within a national economic area, i.e. free movement of goods, factors and capital which immediately reduce to a common level any autonomous movement in prices or wages. This is the logic of a community. Vis-à-vis countries outside the Community it is the common rate of exchange that can be varied and the outflow of the common currency where there is a deficit.

On the other hand, budgetary and taxation policies have no need to be concerted : the independance of the German länder or the U.S. States with regard to expenditure and income do not prevent the central government from having a definite economic policy. Budgetary and fiscal autonomy forms part of the independent rights which the federated nations in general and the local authorities in our countries have always exercised without ano drawback.

II. The common currency is indispensable for the future of the Community

Without it the Community will die, and that very quickly. But if we go on to what it is positively desirable to have in the future, monetary unity also appears to be indispensable.

It has often been said in recent times that public opinion will only be really favourable towards the Community if it identifies itself in its own view with a Community for a better life (in the qualitative sense), for a less traumatising life and for a plan for a new civilisation corresponding better to genuine human aspirations.

The brave and clear-sighted attitude of Mr. Mansholt has built up for the Community a capital of goodwill. The Community must keep steadfastly to this path. If it does not, it may well identify itself with what will soon be reviled: the forces of conservatism and moral blindness; and this would be a paradox since the first voice which was raised publicly in Europe in favour of a better life was that of the President of the European Commission.

But if the Community wishes to become a new Eden, an oasis of freshness in a polluted world, it must itself adopt a lead the member countries to adopt severe and burdensome measures. This is only possible if the rate of exchange vis-à-vis non-

member countries adapts itself and protects us. These variations in protective rates of exchange presuppose a single rate of exchange with regard to non-member countries, an exchange-rate cordon stretching as far as the frontiers of the Atlantic and the Iron Curtain.

30 November 1972

<u>Conditions for the introduction of the Europa</u>

The note which I was requested to prepare deals by and large only with the practical details of introducing a European currency.

I felt, however, after the first meeting, that the working party was not in full agreement even on the principle of a European currency. For this reason, I thought it necessary first to put forward my arguments, reduced to their essentials, in favour of a European currency before putting forward a possible scheme for the introduction of the Europa.

I. We are not attempting to create a regional currency area for aesthetic reasons or for reasons of prestige. We should create it only if it will be both economically and politically beneficial. From the economic point of view, an autonomous currency unit is necessary only if it can be shown that the currency area over which it extends is optimal. For this purpose one may refer to the analysis of the problem of the optimum currency area, which perhaps constitutes the greatest step forward in international monetary theory in the last ten years.

Since no-one has suggested that the currency areas of the present states should be divided up, the only problem is whether the states of the Nine constitute optimum currency areas or whether the areas should be merged. Do Belgium, the Netherlands, Ireland or Denmark constitute optimum currency areas? - Probably no more so than the United Kingdom, Germany, Italy or France. To demonstrate that a particular state constitutes an optimum currency area would, however, be more difficult in a case where the state's GNP is smaller than in a cas where its GNP is larger. Therefore, if one were to dismiss the idea of a European currency unit one would have to consider the formation of various new groupings, either by way of closer monetary links between the Benelux countries, or in the form of a grouping of the United Kingdom, Denmark and Ireland or of some other combination...... Prospects which hold little political attraction.

Purely from the economic point of view, however, it seems that it can be shown that the boundaries of the states of the Nine (which are an accident of history) do not delimit optimum currency areas.

1) A unit of account common to the Nine makes sense only if changes in parity among the Nine themselves are less likely to occur (or are likely to be smaller in amount) than changes in parity between the Nine and the rest of the world.

Let us take the two extreme cases:

a) Suppose that, during the next twenty years, parities remain precisely or nearly fixed, both among the Nine themselves and between the Nine and the rest of the world. In such a case a unit of account common to the Nine makes no sense. Nor would it make sense to interpose between the currencies of the Nine and external currencies, whose several parities vis-à-vis each other are <u>ex hypothesi</u> substantially unchanged, a

structure which is itself in a fixed relationship both with the nine currencies and with the currencies of third countries. To apply such a reference standard to relationships which are themselves already fixed would serve no purpose. Where reality is called for, a mere ornament is clearly inappropriate.

b) Suppose secondly that, during the next twenty years, the parities of the currencies of the Nine vary considerably, both between themselves and each individually in relation to the currencies of third countries. To introduce a European monetary structure in such a case would likewise make no sense, and one could not even in theory conceive of the Nine adopting such a currency unit. It would not amount even to an abstract ornament, but would form an indefinable structure having no secure foundation and being incapable of definition in relation to anything in a world of currencies that is totally mobile.

A European unit makes sense only if, according to a significant degree of probability, the exchange parities of the currencies of the Nine inter se will vary in relation to each other much less than the whole group of them will vary in relation to the group of the currencies of third countries.

In a world of relative currency relationships (which is one of the few matters which the working party accepts, since no member of the party has suggested a gold standard or a standard based on an actual commodity), the only practical possibility in the international monetary field is that of interparities - the reference to a third yardstick being merely to a convenient intermediary to be used because it is more convenient to quote n rather than $\frac{n(n-1)}{2}$ rates of exchange - and it is only the closer alignment of European currencies as compared with the wider dispersal of third country currencies which, in the constellation of world interparities, justifies and provides a purpose for a European unit (and for means of payment defined by reference to it) (1).

The question to decide is whether the probability, during the next twenty years, is that large-scale changes in the flow of trade and capital will be much slighter between the countries of the Nine inter se than they will be between the Nine and the rest of the world. I will now attempt to show that the answer to this question is in the affirmative.

(1) It is clearly at this point that the tempting suggestion of Professor Meade comes in: a unit of account fixed on the basis of a European price index. Such a suggestion is almost a necessity if one wants a European unit of account which is mobile in relation to external currencies and mobile in relation also to internal currencies. But a unit of account fixed on the basis of a price index, however attractive it may sound, can never evolve into a transactions currency or even into an exchange currency. It seems to me that, in its pure form, it is a unit of account in which certain contracts of sale or loan (issue of bonds) may be denominated. However, one cannot imagine a transactions currency based on such a unit.

At the real root of the international monetary problem lie changes in the pattern of world trade between 1963 and 1971 - vast changes which, for the economist, are much more significant than the increase in the actual volume of the same world trade taken as a whole; the monetary problem is only the reflection of an international economic problem: the problem of differences in growth rates and in rates of competitiveness, not only between national economies but also between different sectors within the various national economies.

Table A (in the Annex) sums up, by major sectors, the imports and exports of the three major groups of developed countries in the world for the period 1963 to 1971, by major sectors.

Table B shows changes in the trade of each of the Six between the same dates and for the same sectors.

Table A - taken from "The Economist" which prepared it on the basis of a recent OECD publication - is simple to interpret. Two fundamental movements have affected world trade over the last seven years:

- Japan, on the one hand, and the Nine, on the other, have experienced a steady worsening of their deficits in energy and raw materials. The United States have benefited slightly from this situation, and producers in the third world, and particularly the oil producing countries, have benefited very greatly.
- The United States have experienced a dramatic deterioration in their balance of trade in industrial consumer goods.

The positive counterpart is to be found partly in Europe and in Japan - but only partly. As regards textiles, transistors and manufactured goods other than motor cars, the developing world floods in a relentless drive the markets of the developed countries with its simple and very cheap industrial goods. Unfortunately, countries in the process of industrialisation do not appear in this Table, and, for lack of data, no diagram can be made out for them.

Let us now consider the Six in Table B, There, some noteworthy but little known facts emerge:

- the main branches of the profiles for overall trade (intra-EEC and extra-EEC) are all generally oriented in the same direction. However, the lengths of the bars are unequal. This is particularly evident in the fourth line, under "machinery and transport materials": the GFR, Italy and France had surplus balances during the eight years 1963 to 1971, while Belgium and the Netherlands during that period had slightly negative balances. Germany especially had a much more substantial surplus than her partners. To a lesser extent, the same is true of chemical products.
- If a distinction is made between intra-EEC and extra-EEC trade, the results become very interesting: intra-EEC trade profiles are very similar; trends are not always the same, but for 1963-1971 the surpluses or deficits are very small.

As a result, over the past eight years the development of internal trade between the six integrated countries has been balanced and symmetrical.

The third diagram shows that it is the external trade of the EEC which is responsible not only for the overall surplus but also for the large German surpluses (and, to a lesser extent, for those of Italy), under the headings for heavy industry. At the other end of the scale, no country has a very large deficit in its trade with the outside world.

It was not possible to include Great Britain in this study because no figures were available for the breakdown of British trade by country or of trade by major sectors. By way of a guideline, a table is given of the overall trade of the United Kingdom (outline by major sectors of the 1963-1971 balances). It will be seen that this profile of the overall trade is extraordinarily close to that of France.

2) Such findings are important. They lead to conclusions along these lines: in 1969 it was perhaps necessary for France to devalue in relation to third countries, and, in 1969 and again in 1971, it was perhaps necessary for Germany to revalue in relation to third countries, but it does not seem that it was necessary for either of them to devalue or revalue in relation to their partners. It could furthermore be said that such adjustment was not necessary, and probably had, from the Community point of view, a destabilising effect. One could say that this is a theoretical conclusion since it is impossible to revalue in relation to one group of countries but not in relation to others, or to revalue in relation to third countries without revaluing in relation to one's partners. This is true, of course, but, for occasions where it appears inadvisable to alter the rates of exchange in relation to the Community, one can imagine other forms of adjustment than changes in exchange rates, such as, for example, an organised foreign investment policy directed towards those countries with which one has a trade surplus. To consider another possibility, the Community, which is responsible for commercial policies towards third countries, might adopt discriminatory customs measures. It is not certain that we can ensure optimum growth on a world scale during the next twenty years while adhering to the principle that customs measures must not discriminate between countries (see below). The proposition that for the sake of world stability one may need measures which derogate from the principle of equality of treatment has, to my mind, been convincingly upheld by certain English authors, and by A.C.L. Day in particular.

3) The Six do not have any major problems regarding trade between themselves. Does this mean, therefore, that they should be combined to form a single currency area (subject to the accession of the three new members)? The trade patterns of the individual countries do not differ. This may be so: very well, but one might object that one cannot draw from that any conclusions with regard to a currency area.

The reply one would like to give would be to attempt to prove the thesis that where an area is an optimum currency area, any internal variation in the rates of exchange - and _a fortiori_ any degree of flexibility - is a step away from the optimum.

Of course, it is difficult within the scope of this note to give precise proof of this opinion in the form of a theorem.

One should in essence argue the thesis as follows: an adjustment in exchange rates is meant to correct a tendency in a balance of payments towards a surplus or a deficit, resulting from either a difference in competitiveness or a difference in growth rates. Ex hypothesi, differences in competitiveness may be almost disregarded in an optimal area. One should, however, add that variations in exchange rates operate on trade surpluses and deficits, i.e. on effects rather than on causes. Thus as a rule, since the causes remain unchanged, any differences in competitiveness will begin to re-emerge.

As to differencies in growth rates, there are good reasons for doubting whether variations in exchange rates will reduce them. If there is an expansionist drive in country "A" it brings about a deficit trend. Hence a depreciation in the currency of country "A", which will have two effects:

- the effect of adjustment (more or less hypothetical according to Robinson's theorem, but which we shall suppose to be positive);
- the effect of encouraging further expansion in country "A". Devaluation whips up expansionist forces to meet not only the increased export demand but also the increased internal demand in a protected market. Hence further acceleration in the growth rate and further depreciation in "A's" currency, etc.

The case of France, which, over the past four years has experienced more rapid expansion than her partners, but with a higher rate of increase in prices due to her failure to make a slight exchange rate adjustment, in our view confirm these arguments.

This destabilising effect would be even more marked if there were flexible exchange rates.

To sum up, a system of fixed exchange rates within a customs union levels out variations in growth rates. The advocates of fixed exchange rates believe that the effect of integration is a surer means of reducing occasional departures from equilibrium than is the effect of the adjustment of exchange rates, since the adjustment may cause imbalances to accumulate.

4) Table A shows the extent of the changes in the pattern between the three or four economic groups of the western world over the past ten years. It is extremely probable that such divergent trends will continue, and may even accelerate, during the next twenty years. We should like to indicate the conclusions which may be drawn from this as regards the system of exchange rates.

It is clear that adjustments to exchange rates alone cannot solve the problem of the changes in the trade pattern illustrated in Table A. The United States, for example, invaded by products manufactured in Europe, Japan and countries in the process of industrialisation, should eventually devalue in relation to the three other groups.

Europe on the other hand, with its increasing lack of energy and raw materials which it imports from countries in the process of industrialisation, is facing a growing threat from exports of simple manufactured products from those countries, as it does from exports from Japan, and should either slightly depreciate its currencies in relation to those countries or keep them stable.

Lastly, Japan should revalue in relation to the United States but maintain its currency stable in relation to the currencies of the countries in the process of industrialisation, which it supplies with raw materials and energy.

It is evident that the necessary changes in parity are mutually incompatible: For example, the United States should devalue in relation to Europe and to countries in the process of industrialisation but Europe must also devalue in relation to the countries in the process of industrialisation, while at the same time revaluing in relation to the United States, etc.

Two conclusions can be drawn from this:

- First, the necessity of having occasional major confrontations between the major economic areas, ending in package deals containing both changes in parity and customs changes together with even further measures, where necessary, (but these measures would still be **on a zonal basis.** The Smithsonian Agreement of 18 December 1971 is of great historical importance in this respect. It is the first example of a world crisis which nations have attempted to solve on an overall scale by exchange measures and by customs measures (aboliton of **the American** surcharge). In my opinion, however, they did not sufficiently involve in the Agreement the fourth group, i.e. the countries in the process of industrialisation, and it is well known that the countries producing oil and raw materials - which all devalued at the same time as the United States in relation to Europe and Japan - have up to now profited more than the United States from the adjustment of exchange rates. We will need many more agreements of the Smithsonian type in the decades to come. They will have to become quasi-systematic and be prepared with even more care.
- The preceding statement appears to me to be a powerful argument against flexibility of exchange rates between the major groups of nations. Indeed, when the changes in parity, called for by the developments in trade balances, are contradictory, how can the market find the optimum solution? There is the danger that matters will be solved under the threat of a crisis situation, on which the operators count, or haphazardly as a consequence of the operators' psychological impulses etc. The situation which I have just described presupposes adjustable exchange rates, with periodic adjustments linked to customs measures and to a voluntary organisation of capital movements; it is not compatible with a system of flexible exchange rates.

5) We have already explained briefly in a previous note (of 30 November 1972) that it is in their own pressing interest for the Nine, purely from the point of view of integration, to build up a common monetary structure.

This is not to say that the other aspect should be under-estimated, i.e. that of the *common interest* of the Nine in the international monetary discussions. In particular, the vital importance of the Nine adopting a common position within the Twenty.

A solution of the international monetary problem, on the scale of the western world, within the framework of the IMF - such as that being studied at present by the Twenty - can be politically realised only if one adopts to some extent the American suggestions regarding periodic adjustments of exchange rates, linked *more or less* automatically to criteria still to be defined. Much could be said about such a solution. However, it is clear that either:

- it will be adopted, which will then really require a currency Community in Europe: the criteria of automaticity must apply to the area of the Nine and not **to that of each** nation; or
- it will fail, which will make the need for a European monetary identity more evident than ever. The present de facto system is so fragile that it is in the interest of the Nine to combine in monetary matters in order to meet any future crises with less difficulty. If they can do this (given that they constitute an *optimum* monetary area), they should.

II. Possible scheme for the progressive introduction of the Europa

A European Monetary Fund will exist in embryo form from 1 April. The Fund will keep its accounts in Europas, but in so doing will not be acting differently from the way in which the Community acts in other financial matters. One rightly hopes that, in general, emphasis will shift from the Fund to a European monetary structure. Let us examine under what conditions this would be possible:

1. The Community should first have at its disposal a currency which I shall call **an exchange**-currency, i.e. a currency used by the Fund, the central banks, the commercial banks, and large undertakings on the exchange markets. This currency would be linked to something which the Nine have already decided upon, namely, the **grouping** of their parities inside the wider margin provided for in the Smithsonian Agreement. We know the technical solution which was adopted:

a) Each central bank would continue to be responsible for maintaining its parity within the margin of ± 2.25 either side of the central parity defined in relation to the dollar, using for this purpose dollars purchased or sold.

b) Each central bank would, in the second place, ensure that the parity of its currency in relation to other European currencies would be maintained within the margin adopted. For this purpose it would intervene in European currencies (procured by a swap of mutual credit if necessary) on the 26 (sic) bilateral markets concerned [$\frac{n(n-1)}{2}$, i.e. $\frac{8(8-1)}{2}$ = 26 (sic). NB There are only 8 currencies within the Nine; Luxembourg does not have its own currency].

It is this system which is heavy and cumbersome and, to our mind, very fragile (a fair-weather tool which would not stand up to strong winds) which should be modified.

2. There would be two principles:

a) Each European currency would define a central parity in relation to the Europa (defined as 0.888 g or $ 1.08). The central banks of each country would be required, each on its own responsibility, to defend that parity within whatever margin is determined. The defence would be conducted with the aid of the exchange currency defined above, i.e. of funds held in Europas.

b) Maintenance of the parity of the Europa, as declared to the IMF (1), in relation to the currencies of third countries would, on the other hand, be the responsibility of EMF alone, under the technical supervision of the Monetary Committee (or of a Committee of Governors) and under the political supervision of the Council of Ministers of the Nine.

3. This separation of exchange functions within the Community is the essence of the proposed European monetary reform: on the one hand, the defence by means of Europeas, of the parity of each national currency in relation to the Europa would be the responsibility of the national central banks; on the other hand, the task of defending the parity of the Europa in relation to the dollar and the currencies of other third countries would be delegated to the EMF.

Let us be clear that, within the system advocated as at present, each national currency would remain free, within the limits of the Treaty, to modify its central parity in relation to the Europa. The proposed reform is technical and not political: it does not consist in fusing the nine parities.

This system would put an and to the "snake in the tunnel" which was in reality invented for lack of a European currency.

In this way the Nine would defend their inter-parities and would keep them within a margin which is narrower than the IMF margin, by means of a European Unit of Account and a European exchange currency. They would thus also avoid the anomaly of using dollars to defend the European inter-parities in relation to the dollar. They would also avoid the complicated and weighty machinery of the snake in the tunnel, with its interventions on 28 different exchange markets, which would be likely to break to pieces at the slightest crisis.

4. In order that the central banks may have Europas at their disposal, provision should be made for an issuing procedure: any central bank would be able to deposit with the EMF a certain sum in dollars or convertible currency of a third country and be credited in exchange with Europas. It is not necessary to make provision for a

(1) The IMF would have to recognise the Community as a Currency Unit in the same way as the GATT has recognised it as a Customs Community.

compulsory amount to be deposited. Each central bank would thus have paper assets in Europas with which it could intervene on the Europa exchange market in order to defend the parity of its own currency against the Europa, for which it alone is responsible.

5. The market at the higher stage, Europa against the currencies of third countries, would be controlled by the EMF. The Community central banks would be able to act in it as operating agencies but control would lie with the EMF alone. The question remains open whether or not this Europa market against the currencies of third countries should be flexible or adjustable. I have stated my views above. It will be necessary during the next twenty years to make periodical exchange adjustments linked to adjustments of a trade nature. This supports the view that there should be adjustable exchange rates in relation to the outside world but not flexible ones.

6. Is such an introductory scheme realistic? In other words, is it conceivable to have national currencies existing alongside a European transactions currency? Could the scheme last?

Behind the unshakeable opposition of many to the creation of a European currency there is evidently the conviction that such a coexistence could not last. Their thinking runs somewhat along these lines: either the national currencies will continue to be living currencies, used to settle 90 % of the trade within their national territory, in which case there is no obvious purpose in having a European currency; or, which is something to be feared, the European currency will become the living currency and will gradually or brutally oust the national currencies. This fear is all the more understandable since the secret hope of many supporters of a European currency is precisely for such a fading out and such a victory for the Europa.

It is not difficult to understand fears of an excessively complete and swift victory of the European currency whereby it could be introduced into the national monetary channels and oust national currencies. There is a real danger of this happening. By wishing to progress too fast we run the risk of failure. It is not enough, in order to dispel such fears, to cite the case of the Eurodollar which is a currency circulating in Europe side by side with national currencies but which, up to now, has not harmed the exchange functions of national currencies (even though it may have harmed the effectiveness of national monetary policies). In fact, the Eurodollar is not a transaction currency in Europe: no-one holds a cheque book enabling him to mobilise deposits in Eurodollars (which are moreover always term deposits). The Eurobanks (the part of the balance sheet of our banks which is drawn up in dollars) are, from the point of view of monetary theory, comparable to savings banks rather than to ordinary banks. Thus the reasons given in support of a reform of the Eurodollar, designed to reassure people who fear an excessively swift victory for the Europa, are unconvincing.

7. Nevertheless, the example of the Eurodollar is quite striking. In Europe the dollar is the currency which must be used in interventions on the exchange market, and is held for this purpose by banks, undertakings and even individuals with a large income from abroad. It has therefore become the basis for an enormous market for term deposits and bank credits: in this form it has united the European currency market: lastly, it is the unit used on a large bond market.

These are precisely the roles which we wish the Europa to play. Firstly as an exchange currency on the internal Community exchange market and on the external exchange market, i.e. dealings in dollars; secondly, as the commodity traded on the European currency market; and thirdly, as the money of issue and quotation on the European money markets. It is quite possible and even desirable to prohibit it from performing any other function: in particular to prohibit the settlement in Europa of national transactions.

But the advantage of substituting the Europa for the Eurodollar would be considerable. If it was controlled by the EMF, the supply of Europas would not be such a disturbing element as that constituted by the unregulated supply of Eurodollars. The rate on the market would be standard like that of the Eurodollar but it would be in the hands of the EMF and hence of the Monetary Committee. The supply of money in Europe could at last be regulated at a European level, now that it can no longer be regulated at a national level. We should finally be on the road to having a European capital market made easier by the existence of a single money of account.

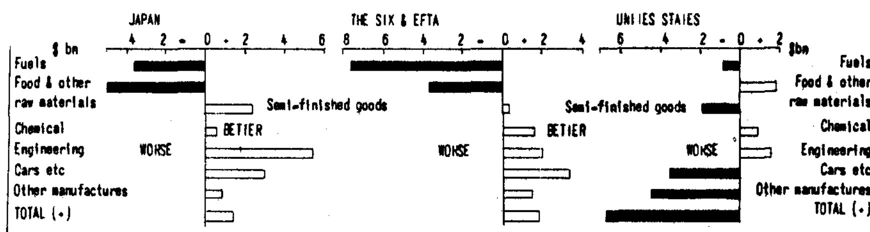
16 January 1973

TABLEAU A

EUROPE - JAPON ET ETATS-UNIS

(chiffres Cif-Cif pour Europe et Japon, chiffres Fob-Fob pour Etats-Unis)

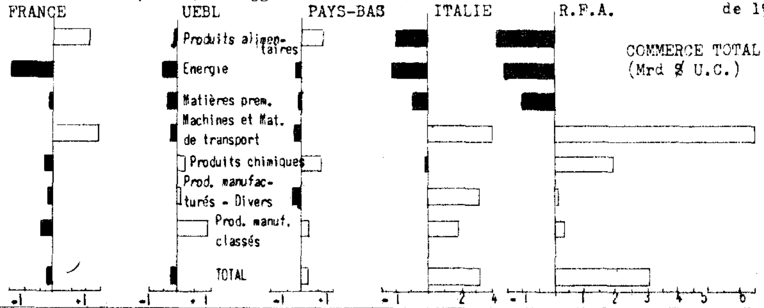
Amélioration (blanc) ou aggravation (noir) des soldes par grands types de produits de 1963 à 1971

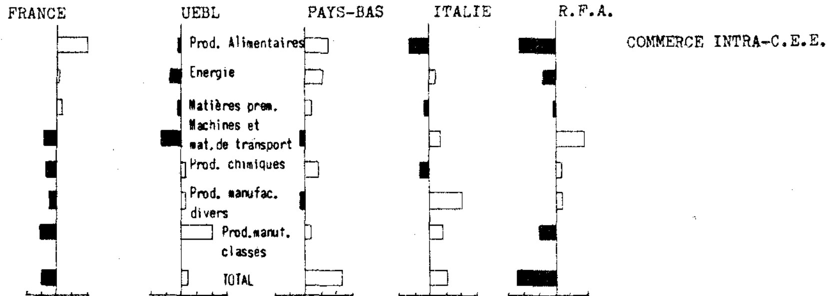


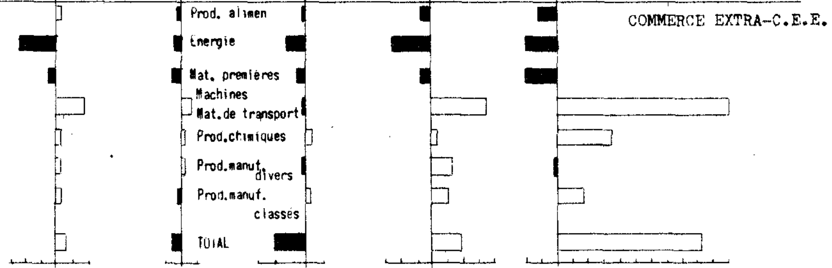
Source : Economist

POUR LES CINQ PAYS DE LA COMMUNAUTE — TABLEAU B

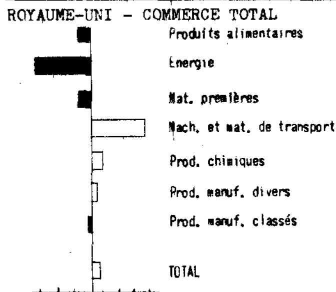
Amélioration (blanc) ou aggravation (noir) des soldes des grands types de produits de 1963 à 1971





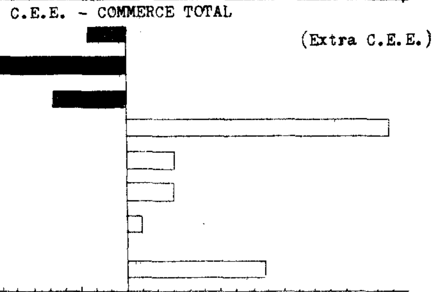


ROYAUME-UNI - COMMERCE TOTAL



C.E.E. - COMMERCE TOTAL

(Extra C.E.E.)



C

Documents written by Professeur D.G.M. DOSSER

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Economic and Monetary Union Compared

The composite term, "economic and monetary union", comprehends issues of European integration of very different clarity, usefulness and feasibility. The difficulties mostly arise in the "economic union" arm of the concept. The aims and methods for "monetary union" are comparatively well agreed; all that is well-agreed regarding "economic union" is that fiscal, budgetary, and prices and incomes policies are required to supplement "monetary union" as follow-ups if one is a monetarist or precursors if one is an economist. What these elements of economic union imply for European policy largely lack definition at present.

The aims of monetary union are well-recognised: a unicurrency area (all the rest - common central bank, no exchange rates between members or balances of payments, etc. - follow), and the method is now mostly agreed in principle by pro-market economists. This is as set down in the Federal Trust paper of Magnifico-Williamson. Very briefly, this envisages the creation of a European currency controlled by a European central bank. This Eurocurrency is to be near-floating against extra-Community currencies. Existing Member State currencies, continue to exist near-locked with each other, in the intermediate phase. In the final phase of monetary union, of course, only the Eurocurrency exists.

Matters are very different in the case of "economic union". The characteristics of an "economic union" are so profound and widespread that it would be quite meaningless to state them as aims to be achieved by the Community in a second, third, fourth... stage of "economic and monetary union". Briefly, in its private sector aspect , economic union requires the integration of capital and labour markets (involving not just the permissibility but the actuality of factor flows throughout the Community in response to economic incentives). And, in its public sector aspect, it implies economic policy integration both through the budget (requiring the dominance of the European budget) and through joint processes (e.g. European planning, prices and income norms); it also implies common commercial law facing businesses and perhaps labour unions, and common tax schedules (even personal income tax) and social security systems.

It is therefore hardly possible to define "intermediate" and "final" stages of economic union analogous to monetary union. Certainly, a final phase, of completion, may never be an aim, if only a federation is ever acceptable to Member States.

Which items from this rich menu might be stated as aims of "economic union" in the second phase of economic and monetary union is very debatable. What seems clear is that only a very small selection is feasible.

What criteria should govern this selection? Obviously the question of political practicability is paramount. But within that constraint, two principles stand out:

i) Choose policies with the maximum yield in acceptability or popularity among people in the Member States. This is particularly consistent with the 1972 Summit declaration;

ii) Follow policies which act as a counter-weight, for social and political purposes, to the impending massive European integration and re-structuring of business and industry.

Sometimes, these two principles converge, for example, in matters to do with employment and regions; sometimes, they do not, for example, in the regulation of takeovers and monopoly

practices.

In general in this paper, we shall be looking for policies which converge both principles.

Enough has been said to emphasise the big difference between "monetary union" and "economic union" as a contrast between a compact or defined programme as the first is, and the diffuse, open-ended, nature of economic union.

However, the contrast is partly a trick. The aim of monetary union as a single currency area is <u>still</u> a <u>proximate</u> aim so far as economics is concerned, since it only holds economic merit if it enhances the ultimate economic gains expected from the Common Market, involving real income growth rates (suitably qualified by environmental factors), employment, and price stability.

Both monetary union and economic union in fact have the same ultimate aims; it is only that monetary union has a handy catch-phrase, "common currency", to hang on.

Actually, a similar proximate, unifying, measure of progress is available for economic union. This is the size of the Eurobudget in relation to the sum of Member-State budgets. This corresponds to the European/national currency measure, but of course highlights once again the undefined or open-ended nature of union, since some will argue that 10% or 20% budgetary transfer represents, the "end" of the process.

The constituents of economic union act in a much more direct way on the ultimate aims than monetary union. They are thus likely to be judged more directly and more harshly than currency union. They are more acutely observable by electorates and the balance of cost (the "loss" of fiscal and budgetary and economic management sovereignty) and advantages (arguable gains to employment, etc.) harshly and unfairly drawn.

Monetary union has a simple target, and a reasonable means of approaching it. The target itself is rather "neutral" and academic as far as political electorates are concerned. The relation between the target and the ultimate economic aims is not much questioned.

All this is the converse for economic union. We have a variety of constituents leading straight to a variety of ultimate aims. The advantage of operating these on a European scale has to be much more explicitly stated, and is likely to be much more harshly examined by electorates in Member States.

As regards the balance between economic and monetary union, and the controversy that has sometimes surrounded their relative priority, the present writer finds himself in the position of believing that pressing forward with as many elements of economic union as possible is most important <u>economically</u>, but progress on monetary union is more feasible <u>politically</u>.

Since monetary union is simpler and more advanced in aim and method, and proposals for growth points exist, this paper will concentrate almost entirely on the less clear area of economic union.

Economic Union : Budgetary versus

Extra-Budgetary Growth Points

Most of the particular policies usually included as growth points under economic union can initially be classified as requiring budgetary resources or not requiring these (over and above administration).

i) Budgetary growth points : expansion of the Social Fund, creation of an Industrial Policy and a Regional Fund;

ii) non-budgetary growth points :

joint medium-term planning, capital market integration, monopoly regulation, open public procurement policy, etc.

It is obvious that the second category is rather open-ended. And several more items could be included here, but one problem is the degree to which consultations, without binding force on Member-States, should be construed as growth points in economic union. Where budgetary growth points are concerned, they are necessarily linked with resource use and no such blurring occurs. The list under the head of extra-budgetary can be severely pruned if Community instruments are considered necessary to define a worthwhile growth point, or can become indefinitely large if consultative telephone calls are allowed to count. Whilst the latter are no doubt important, it is perhaps better to take the stricter view.

Indeed, the present writer would prefer to count progress mostly in terms of budgetary growth points. However, the road is obviously hardest here, this becomes painfully clear when we look later at the financing of budgetary growth points.

It is perhaps best to remember the distinction, have a preference for budgetary growth points as having more bite and more effective impact on Community integration, but not to push the distinction and the preference too hard.

Rather, it will be best to select a policy on the criteria mentioned, for example, regional policy, and push it forward as a budgetary growth point as far as resources allow, but as an extra-budgetary one beyond that, i.e. using non-financial instruments, consultation and co-ordination of national regional policies, etc.

Budgetary Growth Points : Financing versus

Expenditure aspects

It is much debated as to whether the growth of public sector expenditure is tax-led or demand-led. The traditional view is the latter (demand for public goods). But it is clear that in some periods, the tax-led thesis carries much weight, e.g. the new level of expenditure set after the revolution of tax systems by wars, and the more-than-proportionate to national income growth of national budgets in most OECD countries in the last few years which may be due to the "fiscal leverage" of the tax systems in inflationary times.

It is arguable that the tax-led idea is very important for the European budget at the present time : the institution of "resources propres" with propitious long-run implications for Community revenues. Against this can be argued the fact that no political settlement

on resources propres could be obtained unless most members agreed the need for new and expanding expenditure projects. Perhaps it is best to give each side equal weight at present, though simply arising from the present writer's main interests, the financing side is discussed more fully in this short paper.

Financing Budgetary Growth Points

If a substantial expansion of Community expenditure policies is to be achieved during the second phase of economic and monetary union, it appears that new sources of finance for the European budget must be found along one of three lines :

i) Increase in the Community V.A.T. above 1 per cent.

ii) Use of the corporation tax

iii) Re-introduction of direct contributions.

The preference between these methods depends on a complex of factors. It must be politically sensitive (especially, do least harm to the Community image among tax-paying electorates), equitable between the member -states (being proportional or slightly regressive per national income per head), revenue-raising for a Eurobudget of some substance, and economically sensible in allowing national/regional demand management in the absence of monetary instruments which will disappear with monetary union.

The writer has expressed a preference for (iii), the use of the corporation tax, and the reason has been developed in detail elsewhere. Within the balance of this short paper, only a brief summary of the comparison is stated.

The proposed system, which basically puts the corporation tax in front of the V.A.T. as the Community tax in the medium term, has the following merits :

i) The Community tax system, consisting as it would do of the corporation tax and 1 per cent of the V.A.T. goes some way toward fiscal unification, provides sufficient revenues for the Eurobudget in the medium term, and is expandable (by increasing the V.A.T. %) in the long-term, if further Eurobudget growth is then acceptable.

ii) The member-state tax systems, consisting of the member-state V.A.T. as well as the non-harmonisable taxes, provide ample scope for fiscal flexibility , i.e. the fiscal management of nations/regions in the Community, and also leaves plenty of resources in member-state budgets for their own autonomous policies.

iii) Politically, that tax is transferred to Brussels which least obviously impinges on shop prices, and where some of the tax-paying sector would welcome the economics of a single tax payment on an international (Community) operation.

iv) The corporation tax is probably a slightly progressive Community tax, state-by-state, compared with the neutrality or proportionality of the V.A.T.

It will be seen that the proposal combines economic, political and social merit. Its main drawbacks are (a) the varying degree of incorporation of business in member-states and (b) a possible secular relative stagnancy in the base, profits, compared with the base of VAT, consumers expenditure.

The alternative financing systems can be brought into relation, at least in their revenue-yielding aspects, and in that way, in relation to the expenditure policies they would allow, by constructing a series of hypothetical Eurobudgets. The figures are, of course, approximate in the extreme, but are sufficient to throw up some illuminating facts. All the figures are derived from 1970 national accounts and are all based on 1970 prices. Later figures, e.g. for 1980, thus reflect real rates of growth of national income and other aggregates, but not inflation.

<u>Eurobudget 1, 1980</u>
(present expenditure structures)

Total revenue	Ł 1800	C.A.P. expenditure	Ł 1600
		Other expenditure	Ł 200

In the case of Budget I. the full financing system is in force, including, that is, up to 1 per cent V.A.T. as required to meet, essentially, the costs of the C.A.P. This budget is determined by the expected growth of the C.A.P.; in fact it involves the U.K. in paying over between a 0,4 per cent and a 0,5 per cent V.A.T. Budget I is not very realistic or interesting, except as a basis for the expanded Budgets.

<u>Eurobudget II, 1980</u>
(full use of 1% V.A.T.)

Total revenue	Ł 2200	C.A.P. expenditure	Ł 1600
		Other expenditure	600

An important fact now clearly emerges: there is no worthwhile scope left for important new policies with presently agreed revenue provisions.

To make room for one or more of these policies, revenue sources must be expanded either by the V.A.T. method (Commission method) or the corporation tax method (as proposed in this paper). This is done in the following budgets III and IV.

<u>Eurobudget III, 1980</u>
(increment of 1% V.A.T.
added to Budget II)
i.e. total of 2% V.A.T.

Total revenue	Ł 3350	C.A.P. expenditure	Ł 1600
		Other expenditure	Ł 1750

<u>Eurobudget IV, 1980</u>
(corporation tax proceeds
added to Budget II)

Total revenue	Ł 7000	C.A.P. expenditure	Ł 1600
		Other expenditure	Ł 5400

The first important lesson from Budgets II, III and IV lies in the fact that considerably more scope arises if the corporation tax becomes the Community Tax System. To achieve the same effect using the V.A.T. requires an additional 3 1/4 per cent over the 1 per cent maximum already agreed and written into Budget II.

In the case of the U.K. this would involve an increase in the standard rate, assumed to be 10 per cent, of 5 1/4 per cent, which would be the Commission's tax on the British public. Note that this would be fully reflected in shop prices so that, once again, the public would face a substantial price increase acting as a serious check on enthusiasm for the

new expenditure policies provided for.

This does depend on the base of the VAT and the base of the corporation tax growing in line, in both real and monetary terms, to 1980.

Expenditure Priorities in our Expanded Eurobudget

We have three small-scale policies capable of great expansion.

The original scope of the Social Fund has already been extended, in 1970, so that financial intervention for retraining and resettlement of workpeople is possible when unemployment has been caused either directly or indirectly by Community policies. Thus the only limitation to much more extensive use of the Fund lies in resources made available to it (at present, about 40 mn.u.a.), plus perhaps a clearer definition of qualifying purposes. Over and above it present scope, the idea has been mooted of an eventual extension to a Community system of social security in its unemployment context.

The general aspirations of Industrial Policy are well-known, consisting of the promotion of greater size for the firm, transfrontierism and advanced technology. The only existing Community instrument, the loan-making European Investment Bank, should, it has been declared, be supplemented by: Community Development Contracts, a European Research and Development Agency, a Community public procurement policy. The first two additions would create a charge on the Eurobudget.

Small and piecemeal provision is available for Regional Policy at present (the European Investment Bank and small parts of ECSC and, prospectively, CAP funds). The hottest favourite as a growth point in economic union is thus the least-advanced as to definition of principles of disbursement and power to disburse.

An important lesson to be drawn from the sketched Budgets II, III and IV is that even if either the corporation tax becomes the Community tax or the Community receives the proceeds of a 5 1/4 per cent V.A.T., the revenues provided are not all that vast, when it is considered there will be fully nine claimants compared with the restricted beneficiaries of the CAP.

This prompts the point that, even if the advanced position of Budget IV were reached (whichever tax is used), a serious question of priorities between the three new heads discussed is required. Insofar as expenditure falls short of Budget IV, the ordering is all the more important.

This is, however, perhaps not quite as serious a problem when it is noted that there is considerable overlap between the three heads, e.g. they all have an employment aspect and they all have a regional aspect.

Whether it is wise to press on with three embryonic new policies, or amalgamate them into a Common Industrial Policy integrated in principles of application and administration, or pursue the creation of new Funds (and administering departments) alongside the Social Fund, is an open question.

The question which would be the next to pursue, but which it is perhaps premature to do, is what can be done in detail with a Social-Industrial-Regional Fund of the magnitude of "Other expenditure" in Budget IV. There are numerous ways of merely looking at its

magnitude before attempting any analysis of its efficacy, e.g. in relation to total unemployment in the Community (implied unemployment benefit per head), as a proportion of national product of a list of backward regions, or of the rate of growth of these or the whole Community, or again, its comparison to existing member-state assistance to industries/regions, etc. etc.

Basic Issues of Economic Union: a Re-Statement

Some basic issues in economic union have been raised by the short discussion in this paper, but a number of others are implicit rather than explicit. Without going into detail, both the implicit and explicit are re-stated in this concluding section on economic union.

1. Budgetary vs Extra-Budgetary Growth Points

This has been dealt with in a little detail. One might feel that the budgetary ones are the real stuff of European economic advance, but they involve the most political obstables because of the resource cost involved.

2. V.A.T. vs Corporation Tax

On the financing side of budgetary growth, which is the preferable method?

3. Constituent Policies vs an Integrated Social/Regional Fund

Should resources be spread thinly between the Social Fund, Industrial Policy and Regional Fund, or a set of common principles of disbursement applied to a single fund?

4. Community Policy added to, or in lieu of, National Policies

It was obscure in our calculation of budgets whether new Community taxation would add to, or replace, national taxation. In general, there must be an expectation that it would largely add; otherwise, to take an example, a Community regional policy simply replacing a national tax-and-expenditure regional policy would have little meaning. Thus, using the VAT would add to the national rate, using the corporation tax implies its replacement by extra revenues perhaps from other parts of the direct tax system.

5. Welfare vs Efficiency Policies

This distinction should not be pushed too hard, since many policies partake of both aspects. But it does relate to the criteria used in progress toward economic union: should popular support be sought by welfare-oriented expenditures, or industry both aided and regulated by carefully-chosen subsidies?

6. Short-run vs Long-run Policies

There is a tendency to pick on the dominating issue of the time and consider it the initial growth point for economic union - it would have been real growth rates a few years ago, now it is inflation control, later it may be environmental aspects of production and growth. Perhaps it is essential for political reasons for the Community to respond to these imperatives. On the other hand, the establishment of deep, or long-run, common policies (and possibly budgetary ones have more of this character) should not be lost sight of.

<u>A Return to the Interrelation of Economic and Monetary Union</u>

We have dealt with some aspects of economic union in this paper separately from monetary union, since it seems to be the half of the equation which is more obscure, diverse, and politically difficult. But the inter-relationship between the two must not be too much ignored.

The inter-relationships with some of the issues of economic union discussed in this paper should be stressed.

Monetary union is a constraining influence on several issues discussed, although a possibly liberating factor on one key issue.

With the disappearance of most monetary instruments for national/regional demand management (exchange rate policy, and national money supply and rate of interest policy) reliance has to be placed on fiscal and budgetary instruments. Thus the need for <u>fiscal flexibility</u>, particularly as regards rates, in certain major taxes, and short-run stabilisation policy on the expenditure side of the budget as well.

Since the V.A.T. is a much more powerful device for this purpose than corporation tax, it emphases the case for the retention of fiscal flexibility for the former (different and changeable national/regional rates), whilst the latter becomes the harmonised Community tax (uniform structure and rate). And on the expenditure side, facilities must be available for short-run assistance to depressed regions (Keynsian "public works" type of expenditure) as well as for long-run structural re-development.

Of course, the extent to which taxes and the budget have to be used in these ways depends in the degree of convergence of inflation rates in different member-states. Insofar as they converge, stabilisation is a matter for the whole European economy, and the Community exchange rate can be used. However, deep economic union in the private sector seems as far off as in the public sector, during the second phase of economic and monetary union.

Turning to the aspect in which monetary union is a liberating influence on economic union, we have hitherto assumed that budget expenditures are entirely tax-financed. But budget deficits might be feasable, financed by European central bank issues. These European "gilt-edged" might command support without backing, as a Member-State debt does, or need pledges by Member-States in the second phase. Either line of advance is interesting; even the second avoids the tax obstacle to budgetary expansion whilst not directly bringing back direct Member-State contributions to the Community.

Finally, the progress of economic union and monetary union could help each other if as many as possible of the financial aspects of economic union that we have discussed are transacted in the new European currency (called Europas for convenience). The Eurobudget is cast in Europas, corporations (or Member-State V.A.T. subvention) are paid in them, European "gilt-edged" issues are raised in them, and the benefits to regions or unemployed people are paid in Europas. Thus the European operation is clearly distinguished from national ones, and hopefully it is a constructive and appreciated one.

20 November 1972

The Community Budget and the Member-States Budgets

Introduction

There are many important political and administrative issues concerning the European budget with which this note does not deal. Chief among these is the inter-relationship between the Parliament, Council of Ministers, and Commision in the preparation, approval and control of the Community budget. *

Rather, this note discusses in a preliminary way three economic issues of principle concerning the Community budget: rôle, size and realisation. The first two are closely inter-related, the developing rôle or function of the Community budget during the second stage of economic and monetary union, and the size of budget that this implies. The third issue involves the process of reaching such a goal in 1980.

In discussing the rôle and size at the present time, when the Eurobudget is in its infancy, consideration should be given to some fundamental principles of the Community in relation to the Member-States.

Just as criticisms have been made over the pursuit of "harmonisation" as a dogma, so the transfer of budgetary powers to a European central authority should not be pursued where a balance of advantage is not evident.

Of course, enormous scope exists even within this constraint, since the benefits of _scale_ have been a prime argument in favour of European integration, and this must apply to many governmental budgetary functions.

On the other hand, the benefits of _scale_ often involve a loss in democratic contact or of a feeling of participation on the part of electorates. It is important therefore to be aware that the realisation of the lofty idealisation about the Community often heard - the newest and most modern form of participatory democracy - may require _development_ as well as _centralisation_ of budgetary functions. After all, the vision of some of the founding fathers of the movement of European integration was of a Community of partially - self-governing Provinces each of 10 million people or so.

How lop-sided is the division of budgetary powers between the three levels of government at the present time can be gauged from the figures below :

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* On such questions, see D. Coombes, _The Power of the Purse in the European Communities_, Chatham House/P.E.P., November 1972

Table 1

		% corresponding G.N.P.
Community budget of the Nine (1973)		0,50%
Denmark budget	: excluding social security	36.0 %
	: including " " "	39.7 %
U.K. budget	: excluding " " "	31.6 %
	: including " " "	36.6 %
Ireland budget	: excluding " " "	27.4 %
	: including " " "	29.8 %
Netherlands budget	: excluding " " "	25.5 %
	: including " " "	39.8 %
Belgium budget	: excluding " " "	24.0 %
	: including " " "	33.8 %
Germany budget	: excluding " " "	23.2 %
	: including " " "	34.0 %
Luxembourg budget	: excluding " " "	22.9 %
	: including " " "	32.4 %
France budget	: excluding " " "	21.8 %
	: including " " "	36.4 %
Italy budget	: excluding " " "	19.2 %
	: including " " "	30.2 %

Denmark	: central government to general government	(1969)	70.4
U.K.	: " " " " "	(1970)	73.3
Ireland	: " " " " "	(1968)	90.2
Netherlands	: " " " " "	(1970)	58.7
Belgium	: " " " " "	(1970)	63.6
Germany	: " " " " "	(1970)	34.3
Luxembourg	: " " " " "	(1968)	58.4
France	: " " " " "	(1970)	53.8
Italy	: " " " " "	(1970)	53.0

Sources & Notes

1. Community budget from E.E.C. Memorandum on Preliminary Draft Budget, July 1972.
2. Member-State total budgets, based on total taxation to G.N.P. from O.E.C.D. Committee on Fiscal Affairs, Report of Working Party N° 2 on the Classification of Tax Revenues, June 1972.
3. Member-State central/general government, based on total current expenditure by central/general government, from O.E.C.D. National Accounts, according to U.N. New S.N.A.

The first two parts of the table, showing the division between the first two tiers of the fisc are highly significant, but the third, showing the extent of provincial/regional/local participation in the fisc cannot be taken too seri[illegible] these figures since the extent of control by the Member-State central government is surely much greater than the

figures imply. (The difference in centralization shown by this method in the case of the three new members is, however, interesting).

The immense question before us in the budgetary sphere, impossible of course to come near to answering at this time, is what the appropriate division of the fisc between the three levels might be, considering the critera of large scale for economic efficiency, and small scale for people to achieve a feeling of democratic participation in decision-making in the public expenditure sphere.

The Broad Rôle or Function of the Community Budget

The implication of this grand design so far as the Community level of the fisc is concerned is that it should take over those budgetary functions where scale effects are prodominant. To go to the opposite extreme and, for the sake of argument, to consider the administration of local programmes of public services, planning and welfare from Brussels is only to invite disenchantment with the European Community idea especially as the desire for involvement grows among the young and the expanding educated class.

Moving toward a more practical level, the first approach to a realization of these principles is to think in terms of government expenditures of a "business" character as opposed to "social", "personal" or "welfare" expenditures.

On the financing or taxation side of the budget, the proposition was made in my previous paper for the Study Group that this should be raised from the business sector rather than the personal sector. The Community already acknowledges this in part in not having any plans to harmonize Member-State personal income tax systems (at least, for a very long time) since these embody the deepest national idiosyncrasies. Using the V A T as a Community tax instrument is a half-way application of the principle, being paid nominally by the business sector, but clearly in everyone's eyes, effectively by the public. The corporation tax, on the other hand, is nominally paid by the business sector and might partly fall effectively on business earnings, which in compensation are assisted by the services rendered by Community policies.

Thus the same broad division between the business sector and the personal sector should be drawn on the expenditure side of the European budget.

Such a scheme has many advantages. It is the area of government expenditures where, a priori, the most important scale effects are likely to be found. It matches up the payments and benefits side of the European operation, if taxation is to be raised in the main from the business sector, and places it in that sector of national economies most favourable to Europeanisation. And, conversely, it does least damage where damage can easily be done, in national sovereignty over health, education and welfare policies where national differences in approach are at their height.

As one proceeds beyond this broad division, difficulties, of course, increase. This arises partly out of the existing classification of governmental activities, both as regards administrative structure (existing ministries, departments, etc.) and financing (present classification of expenditures in budgets).

The desirable approach would be to review "business" type expenditure in each

Member-State budget and see in which cases useful scale effects could be obtained as a preliminary to welding them together into a European policy. But currently conventional departmental categories or financial heads may include appropriate and inappropriate European budget expenditures.

The best prospect for this task lies in work in progress in the functional re-classification of government expenditure accounts.

On the broadest plane, international organisations have been endeavouring to compare various elements of "social" expenditure, particularly health, education etc, in different countries including the Member-States. *

These are of only minor assistance in the determination of appropriate Community expenditures. The reasons are two-fold: (i) more attention is paid to the "social" side of public expenditure than the "business" side where the main potential for European budgetary expenditure lies (ii) the degree of aggregation is still too great.

A better prospect lies in the detailed functional re-classification of certain sectors of certain economies undertaken in connection with P.P.B. ("Planning, programming, budgeting").

Work in this direction, originating largely in the U.S.A. is being pursued internally in some Member-States. As an example, there has been some non-official work in re-classifying U.K. government expenditure on health, law and order, education, transport on a microeconomic basis **(though not necessarily in a way suitable to distinguish the possibility of scale effects). And the commencement of the present U.K. government in 1971 saw the establishment of a P.P.B. unit attached to the Cabinet Office. The U.K. Government also now publishes a broad functional classification annually. ***

It is not possible in these notes to review this work in detail, or that in other Member-States. In any case, the functional re-classification used would not be in correspondence or exactly suitable for the purpose.

The establishment of a standardized system of expenditure re-classification for the Community would seem to be a desirable, long-run task for Directorate D of D.G. II of the Commission.

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* See, for example, O.E.C.D., Expenditure Trends in O.D.C.D. Countries, 1960-1980, July,1972.

** See P.Else, Public Expenditure, Parliament and P.P.B., November 1970.

*** See H.M.S.O., Public Expenditure 1969-70 to 1974-75, and annually.
See also Federal Ministry of Finance, Financial Planning in Germany, 1970-74.

The Relative Size of the European Budget

This was dealt with to some extent in my previous paper for the Study Group. As mentioned there, the forecast of size in 1980 must be based on an appreciation of both the financing possibilities for the Community budget and the demand for government services at the European level.

The forecast in that paper was derived largely from the financing side. The figure arrived at for the total size of the 1980 Eurobudget was £7,000 mn. or approximately 17,000 u.a. (at 1970 prices). This was a tax-based budget, using either the proceeds of a Community corporation tax or a Community V A T rate in the Member-States of about 4 per cent. It does not, of course, take account of the possibilities of additional capital expenditures financed by loan finance (or current expenditure financed by loans), nor of current or capital expenditures financed by the re-introduction of direct contributions by Member-States.

If we continue to confine ourselves to tax-financed current expenditures, let us, in the light of the discussion in the previous sections, look at the question of size from the demand side.

The first approach could be called a "balance" approach - trying to judge what are proper national expenditures and seeing what remains for a Community budget. Let us make the bold assumption that "social" expenditures, * plus education and public expenditures on housing, are not appropriate expenditures for transfer from national budgets to the Community budget. We then have the following situation:

		% G.N.P. at current price:
U.K.		
Total current expenditure	(1967-69 average)	27.9
Social expenditure	(1970)	12.3
Education	(1965)	4.6
Housing	(1965)	3.8
France		
Total current expenditure	(1970)	37.2
Social expenditure	(1970)	20.7
Education	(1966)	4.9
Netherlands		
Total current expenditure	(1970)	44.1
Social expenditure	(1970)	19.9
Germany		
Total current expenditure	(1970)	37.6
Social expenditure	(1970)	18.8

* By the O.E.C.D. definition, expenditures on health, old age, unemployment, family allowances and war and disability pensions.

		% G.N.P. at current prices
Italy		
Total current expenditure	(1970)	32.3
Social expenditure	(1970)	17.0
Belgium		
Total current expenditure	(1970)	34.8
Social expenditure	(1970)	16.3
Luxembourg		
Total current expenditure	(1970)	34.8
Social expenditure	(1970)	17.1

Sources and Notes

1. Current public expenditures include transfers to households and abroad, subsidies and debt interest.

2. Statistics from O.E.C.D., Expenditure Trends in O.E.C.D., 1960-1980, July 1972.

The incompleteness of statistics on a comparable basis prevents more than the broadest overview using this "balance" approach. It does appear that roughly half of public current budgets in the Six plus U.K. involves social expenditures as defined. That is to say, a balance of 18-20% G.N.P., remains after social expenditure. Another 8% is roughly the norm for education and public assitance to housing. The remaining 10% G.N.P. still includes the major "national"items of national debt interest, internal law and order and maintenance of national defence forces. Defence in some cases (eg. France and U.K.) accounts for 5% G.N.P., so that we are finally reduced to a figure of 2 to 3% G.N.P. as potentially transferable "business" expenditure. *

This is still considerable since as stated in the Introduction, the 1973 draft Community budget represents only some 0.6% of Community GNP.

The figure arrived at for the size of the European budget in 1980 from the financing side, namely 17,000 mn.u.a. represents 1.8% of projected Community GNP in 1980. **

Thus, in summary, this broad approach suggests:

1973	Budget as drafted		0.6% Community GNP
1980	"	(financed by corporation tax of 4% GNP)	1.8% "
1980	"	(Provision for "business" services at Community level)	2.0-3.0% "

Of course, the demand side would be only properly dealt with not by this residual procedure, but by a positive review of government activities by function using PPB work.

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* The figure of 3% would be roughly correct in the U.K. case, since this would comprise the headings: Agriculture, fisheries , forestry; Research Councils; Trade, industry and employment; Roads; Transport; in Public Expenditure by Programme, in HMSO, Cmnd 4578

** From OECD, Growth of Output, 1960-1980, December 1970

As stated, one is not able to do this at present. But the approach would single out elements in transport, fuel, research and other industrial expenditures where operation on a bigger scale would be economically justified.

Allocation, Economic Management and Redistribution through the Community Budget

It is most important to emphasise that the view of the Community budget that we have been taking, and the determination of its size, was based strictly on its allocative function- where the provision of public goods based on scale economies was justified most fully on the European level of government.

This does not necessarily complete the picture for the type and size of European budget that might be justified.

When we consider the responsabilities for demand-management of the modern government tax-and-expenditure system, we have to answer the same question as to the division of the fisc between three levels of government for this purpose, as we did in the case of the "pure" provision of public goods.

What criteria correspond to those which operated there? The answer partly depends on the "region" for which demand manipulation is necessary. If it be the whole Community in relation to outside blocs, clearly a Community instrument is appropriate. But, taking account of monetary union, at this level exchange rate policy will still be available, so tax or expenditure policies are perhaps least required.

If the "region" is the Member-State or province of a state, budgetary policy is going to be important in the light of monetary union, but it is problematic whether stabilisation should fall to the Community level or national (or provincial) level. The solution may be along the following lines, consistent with the previous sections of this paper.

Assistance to an ailing region partakes of short-term income support policy on the one hand, and long-term structural policy on the other. The Community's "business" budget would take care of the promotion of industry and infra-structure in the depressed region, whilst temporary income support (unemployment pay and other social security benefits) remains the responsibility of national (or provincial) budgets.

This is a separation of tax-and-expenditure policies, requiring certain "own tax resources" for the Community, and variability of certain taxes ("unharmonisation") in member-states (or provinces).

There does not seem any economic case *per se* for the "income support" part of regional policy to be in the hands of the Community. This statement would be modified, however, if an explicit redistribution policy became acceptable to the Community.

Turning to this third aspect of modern budgetary operations, redistribution, distinctions are again very important: redistribution between member-states, between regions, between households in different income groups?

It is hardly worth mentioning deliberate redistribution between member-states at present, since such a departure from national *juste retour* is not likely to come on outright redistributional grounds, but rather as a consequence of the operation of European principles in the

distribution of Eurobudget public services.

Redistribution between regions might be a better bet, although not on systematic criteria such as relative regional income per head, unemployment levels, or growth rates. Rather, a few abjectedly depressed regions may qualify for special assistance irrespective of country. However, this would simply be part-and-parcel of the "business-type" structural support to a region discussed in the preceding paragraphs.

Personal or household redistribution should, by all the arguments of this paper, be left within the sphere of member-state budgets since this reflects national attitudes as closely as the structure of personal income tax and most of social security.

The result of considering the stabilisation and redistributional aspects of the modern budget has added little to the proposed rôle and size of the Community budget, except the business or structural side of regional policy.

This involves the same type of expenditure as suggested for it under the allocation branch: it only qualifies the distribution of those expenditures. It may be argued that the figure derived from "allocation", some 3 % Community GNP, will prove too small to provide Community wide common services to business, <u>and</u> special expenditures in stagnant regions. Then there is a case for a larger than suggested Community budget.

<u>The Process of Fiscal and Budgetary Development.</u>

What has been said - concerning the functioning of the European budget and its financing-might be accepted as a goal, but the road toward it seen as a daunting one.

For example, the obvious objection to the idea of the use of the corporation tax as the main instrument of Community financing lies in the present heterogeneity of corporate law and practice between one member-state and another. This is, of course, a problem, which would lead to great inequity in the national and sectoral distribution of the Community tax burden. However, let it be remembered that the harmonisation of corporate law is equally an objective of Community development as harmonisation in the harmonisable tax areas.

The unification of corporate law <u>and</u> the corporate tax base could therefore be seen as a single process. The way ahead appears to be the creation of a European company code, under which some companies in some member-states would incorporate. It could be these companies which paid tax on their earnings to the Community. This would provide a gradual transition from national corporation taxes to a European one, and a gradual build-up of Community budgeting revenues.

Two problems arise: For the first, companies may require an incentive to incorporate under European tax law. Since they are likely to be multi-national companies, the advantage of a streamlined tax payment on a multiple-member-state operation might be sufficient. Alternatively, some slight tax advantage compared with the total to be paid to member-state administrations might be necessary as on interim measure. The second problem is that, during this transitional phase, inter-member-state equity as regards contributions to the Community budget might be unacceptable, depending as it would on the proportion of a member-states business which was transacted by European companies. An equalisation scheme might be necessary in the transitional period, and a "fair" balance struck between member-states on the basis of total corporate earnings in each state or some other measure of business activity.

But this should be avoided if possible. If _juste retour_ should be given up on the benefits side as implied by this paper and _European_ principles of disbursement established, there is no case for proportionality (to GNP corporate earnings etc) on the tax side.

If these difficulties of transition can be overcome, the important advantage is added to the previous merits of the corporation tax as the main Community fiscal instrument: namely, that the development of European company law and taxation becomes a single, mutually-reinforcing, programme.

So much for the transitional problems of reaching a suggested goal of Community financing. Similar transitional problems are involved in moving toward the goal of a Community budget with an extended business-orientated expenditure programme.

Notes on some public finance issues as they relate to Economic Union

In the division of public policy functions between the Community and Member States, the tendency has been to proceed by enumeration of likely areas for Community policy: transport, energy, industrial research and development, etc., these being merely an extension of embryonic policies in existence, and perhaps vaguely based on notions of scale and efficiency.

A more through-going appraisal of appropriate public policy powers for the Community in an economic union might draw on some of the standard, and newer (1), discussions (and controversies) in public finance economics of the last few years. These notes are an endeavour to briefly relate some of those issues which seem relevant to the public policy side of economic union. They refer largely to the Community budget in relation to Member States' (and Regional/Provincial) budgets.

The broad classification introduced by Musgrave (2) for the study of tax expenditure, or budget, systems can be used and where necessary, usefully extended to include non-budgetary public policies as well (3). This classification was threefold: the allocation branch of the budget, the stabilisation branch policy, and the distribution branch policy.

Allocation

The case for the public provision (4) of goods rather than private provision - within the general context, of course, of the type of socio-political societies that Western European countries at present are - has always been the classical issue in public finance, but has recently been the subject of a new burst of discussion in economics.

The impetus to this was the juxaposed observed facts that, on the one hand, the relative size of the public sector is growing steadily larger in nearly all O.E.C.D. countries (5), and on the other hand, that either (a) taxpayers feelings were being thwarted and in revolt (6) or (b) their responses, i.e., the disappearance of money illusion and claims for ever larger money wage and salary increases, plus the enlarged public expenditure itself, were prime causes of inflation (7).

(1) Actually, the economics of politics and of the structure of government, which may seem particularly appropriate here, has been one of the most active fields for public finance scholars in the last few years.

(2) In R. Musgrave, Theory of Public Finance, (McGraw Hill, New York, 1959).

(3) A distinction made in my paper for the first meeting: "Introductory Comments on Economic and Monetary Union".

(4) This has, of course, both a production aspect and a consumption aspect, which do not necessarily correspond; we shall deal with this later.

(5) See O.E.C.D. Expenditure Trends in O.E.C.D. Countries, 1960-1980 (O.E.C.D., Paris, July 1972).

(6) As an example of this view, see J. Buchanan and M. Flowers, "An Analytical Setting for a Taxpayers Revolution", Western Economic Journal, 1969.

(7) "It is a question whether the progressive reduction of the share of privately financed consumption has aggravated inflationary tensions", from O.E.C.D. Expenditure Trends, op. cit.

The modern discussion on the role or nature of a public good, which has been intense throughout the 1960s, has been dominated by the attempt to define the characteristic of a "social" good (as opposed to a "merit" good)(1) with a comparative evaluation of the three characteristics of such a good: joint supply, impossibility of exclusion of particular consumers, impossibility of rejection by consumers. The weight of emphasis now lies on the impossibility of exclusion (2), particularly because this provides the most important element in the difficulties of market provision of such goods due to pricing problems, and thus the need to consider forms of public provision.

The question here concerns the relation of this discussion, which has occupied a good deal of public finance discussion both historically and recently, to the three-level system of government in the Community.

Confining ourselves to what are "social" goods on the above criterion, it is a matter of trying to determine the unavoidable spill-over of a public good, which gives a guide as to the division of its provision between different levels of government. But there are two cases here: the service necessarily carries with it its own benefit area, or the benefit area is at choice. Examples of the first range from the necessarily large-scale area of benefits of nuclear defence to the small-scale benefit of counselling people on local housing and planning problems. Where the benefit area is at choice, the principle of per capita least-cost provision gives some guide line (3).

The expenditure side of public (social) goods has its counterfoil on the tax, or *financing*, side. Evaluating this, the simplest method is to adopt the benefit principle here, (remembering we are still only dealing with the allocation branch) from the voluntary-exchange approach of Wicksell-Lindahl-Musgrave (4) and to try to match the paying group to the benefitting group.

So far, we have a neat theoretical approach to the Community budget: it deals with projects with Community-wide spill-out on technical grounds, and where least-cost may dictate this. The financing side matches this.

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(1) A "social" good is one which has to be collectively consumed because of technical considerations; the consumption of a "merit" good is politically imposed on individuals to a greater or lesser extent than they would choose exercising their preference system in a market situation.

(2) See J. Head, "Public Goods : the Polar Case", in Modern Fiscal Issues (Ed. R. Bird and J. Head) (University of Toronto Press, 1973).

(3) Worked out in detail in C. Tiebout, "An Economic Theory of Fiscal Decentralisation" in Public Finances : Needs, Sources and Utilisation, N.B.E.R., (Princeton, 1961).

(4) Much of the recent literature in this area has concerned other models, of both the quantitative provision of the social good (defined as above) and its financial provision; most significant are the "majority-voting" models of A. Downs in An Economic Theory of Democracy (New York, 1957) and the "log-rolling" critique of J. Buchanan and G. Tulloch in The Calculus of Consent (Ann Arbor, Michigan, 1962).

However, there is the problem of "tapering off" of benefits at the edges of areas (and of the burden of taxation), and conflict between presently-constituted jurisdictions and benefit (and tax) areas. The usual solution in federal finance is to consider that the federal authority should play the role of arbiter in these problems, where necessary, using a financial transfer scheme (this is still not to deal with redistribution).

This opens up a large new area for Community-budget operation, not so much at present, but as integration proceeds with increased movement of goods and people, it is going to become more and more difficult to define areas of benefit (and tax). As benefit areas diffuse and merge, the decision between Community inter-State transfer systems and Community operation becomes the more acute.

We turn now from the "social" type of public good to the "merit" good. The "merit" or "demerit" of a good is determined either, as Musgrave says, by the preference scale of the ruling group (1) or one might prefer, the ethic permeating society over a particular activity; smoking, car accidents, welfare goods. It is probably fair to say that, at present, there is very little case for "merit" goods on the Community level. There is no ruling group or party, politically speaking. There may be more prospect for European merit goods on the "ethic" criterion, where commonality exists between Member States. But, on the whole, merit goods remain for the present in the sphere of the State and Region (there is, of course, scope for a redivision between these two). But, in the course of time, Community norms may be expected to develop, e.g. over minimum educational or health standards.

This short discussion of the definition of a public good in the Community context has been concerned with the "want" or demand side, and the question of its supply has yet to be dealt with.

In fact, there are two aspects to the supply side: its political provision (how much is to be produced and how it is to be paid for), and its actual production. On the first, the matter is already implicitly solved in our use of the benefit-principle, a market-initiative model, where quantities provided of social goods are determined with reference to tax-prices and consumers marginal evaluations of the goods (2).

Majority voting models of Downs get away from tax-prices and marginal evaluation to the more realistic setting of competition for political power between two vote - maximising political parties. Whilst this model is currently applicable to States (and in some cases, Regions) it is not applicable to Community provision, in view of the diversity and inconsequence of parties in the European Parliament. The

(1) R.A. Musgrave, Fiscal Systems (Yale University Press, New Haven, 1969).

(2) The technical difficulties arising, e.g. from the unknown or unrevealed consumer preferences, are very great; see J. Head, op.cit.

critics of the Downs model such as Buchanan and Tulloch, on the grounds of the collusion of interest groups working through the political process, and pressing for pseudo-public goods supply, which in fact are special-benefit goods, may seem more apposite to the Community situation at present.

In summary, the political determination of public (social) goods quantitative supply and its charging (by tax or otherwise) is still in dispute in the literature, and the discussion does not help the Community situation greatly at present.

But we have still to deal with actual production, assuming that a public good has been identified, that x units per time - period be provided, and financed by (say) a benefit system of taxation on the group consuming it.

Provision in the sense of production can still be in the hands of private or public enterprise - government can buy in military aircraft or road construction or these can be produced by public enterprise.

This is a question of ownership, a political matter. The only technical or economic question is whether there are some circumstances which demand public production, and at a particular level of government. The main criteria are (a) security, (b) production at least cost (1) and (c) safeguarding consumers of the service from monopoly exploitation.

In the case of security, military defence, law and order, etc., no degree of risk can be accepted against non-provision as might occur if firms following market criteria were used.

The least-cost, or "economies of scale" argument, is most widely used, but proves quite tricky on analysis. Production may have to be very large to reap economies of scale, and only a public authority can command sufficient resources to achieve it: a major dam or reclamation scheme may provide an example. But, in addition, lower-cost might be achieved by the public authority due to the ability to pledge additonal security, e.g. the public revenues, behind the raising of capital, or the use of legislative powers to obtain a resource "cheaply", e.g. compulsory land purchase. Though such cases are important, the scale argument has less weight to it than some think: "It has a superficially appealing simplicity about it which appears to have attracted many who have argued that...... changes in the nature of service provided by government require increased centralisation in all developed countries in order to capture these economies of scale; it is not clear, however, that the technically efficient size of government has in fact grown in many labour-intensive functions of government (2).

(1) Note that this relates to public versus private provision not the size of the public benefit region discussed earlier although the two are, of course, related.

(2) From R. Bird and D. Hartle, "The Design of Governments" in Modern Fiscal Issues, op.cit; the authors discuss further technical difficulties of founding public production on scale.

Of course, the scale argument, insofar as it holds, tends to validate both public provision and provision over a large (Community-wide) area.

The other two arguments, the security and unavoidable monopoly arguments may justify public provision and small benefit areas, e.g. local police services, local sewerage services.

Of course, the "production" side to public goods is so political: much can be brought under public enterprise where no such justifications as above exist, or the above criteria can be very tightly interpreted and considerable "public goods" production contracted out to private enterprise. But in the mixed economies of the Member States of the Community, it is more or less true that those goods which are "public" goods by the criteria discussed earlier in this section are generally produced by public enterprise.

The ownership question can therefore be avoided to a large extent and the role of the Community budget in the allocation aspect set in this theoretical framework (1):

(i) Provision of "social goods where technical considerations necessitate Community-wide non-excludability.

(ii) Provision of "social") goods where "least-cost" considerations imply large-area provision.

(iii) Transfer system between States (or Regions) where tapering-off and spill-over outside of jurisdictions are unavoidable.

(iv) Provision of "merit" goods where Community ethical norms are developed.

What is interesting is the dynamic aspect of these functions. Technical progress will enhance the importance of (i) and (ii) whilst economic and cultural integration will do the same for (iii) and (iv).

Stabilisation

Of course, what has been a predominating discussion is the bext mix of the two groups of policy weapons, monetary *versus* fiscal, for stabilisation variously defined (various combinations of full employment, low inflation, growth and regional balance for internal stabilisation; plus various definitions of balance in the external account) (2).

The first point to note is that, assuming the existence of monetary union alongside economic union, the above large field of discussion only applies to Community stabilisation policy vis-à-vis the outside world, since most monetary instruments cease to exist inside the Community.

(1) This dwells on the expenditure side and the tax or financing implications are not fully developed here.

(2) Of an enormous literature, a leading example is R.A. Mundell, "The Appropriate Use of Monetary and Fiscal Policy for Internal and External Stability;, *International Monetary Fund, Staff Papers*, 2 (I.M.F., Washington, 1962).

Looking at the Community as a unit, we are certainly looking at large-country situations, one distinction commonly used, but may or may not be considering the problem under a regime of fixed or flexible Community-World exchange rates (1).

Under fixed exchange rates, the general finding has been: fiscal measures are the stronger in unemployment policy, monetary in meeting balance of payments defects (2). But this result has to be much qualified in general, and for the Community in particular.

In general, the finding is based on a very simple categorisation of aims, of employment and balance of payments equilibrum, and of instruments, fiscal and monetary. The nexus between full employment policy and inflation, and its connection with the trade balance, has been over-simplified as have capital movements in these predominately trade mobility/factor immobility models. The addition of growth as an aim brings the need for a third instrument, which may however be achieved by differentiating fiscal or monetary policy into parts.

With exchange rate flexibility toward the outside world, the position is eased. The problem of the external balance is quite clearly in the domain of monetary policy, and in fact, internal adjustment is easier by either fiscal or monetary means. In the fiscal case, the domestic multiplier (change in Community GNP per increase in Community public expenditure/decrease in Community taxation of private expenditure) is increased as the import leakage in the multiplier is reduced by exchange depreciation (provided there are not offsetting inward capital flows due to interest rate of other causes). Monetary policy can also be used for internal expansion by using increased money supply to induce exchange depreciation (e.g. through interest rate reduction and capital outflow) and export expansion. With external balance taken care of by exchange rates, growth and employment are two aims theoretically achievable by two instruments, fiscal and money supply/interest rate policy (3).

Remembering that we are still dealing with Community-World relationships, some suggested implications are these. If the Europa is in a flexible relationship with other major currencies, Community monetary policy (i.e. money supply and interest rate) is available for Community internal balance policy (adjusting the European GNP cycle). This is just as well because Community adjustable fiscal instruments are likely to remain small and primitive: on the tax side, the % of VAT (or of corporation tax) received will be limited and rather invariable; on the expenditure side, expenditures will be rather long-term and structural with little hope of substantial short-run influence over total Community effective demand.

Furthermore, it is obvious that fiscal instruments are going to be crucial in intra-Community stabilisation. The questions which arise here are: which instruments, and how effective?

(1) The basic distinctions used by Musgrave, Fiscal Systems, op.cit.

(2) Musgrave, op.cit., p. 329

(3) A position newly adopted by the UK Government.

Within the economic union, the analysis of regional multipliers developed for within a country now applies to Member States in the union (1). The size of regional multipliers (in relation to regional expansions of expenditure) show the undesired leakage of expansionary efforts going to increase incomes in other regions (often not themselves justifying assistance). Further, the quality of the income increase in the ailing region is of interest; does it consist of new employment or increases in incomes of those employed?

The obvious fact that, as trade integration proceeds in an economic union, the Member State/Regional multiplier is increased due to an expansion in the marginal propensity to import, has been much analysed (2). The broad implication is that direct regional policy interventions is weakened but on the other hand the increased "openness" of the region mitigates the effects of autonomous falls in expenditure in the region and also accentuates the benefits received of booms in prosperous regions.

The net effect of integration for stabilisation policy in a region can be taken as adverse in this sense. In connection with the second aspect above, concerning autonomous shifts in expenditure, it might be assumed that to an approximate degree (a) marginal propensities to import of the set of regions in the Community are expanded in similar proportions (b) autonomous downward shifts in expenditure in one or more regions are matched by autonomous upward shifts in the remainder. This then leaves the first aspect, of public policy expenditure changes, to be considered on its own. Now here the likely combination of public policy shifts in expenditure in the depressed and buoyant regions, contrary to the self-cancelling integration effect in the case of autonomous expenditure effects, both lead in the same direction - a disadvantageous integration effect for the depressed region. For expansion in the depressed region is lessened for a given level of public policy expenditure increase, whilst public policy may simultaneously be trying to cool off income expansion in the prosperous (and hence also by transmission) in the depressed region.

Some idea of the quantitative impact of this effect on the efficacy of stabilisation policy in a region can be deduced from present and projected patterns of trade between the Member States/Regions (recorded flows will, of course, be between Member States).

This is not the place for such a task, but it is important to draw the implications for Community taxation and budgetary policy from the general fact of lowered efficacy of fiscal stabilisation policy.

There are implications for (a) the type of fiscal and budgetary policy used, (b) the magnitude of that policy, and (c) the Commission's role in such policy.

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(1) See for example, D. Dosser, "National Income and Domestic Income Multipliers", Economica, February 1963.

(2) See G.K. Shaw, "European Economic Integration and Stabilisation Policy" in C.Sharp (Ed), Fiscal Harmonisation in Common Markets (Columbia University Press, 1967) and E. Claasen and P. Salin, Stabilisation Policy in Interdependent Economies (North Holland, 1972).

In the first respect, the need to interpret "fiscal harmonisation" as (often) a need for fiscal differentiation in different parts of the Community becomes imperative (1). In particular, fiscal differentation or flexibility is required in those (harmonised) taxes that have an efficacy in increasing/decreasing effective demand in the fairly short-run. These are general sales taxes, i.e. the V.A.T. and excise duties, rather than corporation tax (2). And, as between tax and expenditure policies, the requirements of short-run impact put the weight on tax weapons, insofar as most expenditure policies are structural or otherwise, difficult to charge quickly (the main exceptions being payroll subsidies and unemployment benefits). In the main, however, it is variation of indirect taxes which is required, as traditionally in any Member States, for short-run adjustment.

The second point, regarding the quantitative impact, is obvious; larger variations in V.A.T. (or payroll subsidies or unemployment benefit) are going to be required for regional adjustment in view of the integration effect, than we have been accustomed to. The correlation between the per cent change in V.A.T. required per given income generation in a region and changes in the marginal propensities to consume in that and other regions is, in principle, knowable.

The preceding two points avoid the question as to who controls the Member State/Regional stabilisation policy. The third point relates to the problem of perverse action in prosperous regions, and rather directs it toward the Community fiscal authority. For it is clearly essential that co-ordinated action be taken by way of fiscal differentiation in prosperous and depressed regions.

The broad conclusions of this brief survey of the stabilisation branch of the Community fiscal and budgetary system is that whilst exchange-rate variation can take care of external stability of the Community as a whole and the internal level of economic activity can be dealt with by Community monetary instruments (hence short-run flexibility in Community fiscal instruments is not so important), all the burden for relative levels of activity in the Member States/Regions is placed on fiscal instruments. These have to have effective short-run impact on effective demand (such as the V.A.T. would have), variations have to be large, and have to be co-ordinated between parts of the Community by a central authority.

Redistribution

If public goods provision (see allocation) follows the Lindahl approach of tax payment - benefit by areas of non-excludability, the public section operation is free of redistribution of real income between Member States/Regions. But if other

(1) On the basic conflict between the concepts of tax harmonisation as fiscal uniformity versus fiscal flexibility, see D. Dosser (Ed), British Taxes and Entry into the Common Market (Charles Knight), London, forthcoming, 1973.

(2) This is the "stabilisation" aspect of the preference for the corporation tax as the uniformised Community tax over the V.A.T., argued in the author's previous papers for the group.

differences in the tax base. Although these differences can to some extent be taken account of by differences in service levels and differences in tax rates, when allowed to fully do so, this is so divisive in the Community that the differences in tax bases are partly compensated by a transfer system (1). Transfers can be by various formalae such as pay/receive according to ratio of one's own tax-base (for a particular tax) to the average Community tax-base.

This plan has a moderate positive effect under (a) and (b) and does not suffer a great distincentive problem as under (b). This plan would perhaps be the most realistic in the Second-stage of economic union. It is consistent with a good deal of fiscal flexibility in tax rates, as argued for under Stabilisation.

(iv) Incentives to raise fiscal operations: plans can go further than the last to modify and even reverse the disincentive effect. For example, the Community could offer "matching grants" to Member States in selected fields of expenditure. Such a plan is similar to the last in permitting fiscal flexibility and in transferring real income from low tax base/high need Member-State/Regions to broad tax/low need ones. But its essential difference is that it envisages a larger budget operation in gernal, and this may not be acceptable in the Second-stage either politically or in terms of other economic policy such as combatting inflation.

These four plans all work through the Member States. The first two are severely centralist, and coincide in general with the view of fiscal harmonisation as fiscal unification, the latter two are more federalist and offer scope for fiscal flexibility.

It is possible to take an even more centralist or integrationist approach, by considering the relationship between the central fisc and Community citizens as a direct one (2). The Community may endeavour to achieve horizontal equity by equalising the fiscal residue (benefits from public services minus tax paid), whilst vertical equity (.e.g. a progressivity in the income distribution) is achieved by State adjustment of taxes and transfers (following State objectives) and central adjustment (following central objectives), which would tend to outweigh State action, of course.

This approach is the appropriate one for a truly common market, with full factor mobility. For if the movement of people is to be determined entirely by the sectoral need for labour as indicated by wage-rates, and locational considerations are eschewed, real income adjustment should be on an income basis only, and not on a location basis. However, since such a common market is beyond any present horizon, sa is this approach to redistribution, and plans for action (and minor action at that) though the Member States are the interesting ones.

(1) This is roughly the system of local government finance in U.K.

(2) See J.M. Buchanan, "Federalism and Fiscal Equity", American Economic Review, Sept.1950.

Reconciling the Three Objectives

The problem of areas of jurisdiction - that present government areas do not correspond to an optimal economic division of the Community - which was mentioned in connection with allocation, applies also to the other two branches of the public sector operation, and indeed is compounded, since optimal areas for one economic purpose may not correspond with those for another. For example, if provision of public services or the non-excludability criterion is taken as dominant, so that spill-over is (theoretically) eliminated for provision, a stabilisation or redistribution policy for such an area may spill-over to businesses or households who do not qualify by the criteria in use for stabilisation assistance or income support.

This is, in a sense, a conflict between the three objectives in terms of scope or area. The conflicts can be more direct and too numerous to detail here: examples are between increased public expenditure under redistribution plans versus reduced spending for stabilisation purposes, fiscal uniformity to take-in spill-over benefits under allocation, versus fiscal flexibility for stabilisation, and so on.

Perhaps the final and strongest argument for Community fiscal co-ordination lies in these over-riding conflicts between the three great objectives of budgetary (and non-budgetary) policy. However, the Community role does need to look at the whole Community budgetary operation with respect to the detail of its diverse and manifold parts, where different principles for each part and alternative criteria within each part apply, rather than follow overall obiter dicta such as uniformisation, centralisation, etc.

D.

Document written by Professor H. Giersch

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The Case for a European Regional Policy

1. There is an undisputed presumption that economic union in Europe affects the location of economic activity in a way that many people might consider to be on the whole undersirable from a supra-national point of view (1).

- The freeing of trade within a customs union is generally favourable to locations close to former trade barriers. Although some locations that had attracted "tariff factories" due to high import protection lose this advantage, many more others gain from the removal of trade barriers on the other side of the border (2). This would apply to the Benelux countries and to locations along the Rhine and in the Saar region. Moreover, the transport network that was built up in the nineteenth century, with national capitals as centres, will gradually be improved in the former frontier regions under the pressure of both political and market forces. These locational effects correspond to the trade creation effect (3).

- What has become known as the trade diversion effect has its locational counterpart in the disadvantages which a customs union confers upon locations close to the outside borders. While some peripheral locations may benefit by attracting "tariff factories" from neighbouring countries (like Flensburg in Schleswig-Holstein), the peripheral areas in general, including the centres of peripheral regions, lose their relative attraction for economic activities.

- This process which tends to lead to the emergence of a common centre for the Common Market (comparable to the emergence of national centres in national markets) is intensified by the introduction of freedom for the movement of labour and capital and for the choice of locations by corporations and entrepreneurs. West Germany, which has an abnormally high share of manufacturing in GNP (4) seems to be a case in point. The rate of growth of her manufacturing sector would have slowed down to a greater extent, had the labour shortage in the sixties not been relieved by the inflow of foreign workers from Southern and South-eastern Europe. In other words: the inflow of labour into the central areas of the Common Market made for lower wage pressures and a tendency to have an undervalued currency, a fact that by itself helped to sustain profit margins and to prevent an outflow of capital into less industrialised areas. Moreover, the inflow of foreign workers gave support to industrial growth in the more industrialised areas of the developed countries. In 1969 in West Germany about 9 % of the population in built-up areas was foreign born compared to 3 % in the structurally weak areas (5); without an inflow of foreign workers into Germany industry might have spread to a larger extent to the less developed regions of the country which offered regionally immobile labour notably in the (insufficiently shrinking) agricultural sector.

2. Economic integration has probably fostered active competition and thus contributed to raising the rate of growth of GNP in the Common Market above what it would have been otherwise. In this way it has probably had a secondary effect on the locational structure of Europe. The reasoning behind this hypothesis is based on the

presumption that growth contributes to regional inequality. Regions which already have an infrastructure and a degree of urbanisation that offers economies of contact (to whose who are in and to those who want to come in) necessarily benefit most from any exogenous stimulus to growth, whereas backward areas, by losing capital and labour, also lose voting power and may become unable to press for their fair share in public infrastructure investment. The infant industry argument in support of tariffs has a wider application in this context: as a medium-run argument for regional subsidies in cases where private and public decision makers have an unduly short time horizon so that they underestimate either the development potential of backward regions or the environmental costs of over-urbanisation in the highly industrialised areas.

3. In the long run, perhaps only in the very long run, we can rely on the equilibrating forces. The limits to growth are a regional phenomenon. They become relevant in the polls and in the market place when people complain about sky-rocketing rents, unnecessarily time-consuming commuting distances, air pollution and other forms of a deterioration in the quality of life. If we want a better regional distribution of economic activities, we should first abstain from neutralising these signals in the name of well-meant but short-sight political objectives. Rents should not be prevented from rising, and commuting costs should not be subsidised. If people are insensitive to the non-pecuniary costs of traffic congestion, we can with some technical imagination devise mechanisms that transform these costs into tolls and taxes. Air pollution and water pollution in densely populated areas can be licensed, and licenses can be auctioned, or they can be sold at prices covering the costs of remedial measures. There is no need to give financial help to local communities in overdeveloped areas. On the contrary, the overdeveloped areas should not only pay their own way - by levying taxes equal to the average costs of the public services they render -; they should rather adopt the marginal cost pricing principle in charging taxes and tolls for public services and thus make a profit. In principle, this profit could be used to promote development in backward areas.

4. If and when the built-up areas hit against the limits of industrial growth (and if negative feedback effects in the market place are not neutralised by the political pressures of the voting population), the less developed areas receive a good chance for catching up. The early starter may lose its growth leadership to other areas and countries. Examples are England, the traditional textile regions, and coal and steel areas like the Ruhr . Regions are bound to decline with their dominating industries, unless they change what may be called their "profession". As regards the new "profession" (which may be in the field of services), they have not necessarily an advantage over latecomers. This holds particularly if the latecomers offer a better climate, an attractive environment and political stability. California may be a case in point.

5. As in North America and elsewhere, we have in Europe a regional structure that shows systematic differences in regional per capita income. If we abstract from national capitals like Paris and Rome, from major seaports like Marseille and Hamburg,

and from semi-capitals like Frankfurt and Munich, we find a tendency for incomes to fall from Southeast to Northwest in the UK, from Northeast to Southwest in France, from Northwest to Southeast in West Germany, and from North to South in Italy. Looked at in this way, the regional income distribution in Europe is comparable to a cone, the top of which is located in the Rhine delta region. With some additional imagination, which translates the relative cheapness of sea transport into correspondingly smaller economic distances, we can consider Copenhagen and Stockholm to be almost as much a part of the Centre of Europe as London or Hamburg. In the postwar period the top of the income cone seems to have shifted somewhat in a southerly direction, presumably as a result of rapid growth on the Continent and the failure of Britain to join the Common Market right from the start.

6. In spite of the urbanisation tendencies that are observable in the form of the immigration of foreign workers and the location of industries along the Rhine, we find that regional income differentials have become smaller, at least in Italy and Germany.

In the Federal Republic the coefficient of variation which measures the deviation of regional income levels from the national average, decreased from 0.22 to 0.19 between 1950 and 1960 and went down at a similar rate from 0.19 to 0.16 in the following nine years.

In Italy, the process of equalisation of regional income differentials has not slowed down since the formation of the Common Market. The weighted coefficient of variation fell from 0.36 to 0.34 between 1951 and 1958 and from 0.34 to 0.27 between 1958 and 1966 (6). This reflects the effects of both emigration and regional policy.

The differences in per capita income between the Six have clearly declined since the EEC was founded. To say that in the process of economic growht the rich become richer and the poor become poorer is obviously little more than a myth.

7. The enlargement of the Community can easily create new regional problems. While Schleswig-Holstein, which was on the periphery of the Six, is likely to gain from the entry of Denmark, the peripheral regions of Denmark may find themselves at a disadvantage. Similarly, I feel that the Sough of England, including the London area, will benefit from the closer links with the Continent, but that Northern Ireland as well as Scotland and Northern England will be subject to strong pulls from the gravitation centres of the European economy. These pulls will manifest themselves in larger interregional income differentials, until the equilibrating forces start to work. Whether the outcome will be migration to the South or a flow of capital to the North will largely depend upon whether real wages in the North are allowed to lag behind real wages in the central areas.

8. There are strong reasons to believe that interregional wage differentials tend to be smaller than interregional productivity differentials. Otherwise it would be difficult to explain why there is overemployment (more vacancies than unemployment) in the central areas on the Continent, but unemployment in the peripheral regions, no-

tably in Southern Italy, Spain and Yugoslavia, but also in Ireland and in the North of the UK, of Norway and of Sweden.

9. The tendency for inter-regional wage differentials to become too small may be the consequence of wage bargaining practices and a strong belief in the principle of equal pay for equal work. Equality that is imposed on unequal conditions translates itself into a more serious inequality. It may take a very long time to reverse a process that severely hits the peripheral regions through the outmigration of young skilled workers who cannot find employment at home. It is true that the marginal private productivity is increased, when a worker migrates, but if the immigrant area is already so overcongested that he reduces the quality of life of those already living there, there can be a case for counter-measures. The case is even stronger when outmigration reduces the value of social overhead capital in the depressed area.

10. Much of the regional policy that may become necessary after the enlargement of the Community can still be carried out at a national level. Action on a community level, that involves an international redistribution of incomes, can wait until workers migrate across frontiers either in undesirable quantities or into overcongested areas. Nevertheless, the action eventually needed should well be prepared in advance. This situation may become urgent onse exchange rates are irreversably fixed or once a common currency is introduced to serve as a basis for wage contracts.

11. A "Europa" that is floated in competition with national currencies will probably be used first in wage contracts in the industrial core of Europe. Wage contracts in peripheral areas are likely to be fixed in national currencies for quite a while - just as it takes some time for national languages to replace dialects in areas farther away from the centres of communication. A gradual penetration of "Europa" from central places to economically backward regions might alleviate rather than worsen the regional problems in countries like the UK and Italy, which are probably not yet optimum currency areas under the criterion of interregional balance. The argument for breaking up these currency areas through the floating of "Europa" would be even stronger, if "Europa" were tied to a consumer price index that included the high and increasing rents and commuting costs in congested areas. If these areas become free of both money illusion and cost illusion, they will cease to have overemployment and will no longer attract labour and capital from less developed areas.

12. Sooner or later the beneficial transitory effects of floating a "Europa" will disappear. When all wage contracts are concluded in "Europa", the distorting effects of the principle of "equal pay for equal work" will make themselves felt. This then would be the time for large scale regional policy measures to support peripheral areas. If, alternatively, European monetary integration is brought about through the prevention of parity adjustments, the time for a large scale regional policy may come much earlier. In fact, we can already say with regard to West Germany that the combination of wage restraint and restrictive policies with a reluctance to revalue is bound to produce a growth of GDP which is felt by an inflow of resources, including

labour and human capital from less developed countries and regions in Europe. This is judged against what would happen under conditions of a flexible (equilibrium) exchange rate or a speedy parity adjustment. The result will be of no surprise to those who believe that the contradictions of capitalism largely reflect the inconsistencies of economic policy. A "Yes" to irreversably fixed exchange rates must imply a "Yes" to a European regional policy, if serious inconsistencies and contradictions of this sort are to be avoided.

13. The Paris Summit Meeting of October 1972 recognised

- "that a high priority should be given to ... correcting ... the structural and regional inbalances",
- "that the Governments from now on undertake to coordinate their regional policies" and
- "that a "Regional Development Fund" should be set up before 31 December 1973, which will be financed, from the beginning of the second phase of Economic and Monetary Union, from the Community's own resources".

In the light of the foregoing reasoning, the emphasis on the need for correcting - and preventing - regional inbalances is no more than logical.

14. How Governments can effectively coordinate their regional policies (1) is an unsolved problem. A minimum requirement would be to eliminate

- inconsistencies in the form of actions that neutralise each other,
- regional measures that are a disguised form of industrial protection including measures that are primarily directed at promoting specific new industries,
- all measures in support of already congested areas.

Moreover, it should be possible to agree on a minimum of measures designed to limit industrial growth in areas that suffer from a deterioration in the quality of life, as was suggested in para. 3.

15. The "Regional Development Fund" mentioned in para. 13 could be financed out of

- the receipts from auctioning licenses in overcongested areas,
- the receipts of a special tax levied on the increase in land values (with due allowances for low income earners and old age residents and for the increase in land values due to inflation and other causes that are unrelated to urbanisation tendencies),
- the seignorage gain from the floating of a "Europa",
- a tax on the increase in official foreign exchange holdings insofar as such increases are a reflection of a growth-promoting undervaluation of the national currency.

(1) A survey of actual measures is given in the Annex to this paper.

16. The tax on the increase in land values might be a universal tax levied in the whole community for the Regional Development Fund. Each landowner should assess his own property each year or every second or fifth year. To prevent an underestimation the landowner should declare that he would be prepared to sell his property at the assessed value within a period of - say - six months. This arrangement would make it unnecessary to establish a large bureaucracy. It would also ensure that the assessment value is not too far from the market value. Compared to a tax which is based only on actual sales the proposed tax does not interfere with the movement of land from one owner to another. Moreover, the tax rate can be much lower than would be the case if the tax were levied only when an actual sale took place.

17. The Regional Development Fund should distribute its means to Regions rather than to Nation States. For this purpose new regional authorities should be established, if they do not yet exist already. This is the situation from which one may start. There are

8 zones d'études et d'aménagement du territoire in France

11 Länder in West-Germany

11 "regions in the Community sense" in Italy

4 geographical zones in the Netherlands

3 linguistic regions in Belgium

1 Grand Duchy of Luxemburg

11 new standard regions of England, Wales, Scotland and Northern Ireland.

Similar regions may be defined for Denmark and the Republic of Ireland, so that the total number of regions in the Community might be between 50 and 55, comparable to the number of states comprising the USA. Why should these regions not elect 2 senators each for a European Senate?

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4. G. Fels, K.-W. Schatz und F. Wolter, Der Zusammenhang zwischen Produktionsstruktur und Entwicklungsniveau, Weltwirtschaftliches Archiv, 1971, Bd. 106/Hft. 2, S. 267.

5. K. Schwarz, Analyse der räumlichen Bevölkerungsbewegung, Hannover 1969, p. 134.

6. Coefficients of variation weighted by regional shares in the national population. Cf. D. Biehl, E. Hussmann, und S. Schnyder, Zur regionalen Einkommensverteilung in der Europäischen Wirtschaftsgemeinschaft, Die Weltwirtschaft, 1972, Heft 1.

Survey of Regional Policy Measures (x)

1. Indirect Policies

Improvement of professional and regional mobility

Consulting entrepreneurs and workers.
Individual grants for vocational training and re-training.
Financing or constructing vocational education facilities.
Financing transfer expenses of people who leave the depressed areas (Sweden, Finland) or move to growth centres of the depressed areas (Sweden, Netherlands).

Improvement of infrastructure

Regional infrastructure development.
Urban infrastructure development, urban renewal (GFR) and construction of new towns (UK, France).

2. Direct Policies

Administrative action

Regional priorities in government procurement policies (GFR, USA).
Decentralisation of governmental institutions (Denmark, Italy).
State-ownership of "cornerstone enterprises" (Norway, Italy).

Financial intervention

Low interest rate loans, government grants and tax concessions

- to primary and manufacturing industries only (Belgium, Netherlands)
- to tourism as well as to primary and manufacturing industries (GFR)
- to commercial establishments as well as to the sectors mentioned above (France)
- to growth poles and to integrated industrial complexes (Italy)
- to specific industries suitable to certain regions (France).

Industrial zoning

Planning and laying out of industrial expansion zones (France).
Planning and building up of industrial estates for sale or lease (UK, Italy).

3. Restrictive Measures

Investment controls and licensing in metropolitan areas (UK, France).

(x) cf. OECD, The Regional Factor in Economic Development, Paris 1970

REGIONEN — RÉGIONS — REGIONI — GEWESTEN

ADMINISTRATIVE GRUNDEINHEITEN — UNITÉS ADMINISTRATIVES DE BASE — UNITÀ AMMINISTRATIVE DI BASE — ADMINISTRATIEVE GRONDEENHEDEN

FRANCE

Région parisienne	100
Bassin parisien	110
Haute Normandie	111
Basse Normandie	112
Picardie	113
Champagne-Ardenne	114
Bourgogne	115
Centre	116
Nord	120
Ouest	130
Bretagne	131
Pays de la Loire	132
Poitou-Charentes	133
Est	140
Lorraine	141
Alsace	142
Franche-Comté	143
Sud-Ouest	150
Limousin	151
Aquitaine	152
Midi-Pyrénées	153
Centre-Est	160
Auvergne	161
Rhône-Alpes	162
Méditerranée	170
Languedoc-Roussillon	171
Provence-Côte d'Azur	172a
Corse	172b

BELGIQUE / BELGIË

Région Flamande/Vlaams gewest	200
Flandre Or./Oost-Vlaanderen	201
Flandre Occ./West-Vlaanderen	202
Anvers/Antwerpen	203
Limbourg/Limburg	204
Région Wallonne/Waals gewest	210
Hainaut/Henegouwen	211
Namur/Namen	212
Liège/Luik	213
Luxembourg/Luxemburg	214
Région Bruxelloise/Brussels gewest	220
Brabant	221

NEDERLAND

Noord	300
Groningen	301
Friesland	302
Drenthe	303
Oost	310
Overijssel	311
Gelderland	312
West	320
Utrecht	321
Noord-Holland	322
Zuid-Holland	323
Zuid	330
Zeeland	331
Noord-Brabant	332
Limburg	333

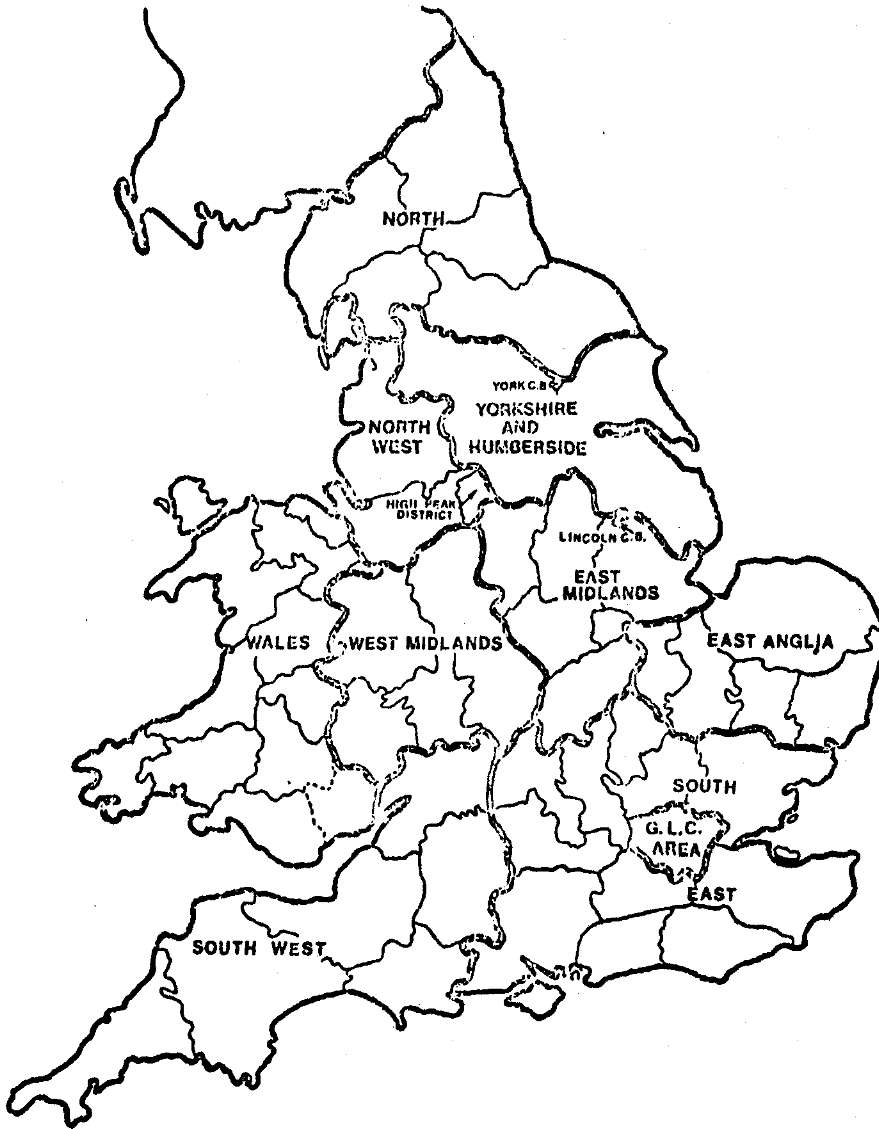
DEUTSCHLAND (BR)

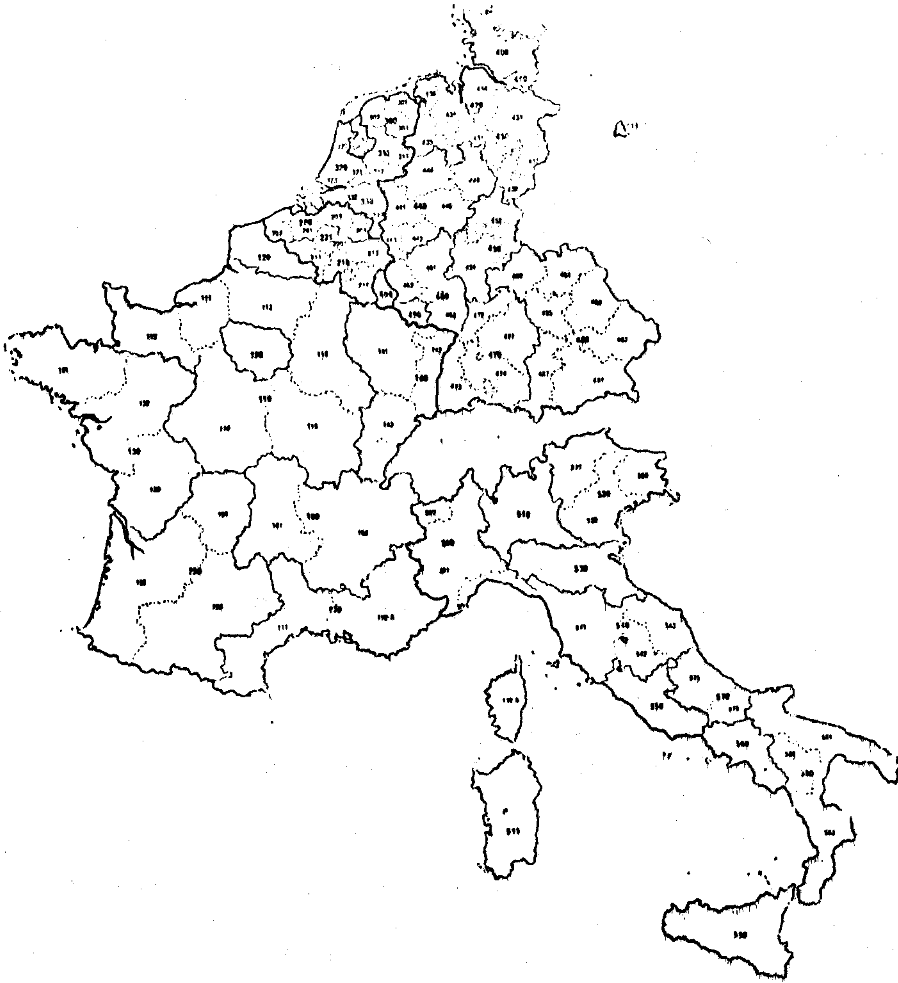
Schleswig-Holstein	400
Hamburg	410
Bremen	420
Niedersachsen	430
Hannover	431
Hildesheim	432
Lüneburg	433
Stade	434
Osnabrück	435
Aurich	436
Braunschweig	437
Oldenburg	438
Nordrhein-Westfalen	440
Düsseldorf	441
Köln	442
Aachen	443
Münster	444
Detmold	445
Arnsberg	446
Hessen	450
Darmstadt-Wiesbaden	451
Kassel	452
Rheinland-Pfalz	460
Koblenz-Montabaur	461
Trier	462
Rheinhessen-Pfalz	463
Baden-Württemberg	470
Nord-Württemberg	471
Nord-Baden	472
Süd-Baden	473
Süd-Württemberg	474
Bayern	480
Oberbayern	481
Niederbayern	482
Oberpfalz	483
Oberfranken	484
Mittelfranken	485
Unterfranken	486
Schwaben	487
Saarland	490
Berlin (West)	411

ITALIA

Nord-Ovest	500
Piemonte	501
Valle d'Aosta	502
Liguria	503
Lombardia	510
Nord-Est	520
Trentino-Alto Adige	521
Veneto	522
Friuli-Venezia Giulia	523
Emilia-Romagna	530
Centro	540
Toscana	541
Umbria	542
Marche	543
Lazio	550
Campania	560
Abruzzi-Molise	570
Abruzzi	571
Molise	572
Sud	580
Puglia	581
Basilicata	582
Calabria	583
Sicilia	590
Sardegna	511
Luxembourg (G.-D.)	600

NEW STANDARD REGIONS OF ENGLAND AND WALES





Final remarks of Herbert Giersch

While agreeing with the general spirit of the report, I should like to make the following reservations and points:

1. We have not discussed in sufficient detail the arguments leading to the conclusion that the Community budget should be expanded to, at least, 3 % of the Community GNP by 1980 (page 64).

2. I do not feel convinced that it would be undesirable for the Regional Fund to supplement rather than partly replace member-state regional spending (page 47). My opinion is that whatever the Community can do should be in addition to what national Governments are doing now.

3. Should it be implied that variations in the VAT are an anti-cyclical weapon with possibilities of regional differentiation (page 44) in the cyclical context, I would reserve my position.

4. As regards the Common European Currency, to be defined as a "bag" of national currencies, I strongly plead that harmonisation of monetary policies on the basis of certain targets and indicators should proceed along with any narrowing of the scope for parity changes. As long as the objective of fighting inflation is recognised to be of primary importance, there should be more scope for revaluations than for devaluations.

5. In order to make the Common European Currency more stable than the average of the national currencies and to enable it to compete with the stronger ones, I suggest that the "bag" should be filled with additional units of national currencies (in the same proportion) whenever its value in terms of goods and services has declined in all countries by more than a certain percentage.

6. The Common European Currency is too important a suggestion to ignore the safeguards that are indispensable for preventing it from beeinga failure. Failure is bound to result if the exchange rates are more rigid than is warranted by the harmonisation of monetary policies.

E

Document written by Professor G. MAGNIFICO

I. Reasons for Economic and Monetary Union 8I

I. Reasons for Economic and Monetary Union

1. The advantages of a European monetary union can be summarised as follows:

- Efficiency gains due to the simplification of transfers, the elimination (or reduction) of the exchange risk, the abolition of internal exchange control discrimination among EC-residents (such controls, as might be necessary, would be applied along the perimeter of a wider and more viable currency area), economics of scale.
- Saving in the holding of external reserves; the pooling of reserves would have to be accompanied by the creation of the Community's own sources of liquidity, to be used for internal settlements; (this is necessary if we are to truly "internalise" intra-group trade).
- Restoration of European control over monetary conditions in Europe.

Perhaps due to the circumstances which have prevailed over the last few years, it is generally held that the benefit last listed above is the most important that monetary unification would bring about.

I believe this to be justified. So far developments have been such that EEC countries have become commercially integrated with one another, whereas monetarily they communicate mainly with, and through, the dollar. This causes sharp conflicts at a time when the cycle tends to diverge on the two sides of the Atlantic. Already in the second half of the fifties, Europe regained autonomy vis-à-vis the United States in the trade cycle, but not as yet in the monetary and financial spheres. Several factors (including, of course, the growth of the Eurodollar market) have accentuated monetary interdependence. However, given the great disproportion between the United States and the fragmented European national markets, interdependence has been lopsided. The European countries' ability to pursue, for other than the short term monetary policies at variance with those of the dominant economy has been severely curtailed.

As long as they act as separate entities, European countries can only make very limited use of technical devices, such as exchange rate changes, in order to regain monetary sovereignty. Separate money and capital markets and independent currencies do not have the same strength; they appeal differently to mobile capital; but if individual EEC countries varied the exchange rate, to the (different) extent needed to curb the dollar inflow, they would run the risk of upsetting their trade balance, now that intra-EEC trade exceeds for the average of member countries one half of their total foreign trade, whereas trade with the United States (with whom the monetary problem arises) averages less than ten per cent.

One might also argue that the freedom to resort to parity "jumps" might unfairly be used to gain a sharp competitive edge within the industrial customs union; it is true that in the postwar period "competitive undervaluations" have been more used than competitive devaluations, but the former generally build up slowly and might be offset by limited and regulated exchange rate flexibility. Finally, parity jumps are difficult to reconcile with present arrangements under the common agricultural policy. Thus, monetary union would also help in managing the industrial and agricultural customs union.

2. The recovery of monetary sovereignty, through union, would mean that Europe would again have the power to pursue an autonomous monetary policy. But which policy?

Monetary policy can be defined as the use of a set of instruments that are available to monetary authorities in order to achieve certain aims, mainly in the sphere of stabilisation policy, but also in other fields. Stabilisation policy, in turn, is part of economic policy and strategy. Thus, monetary policy, which has held such a prominent place in the arsenal of weapons used in the postwar period for stabilisation purposes, is instrumental in achieving the objectives of governmental economic policies. If the role of monetary policy, important thought it is, is subordinate to overall economic policy objectives, monetary union cannot be regarded as an end in itself; nor can it be conceived of as feasible outside the wider context of economic union.

For the purposes of this paper I shall define economic union as a state of affairs in which:

a) The tendency towards equalisation of product and factor prices is not hindered by administrative and other controls which discriminate on the basis of nationality, residence (or location of plant or investment).

b) A network of linkages between companies, trade unions, institutions stretching across national borders, is gradually formed, thereby merging economic systems, which being largely open communicate with one another, into one fully integrated economy.

c) Conscious policies are pursued in order to secure an even pattern of high employment of resources and to close the gaps in living and working conditions throughout the economic union's territory. This would not (and could not) be achieved by relying exclusively on the geographical mobility of manpower; Community instruments, akin to those used by governments within individual countries, would be created and employed for the purpose.

The following deals with some of the issues arising under c).

3. It follows from the above that monetary union cannot be aimed at _in vitro_. The choice of the path leading to it must be made bearing in mind the economic implications; measures of _monetary_ unification need to be appraised with reference to their implications for the union's broad _economic_ policy objectives.

I take it that, as far as those objectives are concerned, the union would behave in much the same way as individual member governments and countries. It has been a distinctive feature of the post World War II period that governments have clearly acknowledged their responsibility to secure full employment (and economic growth) in their respective countries. Although more recently the emphasis has shifted towards improving the quality of life, it is clear that growth based on the progress of productivity continues to be a condition which must be fulfilled if we are to improve "working conditions and conditions of life", to use the language of the communiqué issued at the Paris summit meeting last October. In my opinion, looking at the order of priorities from the Community standpoint, the main qualification to be made is that more attention should be paid to the business cycle's changes _in space_. After all, the process of integrating the economies is largely one of re-arranging the allocation of resources and the location of productive activity throughout the union's territory as a whole. Hence, the bodies which are primarily entrusted with the task of carrying out the integration process ought to be expected to recognise their special responsibility

for growth balanced through space, while cooperating with national governments in order to stabilise the business cycle over time.

Unfortunately, we do not know enough about growth to be able to regulate it in the way we regulate, say, the employment level or the balance of payments. The problem is further complicated by the fact that growth, like inflation, has kept important national connotations, suggesting that the progress made in the postwar period does not go beyond the stage of semi-integration.

This may make it a difficult task to achieve regionally balanced growth; it does not, however, dispense with formulating and implementing a European policy of growth for, although we do not know everything about economic growth, we do know that certain things tend to foster it, while others hinder it. Monetary unification should be pursued in a fashion consistent with a European policy of balanced growth.

4. As long as the ability to sustain the process of economic growth in a context of monetary stability differs from country to country, a mechanism of monetary unification should be chosen which would not hinge on one hundred per cent freezing of parities. It is a good approximation to say that the ratios at which member countries' currencies are exchanged cannot be kept constant over the medium-long run, unless the ratios between the general price levels in those countries can be kept constant. Whereas permanently fixed parities require the same degree of monetary stability, or instability, to be maintained throughout, different national propensities to inflation imply that the rate of price change at which output will be maximised differs from one country to another. The fixed parity contraint would cause a deviation from this optimum rate and, therefore, damage economic growth. A number of factors, including the asymmetry which as a rule requires deficit countries to react more promptly than surplus countries to a balance-of-payments disequilibrium, suggests that adjustment of demand and employment policy in the type of arrangement here discussed would be made prevalently, and perhaps preponderantly, by high inflation-propensity countries (close to the level posited by the low inflation-propensity countries).

Intra-group parity flexibility, however, is not generally considered a synonym of unification (although floating exchange rates seem now to be accepted for transactions on capital account). This attitude is justified because of the danger that flexibility might degenerate into freely floating rates and because the existence of a contraint is likely to foster the move towards mutually consistent patterns of behaviour. In the light of the foregoing argument, it might, however, be argued that a statutory regulation of flexibility, which would gradually shrink so as to finally lead to completely fixed parities, and the early introduction of a European currency would both largely reduce that risk and place progress towards monetary unification, in the transitional period already, on a less volatile basis than would a commitment not to change parities other than in accordance with some agreed procedures.

5. The need to retain flexibility will be less strongly felt if sufficient progress is made towards a European policy of growth. In the previous section, it was shown that there is a built-in link between monetary unification and the growth process, and that the latter may be differently affected in different regions and countries. If member countries were satisfied

as to the Community's ability to take offsetting steps, which would help to sustain a balanced growth, they might agree to depriving themselves of monetary instruments which have a bearing on their economic growth.

The link between monetary unification and economic growth is not only the result of the renunciation to use such instruments as exchange rate policy, exchange controls, credit policy (and ultimately demand management). The link also is there because the process of monetary unification, long before it leads to the use of one currency throughout the whole area, will tend to considerably increase the strength of the automatic factors which push open national economies towards economic integration.

This applies, inter alia, to wages and salaries. Most industrial countries are nowadays on a labour standard rather than on a monetary standard of any kind: money supply tends to adjust to the levels consistent with the evolution of wages and salaries (which is, albeit to different degrees, autonomous in relation to the conditions of demand and supply); rather than vice versa. Given the way in which trade unions have developed, the labour standard is fundamentally a national standard: a fact which accounts for a good deal of the gaps existing in the various countries' propensity to inflation. If we are on a labour standard, re-organization of trade unions' structure and policies, in a fashion likely to turn a national standard into a community-wide one, represents part and parcel of the integration process. In the meantime, as monetary unification measures are taken and their implementation becomes clear to the public at large, the "veil" which tends to blur differences in real wages paid for the same work in different countries will become thinner and thinner. Thus, the automatic mechanisms will work with more vigour towards closing the gaps in the rates of increase of remuneration, irrespective of the size of productivity gains in different countries. In fact the push towards pay parity throughout the Community's territory might, during the transitional phase, imply at the limit a succession of higher wage rises in the regions and countries where productivity is lower and grows slowly. Thus, the position of those regions and countries as industrial locations would, at the very beginning, be weakened: regional problems would be aggravated and monetary unification itself would be jeopardised.

6. Here again the difficulty might be overcome if monetary unification were accompanied by steps which are really part of economic unification. The introduction of a centrally financed pay-roll subsidy in favour of the regions (hardest) hit by the move towards pay parity would weaken the tendency to concentration of investment in a few over-expanding regions. In fact, the subsidy might be dovetailed into a Community-wide system, which, by means of a regionally differentiated pay-roll tax subsidy, would tend to reduce congestion in the overheated regions, and unemployment in the laggard ones.

The introduction of subsidies would not necessarily mean that one would be ossifying a given structure and territorial pattern of production and investment activity, every time that a pocket of unemployment, however small, threatened to form. The process of economic integration would not have much meaning if it did not bring about changes in the location of economic activity and in the allocation of resources (it would not make sense if, on balance, it increased inefficiency).

But the diversification of energy sources and the relative decline in costs of

(multi-modal) transport have nowadays made geography less relevant as a determinant of industrial locations. As far as these are concerned, a weightier influence appears to be attributable to ad hoc policies pursued by governments and/or local authorities and, at the other end of the spectrum, to a sort of inertia which preserves the power of attraction of old-established industrial centres long after the causes, which initially made industry settle there, have subsided.

In a pluralistic economic order, such as obtains in western Europe, profitability calculations do not (fully) allow for social costs. There is a tendency to overrate the external economies which a concentration affords and to underrate the external diseconomies. As member countries become regions of the wider Community area, the peripheral regions of countries which themselves happen to be in a peripheral position within that area, will find themselves farther removed from the European inner circle of industrial concentration, the increased "economic distance" will make them less attractive to capital.

Because integration would strengthen the factors which make for concentration of economic activity, the proposal already made that, as part of a European policy of balanced growth, a tax on the gains from concentration should be introduced, seems to be justified.

7. Economic growth is an objective of stabilisation policy and, thus, of monetary policy also. The policy to be pursued by a European monetary union and, before it comes to that, the path to monetary unification which will be followed during the transitional period, should aim at maintaining high levels of activity in all the main economic regions of the Community. Failing that, some industrial high-activity regions (with a high propensity to inflation) might become tomorrow's "problem areas".

Much of the foregoing, however, refers to the plight of the "consolidated" regional problems. These are rightly considered as falling within the purview of long-term development policies. Indeed, such is the complexity of development problems that it can hardly be hoped to overcome them without a multiple attack by means of tax, government expenditure, manpower training, educational, public works, transport and other policies. But this does not mean that it is irrelevant from the standpoint of the less developed regions what sort of union and monetary policy will be aimed at in the Community. The fact that long-term policies can work the changes in the structures needed to overcome conditions of economic backwardness does not imply that stabilisation policies, and monetary policy at that, have nothing to contribute.

Because structural differences make for a different cyclical performance, and vice versa, stabilisation policies cannot overlook the inter-acting link between the two. Thus, what is the rationale for pursuing the same demand policy for the tendentially low-activity and for the tendentially high-activity regions, when the impact of disinflationary measures tends in fact to concentrate in the former regions, where it is not needed? (Most casualties of a credit squeeze are usually to be found among the smaller firms, which in those regions account for a higher share of the total). Monetary measures are not neutral sub specie regionis: at any rate they have an implicit regional effect connected with (a varying degree of) industrial specialisation by the regions. Whenever that effect is not consistent with a European policy of balanced growth, a regionally differentiated monetary policy should as far as practicable be pursued and/or offsetting policies in other spheres should be enacted.

8. I hope to have shown that monetary unification cannot abstract from economic unification. Of course, economies which are not fully integrated yet are bound to have conflicting perceptions of the attendant risks and benefits. Thus, for some countries European monetary unification should be sought in a way likely to subdue inflation, in the first place. Given the present very high rates of cost and price increases, this attitude in easy to explain. Also, although it is a problem for incomes policy perhaps just as much as it is for monetary policy, inflation appears to lie in the field of monetary phenomena more than does economic growth. I have concentrated on the latter because I regard it as being ultimately the decisive factor in the attitude of member countries vis-à-vis the Community and its transformation into a fully-fledged union.

As Europe will not regain monetary sovereignty without costs, we should make sure that it is put to good use. This can best be achieved by implementing a European policy of growth within the framework of monetary and economic union.

Rome, January 25, 1973

F

Documents written by Professor J.E. MEADE

I. European Monetary Union 9
II. The Objectives of Economic Union 99

European Monetary Union

1. Money is a good servant but a bad master. Monetary Union should be promoted only to the extent that, and only in a form that, makes the basic objectives of Economic Union easier to attain. It is my fear that if Monetary Union is set up as an objective in its own right it will make these basic objectives of Economic Union more difficult, rather than less difficult, to attain.

2. In order to promote the basic objectives of Economic Union we should seek monetary arrangements between the Nine which reduce to a minimum any purely financial-monetary-balance-of-payments difficulties in allowing free trade, free movement of capital, the ready transfer of funds to and from an EEC budget, and so on. This does not mean that an Economic Union must be based solely on laisses-faire principles. On the contrary, in addition to the free movement of goods and factors of production and in addition to the harmonisation of taxes, company laws and regulations, etc, common European policies for agriculture, regional development, pollution control, procurement of public goods, promotion of research, development, and production in such large-scale industries as steel and aircraft production, distribution of incomes and wealth, etc., etc., are the proper stuff of an Economic Union. Such matters are difficult enough in all conscience to bring to successful fruition. It is most desirable that they should be judged on their own proper, fundamental merits and not on their effects on the balance of payments between the constituent parts of the Economic Union.

3. There are only two possible ways of easing these monetary balance-of-payments problems: the first is by currency integration and the second is by variations in rates of exchange between the national currencies.

4. By currency integration I mean the institution of a common currency or a rigid locking of exchange-rates in a manner which has the same effect. If everyone has the same money, then the technical problem of making a transfer of funds between one part and another of the Economic Union disappears. But the basic underlying problems do not disappear; they take the form of depression and deflation in what would otherwise have been a country with a balance-of-payments deficit and of inflation in a country which would otherwise have had a balance-of- payments surplus. Unless the conditions exist for a reasonably painless adjustment of the domestic economies to these monetary deflations and inflations, this method of currency integration will make the building of a true Economic Union more difficult and will ultimately lead to catastrophe which will discredit the whole enterprise. A national government which is coping with domestic unemployment due to the stringencies of membership of a currency union is not going to agree easily to those steps in the building of an Economic Union which may require it to contribute more to a central European budget, to put out its contracts for public works to contractors in other member countries, and so on. A government which is struggling with a domestic restriction due to a currency union will develop a throughly protectionist attitude to such policies. In the end the Economic Union would collapse.

5. The conditions necessary for the successful operation of currency integration include (a) a centrally integrated monetary and fiscal policy, (b) a co-ordinated wage flexibility, and (c) a highly developed regional policy.

(a) With currency integration there must be only one central set of financial authorities, controlling not only the supply of the common currency but also a large and potent range of fiscal instruments, in order to stabilise the general level of effective demand throughout the Economic Union. National governments will have lost these powers; and the difficulties of adjustment for one member country which has to inflate or to deflate relatively to the other member countries must not be compounded by the absence of any authority capable of preventing general inflationary and deflationary surges throughout the Economic Union.

(b) Wage costs must fall in the member country which has to deflate relatively to wage costs in the other member countries. Otherwise we will simply have mass unemployment in the country concerned. We are nowhere in sight of a systems of national wage-fixing which will make this possible. Indeed, the introduction of a common currency, if it encouraged trade unions to demand the same money wage for the same job throughout the Economic Union regardless of differences in productivity, would make matters even worse than they are at present in this respect.

(c) There would have to be well-developed regional policies to ease the adjustments which these relative monetary inflations and deflations would undoubtedly entail, however successful one might hope to be in making monetary wage and other costs more flexible than they are at present.

6. If one considers the present discrepancies between the different EEC countries in their arrangements for coping with inflationary pressures - arising both from the demand side and from the cost side - and if one remembers that it is precisely at this time that the different countries are experimenting with different measures to cope with this problem, it would be foolish to try to fix exchange rates at all rigidly now. It would indeed be tragic that just as the rest of the world (including the USA) were realising the folly of fixed exchange rates in present conditions, the countries of the EEC were to commit themselves to this disastrous policy. Indeed frequent, small, gradual exchange rate adjustments rather than prolonged periods of tension at fixed rates culminating in explosive and disturbing large-scale cataclysms provide much the most hopeful means for a considerable time ahead for minimising the balance-of-payments obstacles to the construction of an Economic Union. Of course, such arrangements are not ideal. Currency integration might well advantages if conditions (a), (b), and (c) of paragraph 5 were fulfilled. Without those conditions, however, it would be disastrous. We can now set about building up conditions (a) and (c); but if we are honest with ourselves, we have as yet no idea how to achieve condition (b).

7. All this does not imply that the Nine should do nothing in the field of Monetary Union. On the contrary, if a system of frequent, small, gradual exchange rate adjustments is to be the order of the day it would be of immense help if they could get together to manage this system jointly. I personally would be happy to see them go the whole hog by

putting the whole of their national reserves of gold, dollars, and SDR's together with considerable quotas of their own currencies into a single joint European Exchange Equalisation Fund. This fund would be jointly operated by the Nine, so that the determination of the exchange rate adjustments both as between the currencies of the Nine themselves and also as between their currencies on the one hand and the dollar on the other hand would become a joint, centralised European operation.

8. There is a second development which calls for immediate action. If the Economic Union is to be developed there will be increasing need for a common unit of account for the denomination of the revenues and expenditures of the central budget as well as for such purposes as the determination of prices for the common agricultural policy. In a regime in which exchange rates between national currencies are liable to frequent small changes, this presents a problem. Moreover a unit of account expressed in gold or dollars or SDR's loses much of its attraction if European currencies are likely to fluctuate in terms of gold, dollars, and SDR's; and in any case for the purpose of a European Economic Union there is obvious point in choosing a unit of account which has more relevance to domestic European monetary units than to the domestic American monetary unit.

9. I propose, therefore, that the EEC should adopt as its unit of account a European unit which is defined as a bag of predetermined amounts of the national currencies of the Nine constituent members. Thus one Europa might be defined as a bag containing Qs pounds sterling, Qf French francs, Qm marks, Ql lire and so on. The Q's would be fixed amounts of the national currencies and would be chosen so that initially each Q was in roughly the same proportion to the GNP of the country concerned. With this unit of account and with variations in the national exchange rates, when value of the Europa went up in terms of one of the constituent currencies it would necessarily fall in value in terms of at least one of the other constituent currencies. But if the variations in the exchange rates, though frequent, were small and gradual, it should be possible to use such a Europa as a useful unit of account for EEC governmental purposes.

10. In the case of the Common Agricultural Policy, for example, support prices fixed in terms of Europas would be more relevant to general European conditions than support prices fixed in units of account tied directly or indirectly to the dollar; and if variations in Europa exchange rates, though frequent, were never more than a few percentage points in any one year, the variations in the agricultural support prices in terms of the domestic currencies concerned would be very moderate and, if necessary, should be absorbed in some way or another by national agricultural policies without the need to reintroduce frontier controls over agricultural products. In any case it would be totally unacceptable if the modalities of the support arrangements for farmers were allowed to dictate the whole of the balance-of-payments mechanism for the Economic Union.

11. There is a further important advantage in defining the Europa in this way as a bag of existing European currencies. Without further ado, since all these national currencies are already used in ordinary market transactions, this bag of currencies could be used by the European Exchange Equalisation Account as a means of intervention in the foreign exchange

markets for outside currencies, and in particular for dollars. The European Exchange Equalisation Account could link the Europa to the dollar, buying and selling this bag of European Currencies for the dollar so as to keep the Europa-dollar exchange rate within a predetermined band around a parity which could itself be adjusted as required. In other words the structure of rates between all the currencies concerned, could from the outset be expressed in two parts: first, as a rate of exchange between the dollar and the Europa bag of currencies and, second, as rates of exchange between each European national currency and the Europa, the latter being merely a way of expressing the rates of exchange between the European national currencies.

12. I believe that the developments suggested above are fully enough for the next stage of Monetary Union: (i) the pooling of European monetary reserves; (ii) the operation of a joint control over the use of these reserves for the regulation of exchange rates; (iii) the formation of a common policy for the use of frequent but small exchange rate variations; (iv) the definition and introduction for the use as between the national governments, the national central banks, the EEC official institutions, and the enlarged European Exchange Equalisation Account of a European unit of account, the Europa, consisting of a bag of European national currencies in predetermined fixed quantities; and (v) the expression of exchange rates in the twofold form of (a) the dollar value of the Europa and (b) the Europa value of each European national currency.

13. The next decisive step (a final decision on which should, in my opinion, be postponed until we are certain that the time is ripe for it) is the development of this unit-of-account Europa into a currency used for commercial transactions by agents other than official national and European governmental and central bank institutions. When the national reserves of foreign exchange and other assets are pooled in the European Exchange Equalisation Account, the resulting liabilities of the Account to the national central banks could be expressed in the unit of account, the Europa. National central banks could settle balances between themselves by the transfer of these Europa deposits with the Account. These are matters of the mechanics of inter-central-bank settlements. But a wholely different set of problems and possibilities arises when commercial banks or other private customers are allowed to hold Europa deposit liabilities with the Account. The Account then becomes a European Central Bank, which I will from now on call the ECB. Presumably the ECB would issue Europa notes or deposit liabilities against the receipt of the appropriate bag of European national currencies and would be under an obligation to redeem any of the Europa notes or deposits which it had issued by the repurchase of these Europas with the appropriate bag of national currencies from its own reserves. Such a step carries with it three major dangers.

14. The ability of private agents to choose between holding Europas or holding national currencies may introduce a new, relatively easy way of speculating between the fortunes of the various European currencies. If one European currency is weak and is expected to depreciate in terms of Europas (say, the pound) and if another is strong and expected to appreciate (say, the mark), then Germans may elect to hold marks and only Englishmen may wish to hold Europas. This, of course, is tantamount to a shift of funds from sterling to the

other European currencies which must be acquired with sterling on behalf of the Englishmen in order to make up the Europas which they wish to hold. It is true, of course, that if freedom of capital movements within Europe is to be a feature of a true Economic Union, the, even in the absence of a Europa currency, Englishmen could speculate directly by selling pounds and buying marks. However, the existence and common use of the Europa might make such speculative movements just that much easier and more natural.

15. The moral is clear. The Europa should not be introduced as a private transactions currency until the process of integration has gone far enough, (i.e. the three conditions in paragraph 5 are sufficiently near fulfilment) for only very moderate exchange-rate variations between the European national currencies to be needed to ease the balance-of-payment problems of the countries concerned. As soon as this is the case, the movement of short-term national funds into and out of the Europa could be controlled by acceptable changes in short-term interest rates. Thus in the case examined in the previous paragraph, suppose that the pound was expected to depreciate in terms of Europas by 1 per cent per annum and that the mark was expected to appreciate in terms of Europas by 1 per cent per annum. Then if the ECB offered a European rate of interest of 6% on its Europa deposit liabilities, a short-term rate of interest of 7% in the United Kingdom and of 5% in Germany would offset any incentive to speculate on the exchange rates. Such may well be the proper ultimate development. The ECB would become the decisive European monetary authority using, inter alia, its interest rate policy to control the total supply of money in Europe, while the national European central banks would need to adjust their interest rates around this basic European level to offset short-term speculative movements in and out of Europas. But all this must wait for the time when European economic integration has gone sufficiently far to make it unnecessary to contemplate any large exchange-rate variations between the national currencies.

16. The second major danger to be guarded against is that the private use of Europas might lead to uncontrolled monetary expansion or contraction in Europe. Suppose that European commercial banks could hold Europa deposits with the ECB. They would, of course, do so only if it were profitable to expand their Europa business by making Europa loans and themselves incurring Europa deposit liabilities to their customers. If there were no control over the ratio of their Europa reserves with the ECB to their Europa deposit liabilities to their private customers, then (in the manner of Eurodollar assets and liabilities) the authorities would have lost control over the pyramid of monetary expansion that might be built on any base of Europa deposit liabilities of the ECB. The private use of Europas necessitates the design and implementation of a European requirement regulating the ratio of Europa reserves to the Europa liabilities for all European commercial banks.

17. The third danger of a premature introduction of the Europa into private hands is by far the most serious. The Europa could become a very widely used currency for all sorts of transactions, starting no doubt with the large intro-European transactions of large multinational companies and banks, proceding through the smaller national transactions of national companies, and ending up for wage payments and retail sales. Indeed, it would present the

path to what in paragraphs 4, 5, and 6 above I have called currency integration. For the reasons given in those paragraphs I regard it as an alarming danger that we might move too quickly in the direction of currency integration before the preconditions to make a currency union work are satisfied.

18. The moral to be drawn from this is clear. It may be possible to control the use of Europas by such regulations of the activities of the commercial banks as requiring them (i) to deal only in blocks of Europas of sums not less than, say, the equivalent of £ 500,000, (ii) to extend credits in Europas only for international and never for domestic transactions, and (iii) to hold exceptionally large Europa reserves with the ECB against their Europa liabilities, so that dealings in national currencies were less restricted than dealings in Europas. But the Europa should not be introduced as a private transactions currency until we are reasonably sure that we have a system of such regulations as will effectively control the rate at which its use is allowed to spread.

19. As the conditions for currency integration (see paragraph 5 above) are approached, there may be considerable advantage in the private use of the Europa for large intra-European transactions and to replace the Euro-dollar. One can imagine in such circumstances the gradual development of a truly European monetary system: a powerful European Central Bank controlling the quantity and the interest cost of the Europa; the national central banks setting their interest rates in relation to this central European rate; and the rate of exchange between the Europa and the dollar and the rates of exchange between the national Europa currencies and the Europa being managed as a central European concern. In the Appendix to this paper I set out in more detail such a scheme, which could be gradually introduced as the necessary conditions for currency integration are more and more nearly fulfilled.

20. But one must close on a note of caution. There is one stubborn pre-requisite for all this very desirable development. If we knew how to influence wage rates and prices in conditions of full employment, so as to avoid rates of wage inflation which exceeded increases in productivity on the one hand and excessive profit margins on the other hand, we could move towards currency integration. But at the moment in this matter we none of us have a clue. Until we do we must be very cautious indeed in our moves towards currency integration.

APPENDIX (1)

(1) The outline in this Appendix is based upon the proposals of Messrs. Magnifico and Williamson in their Federal Trust Report entitled "European Monetary Integration", to which proposals I have added the suggestion that the Europa be defined in terms of a bag of European national currencies.

1. The EEC governments set up a European Central Bank (the ECB). The ECB issues notes and deposit liabilities which constitute a new currency (the Europa).

2. The Europa is convertible by the ECB on demand into a mixed bag of the EEC member currencies. That is to say the ECB undertakes on demand to pay out for one Europa note Qs units of sterling + Qf French francs + Qm marks + Ql lire + ... Conversely for Qs sterling + Qf francs + Qm marks + Ql lire + ... the ECB undertakes to issue 1 Europa note. The Q's are fixed amounts of the national currencies concerned.

3. The ECB is set up in the first place by the payment by the EEC national central banks (the NCB's) into the ECB of all of their holdings of foreign exchange reserves of gold, dollars, SDR's etc. and of substantial agreed amounts of their own national currencies. They receive in return Europa deposit and note liabilities of the ECB. The amount of Europas received from the ECB by each NCB being the value of the assets paid into the ECB, this valuation being made at the current exchange rates in terms of the mixed bag of EEC currencies which constitute the Europa.

4. The ECB fixes from time to time a par-rate of exchange between the Europa and the dollar(? or SDR) and undertakes to purchase or sell dollars (? or SDR's) for Europas at buying or selling prices which diverge from the par-rate by a margin of z% from the par-rate.

5. The Europa - dollar (? or SDR) par-rate is altered from time to time according as the ECB is running out of, or accumulating unduly, SDR's, gold, and dollars, the change in this par-rate being in principle never more than y% in any one year.

6. The ECB fixes par-values in terms of Europas for each of the EEC currencies, these par-values being so fixed that

$$1 = \bar{V}s\ Qs + \bar{V}f\ Qf + \bar{V}m\ Qm + \bar{V}l\ Ql + \ldots\ldots$$

where (i) $\bar{V}s$ is the par value in terms of Europas of the pound sterling and similarly for $\bar{V}f$, $\bar{V}m$, $\bar{V}l$ etc. and (ii), as a result, $\frac{\bar{V}s}{\bar{V}f}$ = the par rate of exchange between French francs and pounds sterling (francs per pound). The par values $\bar{V}s$, $\bar{V}f$, $\bar{V}m$, $\bar{V}l$ etc. are changed from time to time so that the $\bar{V}$'s are raised for countries ~~where~~ overall balance of payments is in relative surplus and are lowered for those whose ~~overall~~ balance is in relative deficit but in principle never in such a way that any $\bar{V}$ is raised or lowered by more than x% in any one year.

7. The NCB's undertake to sell or purchase their own national currencies for Europas in such a way as to prevent the Europa value of the national currency from rising above, or falling below, its par-value $\bar{V}$ by more than a limited margin of w%.

8. In principle the NCB's undertake to intervene only in terms of Europas to prevent the value of their own currency from moving outside the ruling Europa band, intervention in dollars being left to the ECB to control the Europa value of the dollar. The NCB's might, of course, act as agents for the ECB in such dollar intervention.

9. The ECB would be empowered to buy or sell individual EEC national currencies for Europas in the market in order to act as a central exchange equalisation account to offset what it considered to be temporary or exceptional movements between EEC currencies.

10. The ECB would be empowered to pay interest on its Europa deposit liabilities and to make loans in Europas to suitable public or private concerns in the EEC.

11. The national authorities in the EEC would be required by the ECB to make rules about the structure of their own domestic financial institutions which deal in Europas. For example their commercial banks could be required to hold as a reserve against any Europa liabilities which they incurred, specified amounts of Europa notes or deposits with the ECB.

The following notes on the above scheme may be of interest:

(i) If Vs, Vf, Vm, Vl etc. are the Europa values of the national currencies actually ruling in the foreign exchange markets, arbitrage will bring it about that they are such that

$$1 = V_s Q_s + V_f Q_f + V_m Q_m + V_l Q_l + \ldots\ldots$$

For if this were not so, it would be possible <u>either</u> with less than 1 Europa to buy in the market a bundle of currencies which could be sold to the ECB for 1 Europa <u>or else</u> to buy with 1 Europa from the ECB a bundle of currencies which would sell in the foreign exchange markets for more than 1 Europa. It follows that if one V rises in the market, some other V must fall. Arbitrage would also bring it about that the rates of exchange between any two European currencies in the foreign exchange markets was equal to the ratio between the two V's for these two currencies, for example that $\frac{V_s}{V_f}$ was equal to the rate of exchange actually ruling between francs and sterling. Otherwise it would be possible to sell francs (sterling) for Europas, with the Europas to buy sterling (francs), and with the sterling (francs) to buy more francs (sterling) than the initial sum. The actual V's are basically ways of expressing the rates of exchange between the European currencies, but in such a way that the fixed bag of European currencies is in fact always worth 1 Europa. There could, of course, be small divergences from the above equalities, in so far as there was a small spread between the ECB's buying and selling prices for Europas and in so far as there were small commissions on dealing in the foreign exchange markets.

(ii) If $\overline{V}_s$, $\overline{V}_f$, $\overline{V}_m$, $\overline{V}_l$ etc. are the par values of the currencies in terms of Europas, any adjustments of these par-values must always be such that at any one time

$$1 = \overline{V}_s Q_s + \overline{V}_f Q_f + \overline{V}_m Q_m + \overline{V}_l Q_l + \ldots\ldots$$

In other words when the par-values are changed, if one $\overline{V}$ is raised some other $\overline{V}$ must be lowered. This is a consequence of the fact that the $\overline{V}$'s are basically an indirect way of expressing the par-rates of exchange between one European national currency and another.

(iii) With this system of expressing rates of exchange between the European national currencies, if fluctuations of individual currencies are to be kept within reasonable margins, it is essential that the NCB's should undertake both to buy Europas with their national currencies in order to limit an appreciation of their currencies and also to sell Europas for their currencies in order to limit a depreciation of their currencies. Suppose that the actual rates of exchange between all the national currencies remained unchanged except that between sterling on the one hand and all the other hand. Then if sterling appreciated in terms of Europas, all the others would depreciate, and *vice versa*. From the equation

$1 = Vs\ Qs + Vf\ Qf + Vm\ Qm + Vl\ Ql + \ldots\ldots$

it can be seen that in this case the percentage rise (or fall) in Vs would be equal to $\frac{1 - Vs\ Qs}{Vs\ Qs}$ times the percentage fall (or rise) in the other V's. Vs Qs is a fraction expressing the proportionate weight of sterling in the make-up of the value of the Europa. Suppose that this proportion were $\frac{1}{5}$. Then the rise in Vs would be four times the fall in the other V's. If the other currencies were prevented from falling by more than a limited margin of w% because their NCB's were under an obligation to prevent a larger depreciation, sterling could appreciate by 4 w% in terms of Europas; and the sterling rate of exchange with the other European currencies would change by 5 w%. This could be prevented by the Bank of England being under an obligation to restrain the appreciation of Vs to a limit of w%, in which case the other currencies would depreciate in terms of Europas by only .25 w% and the total change in the exchange rate between sterling and the other currencies would be limited to 1.25 w%. Thus in terms of Europas the obligation by one country to limit the appreciation of its currency would in itself reduce the actual depreciation of other currencies and *vice versa*. However if one V appreciated from its par-value by the full w% and another V of a currency with an equal weight in the composition of the Europa depreciated from its par value by the full w% (all other V's remaining unchanged) the rate of exchange between the two currencies would change by the full 2 w%.

(iv) In case of crisis a NCB would have to be free to suspend its obligation to prevent a fall in the Europa value of its currency (if it were subject to an excessive loss of Europa reserves) or its obligation to prevent a rise in the Europa value of its currency (if it were subject to an excessive inflow of Europa reserves). Let us take the former case as an example. In this case, as shown in the previous paragraph, some limit would be put to the depreciation of the Europa value of the country's currency so long as the other NCB's intervened to prevent the appreciation of the Europa values of their currencies. In such a case these other NCB's would be confronted with the choice either to continue in this way to support the weak currency or to suspend their own intervention in Europas. In the latter case the European currencies would float to a new set of Europa values, resulting presumably in the setting of a new structure of Europa par-values.

(v) Under Paragraph (9) of this Appendix it is suggested that the ECB should be empowered to act as an exchange equalisation fund between the national currencies by altering

the composition of its holding of national currencies. Apart from the general arguments in favour of such an equalisation fund, the suggested nature of the Europa introduces a special need for such offsetting arrangements. Suppose that for some reason (other than the speculative motives considered in paragraphs 14 and 15 of the main text of this paper) holders of sterling balances wished to convert their holdings into Europa holdings on a larger scale than did the holders of balances in francs, marks, lire, and other European currencies. Suppose that someone with a sterling deposit in Lloyds Bank wished to convert this into a Europa deposit with Lloyds Bank. Lloyds Bank, I assume, would be required to convert part of its sterling reserves with the Bank of England into Europa reserves with the ECB in order to maintain a Europa reserve against its Europa liability. If the Bank of England had to acquire with sterling the mixed bag of currencies needed to obtain the required Europas from the ECB, the transaction would represent a capital movement from sterling into the other European currencies in the mixed bag. Particularly in the early years of development of the substitution of Europas for national currencies which might well from time to time progress at different rates in different member countries, it would be essential for the smooth operation of the system to allow for some offsetting of these implied capital movements. In the example given above it would not be inappropriate for the ECB to supply some Europas in return for sterling from the Bank of England.

(vi) Europa balances would come to be held by holders other than the NCB's not only by the straightforward conversion of European national currencies as described in the preceding note. People holding foreign currencies, including Eurodollars, might wish to hold Europas in which case the ECB, at its buying rate ruling at the time, would buy dollars for Europas. Finally, the ECB, by granting Europa loans for various European purposes, would put more Europas into circulation. It would be through the terms on which it granted such loans and on which it held deposits of Europas, together with the exchange rate which it set from time to time between the Europa and SDR's or the dollar, that it would influence and control European monetary conditions as a whole.

(vii) In the above formulae the Q's are fixed. But as time goes on, as a result of different degrees of price inflation or of real growth in the different EEC countries, the Q's may come to correspond less and less precisely to the GNP's of the EEC countries. It is an open question whether they should be open to revision after a period of years (ten years or so). This could be done by substituting one Q for another in the composition of the Europa at the current values in the foreign exchange markets (the current V's) so that there was no change in the Europa value of any national currency at the time of the change; but for future transactions the weightings of the various national currencies would be changed to bring them into line with current GNP's.

February 1973

The Objectives of Economic Union

I assume that the objectives of economic union should be economic and not political. The basic question should be: "In what ways can the economic welfare of the individual citizens of the European countries be enhanced by centralised European economic policies and institutions?". It should not be: "What economic institutions and policies can we conceive which will make it necessary to have a large and active centralised European political and bureaucratic machine?". Such institutions as a common customs tariff, a common agricultural policy, or a common currency should be judged on their economic merits as instruments for promoting economic welfare and not as political opportunities which necessitate jount action in putting up or down a duty, a price, or an issue of money. Indeed one of the dangers of European Economic Union is that it will simply add an additional layer of governmental control and regulation in a society which is already overregulated. We shall then have a fivefold hierarchy: - local government - national regional governments - national central governments - European government - world institutions (e.g. GATT, IMF, etc.).

But this need not depress those who do wish to use economic union in order to promote political union. For if one does start by asking what, if any, centralised European economic activities are desirable for economic reasons, one soon finds enough fields of action to satisfy the most enthusiastic proponents of political integration, though, as I shall suggest, the appropriate policies and institutions are not necessarily the same as those on which most stress is at present laid.

What then are the economic fields in which centralised European action is desirable on economic grounds? I give below my own catalogue raisonne.

(1) Marginal Efficiency. First and foremost are those economic policies which promote the efficient use of resources by making the most of the well-known virtues of the market price mechanism in equating social costs and values at the margin, so that resources are attracted from uses where the social value of their marginal product is low to uses where the social value of their marginal product is high.

Much, though by no means all, joint European action under this heading should involve the negative function of getting rid or artificial governmental restrictions - for example, the removal of internal customs duties and other regulations which impede the movement of goods and services between the European countries. This should result in a net reduction of European bureaucracy - a small central body to see that national obstacles are removed replacing the large national bureaucracies which were needed to administer the various national duties and regulations. If a net reduction of bureaucracy in these fields is not in fact taking place, it should be a major concern of our politicians to demand to know the reason why.

The economic advantages of free trade do not stop at the frontiers of Europe. The European Economic Community is now large enough to set the pace in international commercial policy. In my view it should now move by predetermined stages to a position in which it allows the free import of industrial products from all outside sources; and, as far as agricultural products are concerned, it should rely for the relief of inefficient European farmers

by simply adding an additional centralised European control to an existing set of national controls.

(iii) Third, there is the question of the harmonisation of transport charges. How far and on what principles should the charges for water, road, rail and air transport of the various European countries be harmonised in order to avoid inefficient distortions of the use of resources within Europe?

(iv) Finally, there is the question of the harmonisation of taxes, charges, levies, and other regulations for the control of pollution. Here is a relatively new and extremely important field for harmonised joint action. Europe is a sufficiently compact area for one country's polluting activity to have a direct adverse effet on persons in other European countries; and action taken to regulate pollution of a particular kind in one European country will be easier to take and more beneficial in its results if it is accompanied by similar action in competing concerns in other European countries.

(2) Structural Efficiency. Removing or harmonising taxes or other restrictions on competition is not, however, sufficient to ensure an efficient use of resources. Economies of large-scale production or of large-scale concentration give rise to the need for much more positive centralised regulatory action in order to ensure an afficient economic structure within which appropriate marginal conditions can operate to good effect. Precisely because these structural problems are due to economies of large-scale operation of one kind or another they cut across the national frontiers of a concentrated region like Europe and cry out for centralised European action. I must content myself with giving three illustrative cases.

(i) An outstanding example is the planning of a European transport network. It is not sufficient to harmonise correctly the charges that should be made for transport on a given network of waterways, roads, railways, and airports. It is also necessary to consider what is the proper network of waterways, roads, railways, and airports; and this obviously cuts across Eurpean national frontiers. For example, should the total European network be designed to take a given type of traffic in a given direction mainly by road or mainly by rail? Very difficult cost-benefit analysis is needed in the design of such a network; but clearly if any attempt is to be made at a rational solution, it must be on a European scale.

(ii) In some industries, such as nuclear energy and aircraft production, research and development, must be on a very large scale in order to be efficient. The scale may be such that joint action by European governments is required in order to obtain the necessary degree of concentration of effort.

(iii) Finally, one may instance the problem of regional planning. This again is a structural problem which calls for some governmental planning and regulation, which increasingly needs centralised European treatment. The creation of the free common market in Europe will itself increase the power of the existing central areas in Europe to attract a still greater proportion of total economic activity. But other industrial centres might well become viable of once they had grown to a sufficient degree of concentrated size; but where they should be and what neasures should be taken to create them are clearly

more and more on measure for the direct subsidisation of their incomes and on special measures to promote new productive opportunities for them and less and less on the restriction of imports. In so far as the EEC can obtain remissions of duties by other industrialised countries in return for such moves towards free trade, so much the better. But if necessary, it should take the decisive steps unilaterally. It will gain more from the more efficient use of resources than it might lose through any adverse movement in the terms of trade against it; its example would greatly encourage the cause of free trade in other industrialised countries; and free imports from all sources could be one of the most powerful checks to monopolistic practices within Europe by European industria lists.

This in an outstanding case in which it is wrong to use an economic instrument simply in order to promote the growth of a centralised European political and bureaucratic machine. It is wrong to maintain a common tariff on external trade simply in order that European politicians and bureaucrats may have something to put up and down together. Moreover, the abolition of the European tariff on industrial imports would not only allow a considerable reduction in the European administrative machine needed to run the common tariff; it would also shift the emphasis in the control of monopoly in Europe away from bureaucratic regulation towards the constraints of the competitive market place.

This view of the EEC's future commercial policy has far-reaching implications for the EEC budget. As I argue below, there are many reasons why effective steps towards economic union will necessitate a development of the central EEC budget. It is essential, therefore, to develop a source of tax revenue for such a budget which will replace the existing reliance upon import levies and duties - a reliance which in present conditions may constitute a serious impediment to the GATT negotiations for a most desirable freeing of world trade. In my opinion the VAT is the most promising fiscal instrument to develop for the EEC budget.

But marginal efficiency requires positive action in addition to the negative action of removing unnecessary artificial restrictions on market forces. Such positive action is needed in order to harmonise the conditions in which the forces of the market can operate. I must confine myself to a simple enumeration of four such fields for positive harmonisation, each of which is well-known but in each of which a great deal more work needs to be done.

(i) First there is the question of the harmonisation of rates of taxes and subsidies and of similar levies and payments (e.g. in the field of social security). Which of these need to be harmonised and to what extent, in order to ensure that the free movement of goods and services in Europe leads to an efficient use of resources rather than to an inefficient pattern distorted by national differences in taxes, levies, subsidies, etc.?

(ii) Second, there is the question of the harmonisation of the control of monopolies, of restrictive practices, and of excessive prices by producers in the various European countries. How far is it necessary or sufficient to harmonise the various national policies? Or is it desirable to supersede national controls over monopoly by a single uniform European control? Let us in any case avoid the danger of duplicating bureaucracies

matters which need planning on a European scale. Moreover, this problem of regional planning is a good example of the interconnection between the various European policies. The growth of a particular regional centre will clearly be much affected by the appropriate planning of the European transport network; and the proper imposition of pollution and congestion charges or other regulations in over concentrated central areas would give an incentive for growth and development in alternative less congested regions.

(3) Public Goods. Problems arise not only from economies of scale in the production of goods and services, but also in the case of "public goods" from economies of scale in the consumption of goods and services. The appropriate scale of communal consumption of a public good may well be European rather than national. Two examples must suffice to make the point clear.

(i) Governmental expenditures on defense are the outstanding case. It is hopefully inconceivable that the national defense forces of the members of the European Communities will be used to fight each other. Their only legitimate purpose is common defense against aggression from outside. By defending itself each member is thus contributing to the defense of the others. Much grater economies, efficiency, and fairness in burden-sharing could be obtained if defence forces were planned, designed, and financed on a centralised European basis. Any developments in this direction depend, of course, upon political objectives and decisions, but they would involve very far-reaching implications for the design of a European Economic Union, since they would require very far-reaching steps in the development of a centralised European budget.

(ii) A second less dramatic example is to be found in the possibility of a centralised European budget for the finance of research and development: I have already mentioned in 2 (ii) above that there is a case for the centralised European finance of research and development in cases in which the research and development must be carried out of a vary large scale in order to be efficient and effective. The case which I am now making does not rest on this. Consider a particular field in which research and development can be most effectively carried out on a small scale in a lot of competing laboratories and research departments. But it may well be that any advance made in a French laboratory is just as useful to German and British industrialists as it is to French industrialists, and vice versa. The efficient mode of operation in such a case is to pool the results of research; and this in turn calls for the pooling of the costs of research in a centralised European budget.

(4) The Distribution of Income and Wealth. One of the functions of national governments is to consider the effects of their actions and, in particular of course, the effects of their structures of taxation and of social security provisions, upon the redistribution of income and wealth as between rich and poor citizens. At first sight it might be thought the policies for the redistribution of income and wealth should remain a national concern; but on further consideration it becomes clear that in an economic union it may be necessary for redistributive policies to become a centralised European concern with important implication for the development of the centralised European budget.

Let me illustrate the point by taking a fancifully extreme example. Suppose that in one member of the union there were an extreme philosophy of social welfare involving extremely high and progressive taxes on the incomes and the property of the rich and extremely generous aid to the poor. Suppose that simultaneously in another member of the union there were an extreme philosophy of self-help and individual incentives with a minimal amount of redistributive finance. If completely free mobility of persons and capital were a principle of the union, then the rich, able, enterprising, and energetic members of the union would move from the "welfare-state" country to the "self-help" country, while the poor, feeble, unenterprising, and slack citizens would congregate in the former. The result would be catastrophically inefficient.

This problem of redistributive finance is thus in effect one aspect of the problem of the harmonisation of taxes and subsidies already mentioned in 1 (i) above. How far must taxes and subsidies be harmonised in order to cause the free movement of goods, services, and factors of production to lead to an efficient rather than to an inefficient, distorted use of resources? When one asks this question in the context of redistributive finance the implications for a centralised European budget can be very far-reaching. Let us take the extreme case merely for the purpose of illustrating the problem. Suppose that mobility of labour, enterprise, and capital is so great that there must be almost complete harmonisation of tax and subsidy rates on wages, profits, and interest in order to avoid the misallocation of resources. In this case with any given progressive structure of taxes and subsidies tax revenue will be high in those parts of the union which happen to be relatively rich and expenditures will be high in those parts of the union which happen to be relatively poor. In this case complete harmonisation of taxes and subsidies inevitably implies two things: first, the same redistributive policies in all the member states, since in each state there is to be the same rate of tax on the rich and rate of subsidy to the poor; and, second, a centralised union budget, since an excess of revenue over expenditure will occur in the rich member countries and an excess of expenditure over revenue in the poor member countries.

There are two further instances of redistribution which are relevant in this connection. The first concerns redistribution between present and future generations: a government which runs a large surplus on its budget is taxing the present generation to provide saving which will finance capital investment which will benefit future generations. The second concerns redistribution between rich and poor countries: The government of a rich industrialised country which raises revenue to finance foreign aid is in fact redistributing income between its own citizens and the citizens of the country which receives the aid. In so far as tax rates have to be completely harmonised in an economic union, redistribution between present and future generations and redistribution in favour of undeveloped countries, just as redistribution between the rich and the poor of the same generation in the same member country, would inevitably tend to become a matter for a centralised European budgetary concern.

I do not intend to assert that the actual situation is as extreme as this. The issue turns on the question of the degree to which tax-rates must be harmonised if there is to be complete freedom of movement of labour, enterprise, and capital within the EEC. What

I am asserting is that there is great need to examine the extent to which the required degree of tax harmonisation will imply that fiscal and other social measures for the redistribution of income and wealth must also be harmonised and become a matter for centralised European concern.

(5) Dempgraphic Policies. There is one further troubling case of the need to harmonise policies if completely free mobility of labour is to be a principle of the EEC. With a given population it is no doubt desirable that labour should move from points of low to points of high productivity, which – provided that taxes and subsidies have been appropriately harmonised – means movement from points of low to points of high income. But suppose that the low income is due to the fact that population is growing too rapidly in the low-income country, while the high income is due to the fact that population pressure is very moderate in the high-income country. And suppose that free emigration from the low-income country will remove the pressure on the authorities in that country to take steps to reduce the rate of growth of the population. Should free emigration be permitted to lead to the overpopulation of the high-income country? To what extent must population policies be harmonised before the free movement of factors becomes an operative principle of an economic union?

(6) Financial Institutions and Policies. Financial arrangements should be designed so as to make the achievement of objectives (1) to (5) above as easy as possible. They have no other function. I have already had my say on this question in my paper on "European Monetary Union" and I will not repeat what I have said there.

The greater the degree of economic integration in the EEC, achieved through freedom of trade and of factor movements, the greater is the need for a centralised coordination of overall monetary and fiscal policies in the member countries for the purpose of stabilising the economies of the member countries. For one member country's income will be increasingly spent in the markets of other members, so that domestic financial measures taken in one member country to regulate that member's economic activity will increasingly spill over and affect activity in other member countries. Thus coordinated action is needed for the control of total demand throught Europe.

To supplement such coordination of domestic financial policies for the control of total effective demand, the basic requirement is to devise a European monetary system which will help rather than hinder the free movement of funds from one member country to another. Such freedom of payments will be needed for the finance of the movement of goods and services, of capital, and of governmental funds into and out of the centralised European budget. My contention is that this will be best served by a considerable degree of flexibility in the rates of exchange between the national currencies, until much further progress has been made in economic harmonisation. In particular, we require considerable harmonisation of the institutions and principles which will enable relative wage rates to be varied in such a way as to maintain balance-of-payments equilibrium at fixed exchange rates. This, I need hardly emphasise, is not the same thing as equalising actual money wage rates throughout the EEC; on the contrary, it requires those inequalities in real wage-rates which are necessary for balance-of payments equilibrium between countries

with different labour productivities. We are nowhere near such harmonisation. So long as this is the case, the rigid fixing of exchange rates would inevitably lead to protective measures by deficit member countries and would thus impede rather than promote progress towards real economic union.

I would, finally, add one observation. There is a quite ridiculous view gaining ground to the effect that a proper European regional policy can act as a substitute for exchange rate variations. This is really nonsense. A European regional policy is most desirable on its own merits, as argued in 2 (ii) above. It may well help balance-of-payments equilibrium, since a country with severe regional problems may well simultaneously experience a balance-of-payments deficit. But even this is not certain. It is not in the least inconceivable that a country which has an overall balance-of-payments surplus as a result of a badly undervalued currency might at the same time have a serious regional problem. Indeed if Italy had not recently had a serious deficit on capital account in its balance of payments, it would have been a case in point with a strong surplus on current account combined with an outstanding regional problem. Indeed, who really believes that without any basic change in its ruling rates of wage-cost inflation the balance-of-payments problems of the United Kingdom could have been solved at fixed exchange rates over the last decades if only there had been a European regional policy on the scale which it is now reasonable to contemplate? At least let us avoid living in this particular Cloudcuckooland.

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A European Reserve Fund

Let us define the European currency unit (ECU) by the assets backing it. In the event of a breakup of the system the assets of the European Reserve Fund administering the pool would be distributed in exchange for the liabilities of the pool, the Europa itself. Thus the "intrinsic" value of the Europa would be no better than the weighted average of the reserves or currencies that the nations of Europe put in the pool.

The weights would be the actual holdings of the reserves. At the beginning, however, it is very convenient to establish quotas. Current European reserves of the Nine are about $ 50 billion, of which a little over $ 15 billion are in gold. If this sum were put in a pool it would be a larger reserve than is really necessary.

Europe now has more reserves than it needs if it joins together to form a monetary union. A pool of $ 30 billion should be sufficient and only half need be backed by external reserves (SDRs, gold and dollars) since a large fraction of Europe's trade is internal. This means that the nine countries should contribute $ 15 billions of their external reserves into the pool. Quotas would total $ 30 billion of which $ 15 billion would be national currency contributions and $ 15 billion foreign exchange.

The appropriate distribution of quotas could be established by negotiation, although a degree of arbitrariness cannot be avoided, and a simple method is to be preferred to a complicated procedure. I have calculated approximate quotas according to a formula that takes into account population, GNP, IMF quotas, variance of imbalances, etc., and arrived at the following reserve contributions:

	Reserve contribution	Quota
U.K.	3.0	6.0
France	3.0	6.0
Germany	3.0	6.0
Italy	3.0	6.0
Netherlands	1.0	2.0
Belux	1.0	2.0
Denmark	0.5	1.0
Ireland	0.5	1.0
Total E.	15.0	30.0

Each of the countries would earmark to the pool reserves of gold or dollars equal to half their quota, while the reminder would be paid in national currency. Countries would get in return for their contribution a deposit of Europas equal to their quota. Thus France would pay E 3.0 billion of gold or dollars plus an equal amount of francs and get in return a deposit of E 6.0 billion.

The balance sheet of the Fund would then look as follows:

The Pool's Assets and Liabilities

	Assets	Liabilities
Gold and Dollars	15.0	
Pounds	3.0	
DM	3.0	
FF	3.0	Currency
Lit	3.0	and
Guilders	1.0	Deposits
BF	1.0	30.0
Krones	0.5	
Pounds (Irish)	0.5	
Total E.	30.0	E. 30.0

Central banks would peg their exchange rates to the ECU in the same way they are now pegged to the dollar (or by a new method). They could gradually narrow the inside (intra-European) exchange margin, making the "snake" as thin as desired. The manager of the pool would control the outside (dollar or gold or SDR) margins by pegging the Europa to the dollar as at present (or by a new method).

Why Europa?

The Europa is the name we give to a common European currency. The benefits expected from EUROPA rest on political, social and economic foundations. Among the economic advantages one must include :

a) better monetary discipline and a lower rate of inflation arising from a decentralisation of monopoly pressures on the exchange rate;

b) the conveniences of a Europe-wide unit of account and medium of exchange;

c) a more efficient division of labour and capital achieved through the elimination of false pricing arising from disequilibrium exchange rates;

d) correction of perverse capital flows based on invalid speculation;

e) recouping of the seigniorage now accruing to U.S. banks or taxpayers;

f) stronger economic position of European financial firms (trust and insurance companies, etc.);

g) centralised control over continental reserves;

h) strengthened bond market position of national governments;

i) more efficient Europe-wide financing of export credits to third countries;

j) monetary independence from the U.S.;

k) improved Europe-wide quotations and advertising;

l) better harmonisation of social policies through use of a common denominator for social security, etc.;

m) improved continental advertising facilities and other price quotations;

n) convenience to travellers and tourists;

o) reduction in uncertainty concerning international trade and capital movements by reduction in exchange risks;

p) national use of a common credit pool;

q) efficiency of a continental approach to regional unemployment problems.

Among the political-economic gains one has to consider the stronger position of Europe in management of the international monetary system; the advantage of a common research and control center for the promotion of international monetary, trade, commercial, employment and development policy; and a new status for Europe in global politics.

Europe needs an institution for planning, determining and implementing a development policy for the continent as a whole, substantial enough in conception and resources to bring under one roof, _first_, Europe's _external_ economic policies on tariffs and trade, international monetary reform, foreign aid and capital exports policy, and foreign ownership policy; _second_, Europe's internal economic policies concerning regional underdevelopment, unemployment, monetary and fiscal problems, tax

harmonisation and competition structures. Some of these policies are now implemented within the existing institutions and some of the infrastructure, personnel and facilities already in operation could provide inputs for the new institutions.

Detailed arguments for EUROPA have been noted above and do not require iteration. The short-run exigencies converge, however, with long run desires. There is a need for monetary independence from the U.S. dollar. If the U.S. economy recovers from the 1970-2 recession its balance of payments can improve, reducing the sense of urgency usually needed to establish the environment for a monetary agreement. But the exchange crises will recur if the momentum of the U.S. recovery is not sustained or if the European economies change direction.

Uncertainty over exchange rates is certain to continue until there is a reintegration of the two gold markets in a gold convertible system, or else a serious investment made into a world currency. Failing agreement on these matters the case for a Europa as an alternative protection against further crises seems overwhelming.

There are several problems that need to be dealt with. There is, first, the establishment of a convention on a numeraire, or unit of account. There is, second, the need for agreement on the intervention system for fixing European exchange rates to one another. There is, third, the need for a system for fixing the relations between the European standard and that used in the rest of the world. Finally, there is the need for ensuring the adequacy of the world monetary system in which the European system will operate and other issues associated with international monetary reform. These subjects will be taken up in turn, and then we shall conclude with a specific plan for a European Reserve Fund.

1. The Numeraire Problem

The numeraire problem relates to the use of a unit of account and involves both informational and contractual elements. For purposes of quotation a convention is sufficient because it involves no committment. But the stipulation is important in substance because it implies a statement contracts over time and would affect real resources in cases where exchange rate changes are involved. The first step, therefore, is to make the convention.

In practice, however, it must be recognised that the establishment of a convention almost invariably leads to the use of the same instrument for quotation and contract purposes. If this is borne in mind at the outset the establishment of the convention must be recognised as important also in substance. Two "natural" choices are the U.S. dollar and the SDR (or its gold equivalent). A third alternative is one of the European currencies, such as the pound, franc or mark or lire. A fourth possibility is an outside currency such as the Swiss franc. A final alternative is a unique unit independent of any now existing.

The adoption of the dollar as a transitional unit of account has much to recommend it because of its current use as the intervention currency and the most important unit for indexing of bonds and other future contracts. Because it is the currency of an alien government it has the further merit that it could not become the final choice. Europe would not be content in the long run with the use of a foreign national currency as its own unit of account.

The name of the common European numeraire involves no issue of principle, except that it is desirable, not to foreclose at the outset the use of names that have been associated with past proposals and plans. For purposes of this contribution, therefore, we shall use the non-committal designation of the "European Currency Unit" or ECU reserving for the final name the more durable designation EUROPA or EUROR associated with other plans. The ECU is thus simply the name the European governments use to designate their common transitional unit of account, it being understood, that any committments expressed ECUs reflect the value of the US dollar.

The solution of the numeraire problem is thus postponed by the temporary use of the ECU as a transitional device. Its accounting value is the local currency equivalent of a US dollar.

The long run presents many alternatives, beyond those listed above. The suggestion I propound is that the Europa be defined as 10 grams of the precious metals (silver, gold and platinum). The proportions of the three metals in the Europa could be altered every decade or so by an act of the European Parliament should new scarcity relationships emerge. The theory governing its value is closely related to the ingenious invention advanced in Professor Meade's plan of January 1973, except for the substitution of papers by metal.

2. The Exchange Rate Problem

The exchange rate problem is best divided into two parts. The first part is the choice of methods for maintaining inter-European exchange rates. The second part is the method of fixing rates with the rest of the world. Our first concern is the choice of method for fixing European exchange rates to one another or to the ECU (x).

There are several methods of fixing exchange rates of a bloc of countries to one another or to a common unit. A centralised system is to have an agency possessing stocks of national currencies and ECUs to buy and sell the national currencies at the prescribed limits. A decentralised system is to have each central bank fix the common

(x) Exchange rates have time specifications. Forward exchange rates cannot be neglected since they play a vital role in the short and inter capital markets. The function of an exchange parity is to establish a central bank's committment to defend a given exchange rate policy over a reasonably long time interval, to guide, over the planning period, institutions, firms and groups making decisions that rely on the deferred contracts. Floating rates or frequently-adjustable parities amount to a relaxation of the central bank's committment as to future exchange rate policy and opting out of guidelines for the private sector. In what follows I shall assume that countries adopt a specific parity policy except insofar as this is altered by multi-national agreement.

rate within the established margin. A contrained system is to have the central agency sell national currencies when the ECU is weak, and for the national banks to sell the ECU when the national currency is weak. A permissive system is for the national banks to support the ECU when it is weak (against a particular national currency), and for the ECU Agency to support the national currency when it is weak.

Of these systems, the most invulnerable to speculative attack is the permissive system. The currency chains can never be broken as long as each participating member can provide its own currency to the exchange market, and as long as the ECU Agency has sufficient ECUs to dispose of. Its major advantage, therefore, is that it can withstand any speculative attack on the currency no matter how large. In short it would end at once all those elements of unstabilising speculation except those based on deliberate uncertainty created about the exchange rate policy of a member. As long as there is agreement on what the exchange rates should be the exchange rates can be held.

The permissive system is the only foolproof system and it is therefore the best for a group of countries willing to cooperate. This does not mean, however, that it is sufficient in and of itself. It is subject to abuse if one or more countries followed such an expansive monetary policy that their currency was in perpetual excess supply in the exchange market. This would mean that the ECU Agency would have to build up assets of the weak currency. Since accumulations of this sort, if they became persistent, would involve implicit extensions of credit from other members to the deficit member, or, alternatively, inflationary pressure in the region as a whole, inhibitory measures would have to be taken.

One inhibitory measure is what Americans call "moral suasion". The Committee of the Agency could caution the deficit member about further inflation. Multinational surveillance of the balance of payments at the end of each month would provide the knowledge upon which the Committee should act.

Moral suasion has the disadvantage of bad taste, however, and it may also involve a greater use of interference with internal problems of the policy of the member than is considered desirable at this stage of the integration process. A more objective method would be to establish a penalty system for overdrafts. The Agency could charge interest on accumulations of a country's currency beyond an agreed limit. The interest rates involved would have to be left to negotiations, but they should :

a) bear some relation to market interest rates (which should also reflect interest premia);

b) rise automatically as deeper tranches are utilised; and

c) be contingent on security instruments (collateral) against any subsequent alternation in exchange parity.

In this way the system cannot be subjected to abuse through inflation without automatic compensation to the other members. At the same time it allows a country

considerable discretion over the timing of their own adjustment.

The intra-European component of the exchange rate problem is therefore solved by the committment of each member to support the ECU when the ECU is at its lower limit (or sell the national currency at its upper limit); and by the reciprocal committment of the ECU Agency to support the national currency when it is weak. This mutual support system is the only "foolproof" system for guaranteeing absolutely the viability of the exchange rate system. It could only be abused if the interest rate policy of the ECU Agency was too lax and failed to exact due compensation from overly-inflating members (x).

The ECU and the Dollar

The dollar is a viable currency in use on a world scale at the present time. The ECU, we assume, is still in the planning stage. For this reason international negotiations would be required in order to establish the conditions for monetary cooperation. Initially, the ECU Agency may have to accept a temporarily subordinate role until it establishes itself. In other words, they may have to maintain the value of the ECU with respect to the dollar on their own initiative by stabilising against the dollar. The Agency would then be in a position analogous to that of an individual member using the dollars, as at present, as the intervention currency.

In the longer run, however, it may be desirable to work for an agreement between the ECU Agency and the Federal Reserve Board analogous to that proposed for inter-European relations, by which the Agency supports the dollar when it is weak and the Federal Reserve Board supports the ECU when it is weak. The advantage of this mutual support system is, as before, that it is again foolproof in the sense that no amount of speculation can prevent the two monetary blocs from maintaining the exchange rate that is mutually agreed upon. The maintenance of such an agreement would be contingent upon cooperation between the two authorities. At the end of a settlement period excess balances can be cancelled, and any net credits settled in reserves of the other authority.

The Monetary Reform Problem

Although cooperation in the field of international monetary arrangements is the desired system, it needs not involve direct intervention between the ECU and the USD. Indeed, because several countries may not wish to peg their currencies directly to either the (USD) US dollar or the ECU, it is desirable to have a world currency ca-

(x) It should be noted that the principle of supporting the weak currency is not new; it was used in the early experiments with exchange equalisation funds after Great Britain floated the pound in 1931. The British problem was how to use the resources of their exchange equalisation fund to support the franc or the dollar and the outcome of the discussions engendered was that the fund should support that other currency which in the short run was weak. In the longer run, of course, such support operations could only be sustained if the interest rate in the weak center was sufficiently high to reflect the cost of capital and if there was assurance against losses from exchange rate changes. A second and related problem arose early in the operations of the International Monetary Fund. Agains, the same solution emerged and is, I am told, discussed in one of E.M. Bernstein's early papers in the IMF, not available to me at the time of writing.

pable of performing this function. The IMF has its own candidate as a world money in the form of the SDR. But the SDR is not satisfactory in its present state for well known reasons (the gold guarantee, the reconstitution provision, the deficit criterion and the designation system). It must be modified before it can be adapted to the role of a world currency. I shall thus refer to the modified SDR by the non-committal term, International Currency Unit or ICU.

The problem now is how the ICU should be related to the ECU and the USD. Again, however, we can apply the same principle that we have adopted in the earlier analysis. The US or the ECU Agency can maintain their own exchange rates vis-à-vis the ICU, at specified margins, or a cooperative arrangement can be established. Again the permissive system is the most effective in ensuring a given exchange rate parity. To make such an agreement effective at the international scale, however, a strict enforcement of credit rules would have to be made. Because the willingness of the world to concede to a world authority sovereignty may act as a barrier against the use of a permissive system, it may be necessary to depart from the general rule and keep the burden of maintenance of parity on the national or continental states. The burden of convertibility of the ECU into the ICU would then be borne by the Agency of the ECU. The burden of convertibility of the USD into the ICU would be borne by the United States. And the burden of convertibility of the other currencies would be borne by the national currencies involved. This means that each country would have to maintain, as they do at present, adequate international reserves to enable them to fulfill their convertibility requirements.

The Global Restraint Problem

What is the mechanism by which global restraint is maintained sufficiently to prevent world inflation? The answer is, of course, inhibitions of excess money creation. This restraint is provided by the requirements of convertibility. Countries need an ample supply of reserves, where "ample" means sufficient to maintain credibility of the convertibility of the currency, assuming appropriate monetary policies. The solution to the problem of international monetary reform presupposes the creation of a mechanism for generating sufficient liquidity.

But the international monetary system cannot be excessively elastic in the sense that world monetary reserves are created through the balance of payments deficits of a particular member's currency, as they have been in recent years through the balance of payments deficits of the reserve currency countries. A measured increase in global reserves is needed to meet the needs of a growing level of international trade. No one can predict the rate of growth of international trade in the future. But it is hardly likely that it will continue to grow at the same rate it has in the past. There is a natural reason for this insofar as much of the past increase in trade was needed to overcome the backlog created by the inhibitionary effect of trade barriers that have now been substantially reduced. But the growth of world capital flows has created a new avenue by which factor flows have increased self sufficiently. For this reason future international trade will expand at a slower rate in real terms than it has in the past.

Even so world reserves will have to grow at a rate equivalent to about 5 % of reserves. Given the current level of international reserves of about $ 150 billion this means that about 7.5 billion ICUs will have to be created annually once a corrective system is implemented.

The European Reserve Fund

The ECU would be, like any currency, on better than the assets backing it or the goods into which it is convertible. It is best to start with a pool of exchange reserves. The pool establishes confidence in the new currency from the outset even though it is in the long run not necessary to support its value in the exchange market. It is also useful for stabilisation purposes and to ensure the "fallback value" of the currency in the event of withdrawal of one or more members. Thus the ECU would have both an "intrinsic" value and an "extrinsic" value; the former based on the assets backing the currency, the latter on the "moneyness" it acquires as it becomes acceptable as a medium of payment. The time period required to convert intrinsic value into extrinsic value may be very short, however, which is a measure of its success.

At the beginning it is very convenient to establish quotas to determine the size of the pool and for voting purposes. Current exchange reserves of the Nine are over $ 50 billion, of which a little over $ 15 billion are in gold. If this sum were put in a pool it would be larger than necessary.

Europe now has more reserves than it needs if it joins together to form a monetary union. The size of the pool depends on the demands made on it and the scope for expansion of its liabilities. A pool of $ 30 billion would be ample for almost any conceivable purpose and only half need be backed by external reserves (SDRs, gold and dollars) since a large fraction of Europe's trade is internal. But a much smaller pool is sufficient if the mutual support exchange system is adopted. Let us suppose the nine countries contribute $ 5 millions of their external reserves into the pool. Quotas would total $ 10 billion, of which $ 5 million would be national currency contributions and $ 5 billion foreign exchange.

The appropriate distribution of quotas could be established by negotiation or by a formula involving, say, population, IMF quotas, etc. Assume the following initial reserve contributions:

	Reserve contribution	Quota
UK	1.0	2.0
France	1.0	2.0
Germany	1.0	2.0
Italy	1.0	2.0
Netherlands	0.33	0.66
Belux	0.33	0.66
Denmark	0.165	0.33
Ireland	0.165	0.33
Total E.	5.00	10.00

Each country would earmark to the pool reserves of silver, gold, platinum, SDRs or dollars equal to half its quota, while the remainder would be committed in national currency. Because gold is underpriced a special official European shadow price of gold should be set above the official price as a preliminary arrangement until a satisfactory international solution to the undervaluation of gold is found.

Countries would get in return for their contribution a deposit of ECUs equal to their quota. Thus France would pay E 1.0 billion of gold or dollars plus an equal amount of francs and get in return a deposit of E 2.0 billion (x).

The Balance Sheet of the Fund would then look as follows:

EUROPEAN RESERVE FUND

	Assets	Liabilities
Gold, SDRs and Dollars	5.0	
Pounds	1.0	
DM	1.0	Currency
FF	1.0	and
Lit	1.0	Deposits
Guilders	0.33	10.0
BF	0.33	
Krone	0.175	
Pounds (Irish)	0.175	
Total E.	10.0	E. 10.0

Central banks would support the ECU at its lower limit, and in return the ECU Agency would support each currency at its lower limit. If a country began to be in persistent surplus or deficit it would gain or lose ECUs and would eventually have to adjust. The inside (intra-European) exchange margin (the snake) could be made as thin as desired.

The manager of the ERF would control the outside (dollar or gold or SDR) margins by supporting the dollar at its lower limit while the US Fed would support the ECU at its lower limit. Again persistent deficits or surpluses would require adjustment.

After international monetary reform was arranged, each Continental currency would support the ICU at its lower limit and the world monetary authority would support the dollar and the ECU at their lower limits, using the same mutual support systems. In this way the currency alliance could never be broken.

(x) The Fund might also be permitted eventually to accept certain heavier commodities in lieu of currencies or precious metals when these were in substantial excess supply (e.g. claims on wheat, steel, coal or oil reserves), and a stockpiling of specific items could be justified on economic grounds.

Use of ECU as a Fiscal Device

It may be better to launch the ECU as a non-bank currency. National commercial banks would continue to use national currency as reserves. The ECU could be used, however, as a pocket currency by tourists and travellers to replace US dollars. There would also, no doubt, be local demand. It could be declared legal tender for all public and private debts. This would ensure its acceptability at the outside once its value in exchange was established.

The ECU could be distributed directly by the Agency as payment for expenses of the European authority; for regional developments; for the European University; for environmental control; or any other collective purpose. Alternatively, it could be distributed to governments which could then use it for national programs. The money would then be introduced into the payments stream. Because of economic growth the ECU would have to be increased every year and the proceeds from the issue would represent a substantial source of seigniorage and spending power for the European institution. Like a tax the power of issue represents a source of finance. But unlike a tax it involves no sacrifice of real resources on the part of the taxpayer, at least insofar as the ECU replaces US dollars rather than national currencies. But over and above these substitution effects (replacing dollars and national currencies) there is a pure utility creation analogous to the gain a community experience when a new invention is introduced.

To calculate the revenue power of the ECU as an annual tax it is helpful to express the variables symbolically and attach representative values to them.

Let G be the spending per year financed by the ECU and let R be the quantity of ECUs outstanding. Let the total European money supply be represented by M. Then if the ratio of income to money is V, we have

$$MV = PO$$

where O is output and P is the price level. Then it follows that

$$\frac{M}{PO} = \frac{\pi + \lambda}{V}$$

where π is the rate of inflation and λ is the rate of real growth. Now if α is the fraction of ECUs in the European money supply so that

$$R = \alpha M$$

the revenue potential of the ECU as a fraction of Gross Community Product is

$$g = \frac{G}{PO} = \frac{\alpha(\pi + \lambda)}{V}$$

just as a result of the growth of money income. This does not calculate the revenue possibilities arising from the initial (once-for-all) issue of money at the commencement of the plan, which is also a source of revenue.

Looked on as a revenue measure the system is highly productive. For let us assume "typical" values of π = .05, λ = .05, and V = 2.5. Then if the ECU becomes even 10 % of the European money supply, we have the fraction of annual revenue equal to g = .004 or 0.4 % of Community income. This amounts to more than $ 3 billion at current levels of the total product and is a substantial figure compared to the current budget of the Community. Looked on as a source of finance the enterprise, even on cautious assumptions, is a highly profitable venture.

The prime economic gain from the establishment of the ECU, however, goes far beyond its use as a source of revenue. For it opens up the possibility of creating incomes in ways not before anticipated.

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Document written by Professor W. Neubauer

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Alternatives to the Wernerplan

1. Introduction

On the eve of the proposed transition to the second stage in the construction of the European Community, views on the shape to be given to integration policy in the period ahead are divided. Is there to be a phase of consolidation which would include moves to make up the omissions of the first stage? Or should, on the contrary, a major step forward be attempted in certain areas recognized to play a key role, a step not envisaged for this point in time under the stage-by-stage schedule of the Wernerplan? Or have recent political developments opened a way to integration policy which did not seem to exist (any longer) in the past decade and which makes the prependerance of economic policy among the instruments become obsolete?

2. Integration strategy of the Wernerplan

In all these views long-standing doubts are spelt out more or less clearly: can the future still be expected to bring major progress if we rely on the integration strategy of the Wernerplan, i.e. on progressive coordination of national policies and harmonization of national objectives and instruments, hoping that these will converge into what eventually would also be institutionalized political union? The Wernerplan started from the assumption that the political resolve to unite was strong enough to enable progress to be made - at least gradually - in coordinating and harmonizing economic policy, particularly if on balance all member States derived some benefit from the arrangements. This gradual process was expected to be self-reinforcing, every step making the next easier and in a way more natural.

Harmonization, which also means homogenization, has produced good results - not only those of customs union. But many of these results have been achieved outside the arena of high-level politics and are therefore quite often dismissed with a smile as harmonization of axle-weights and preserves. Such irony is misplaced because all measures making national frontiers easier to cross in everyday life are in themselves a contribution to breaking down national barriers in the minds of people.

In the central issues of economic policy, however, coordination has made little if any progress. The integration achieved so far has failed to trigger off or boost integration where formation of the political will is concerned. The integration strategy of the Wernerplan comes up against its limits as soon as the national States' autonomy in so-called "vital questions" is affected. And the number of "vital questions" is surprisingly large. Serious coordination of national economic policies cannot create the will to achieve overall political integration but presupposes it.

In addition, the efforts made under coordination and harmonization policy have so far been hampered by a lack of clarity in the concept. Is it community of economic policy objectives or unification of the instruments that is to be given priority?

A policy of common objectives (in the areas of short-term economic policy, growth policy, incomes policy, etc.) which would have to create a sufficient measure of economic and social equilibrium in Europe could perfectly well manage with

instruments of a national character. This policy would presuppose jointly-concepted decisions by the governments.

A policy of unifying the instruments, on the other hand, leaves room for widely diverging objectives. For example, two countries with similar sets of monetary policy instruments may give price stability or full employment completely different priorities. The advantage of similar sets of instruments is that comparative assessment, and hence coordination, of the monetary policies of the two countries is made easier. If the instruments are not only made similar but also used to the same extent quantitatively (e.g. by introducing not only the same tax system but also the same tax rates), the ideal pursued is that of the centralized unitary state. Harmonizing the objectives and effects of policy in the various member States or regions would generally seem incompatible with such an approach. Because of the unequal distribution of resources, homogeneity of the European area in respect of the politically created ("artificial") conditions of engaging in economic activity cannot be achieved at the same time as homogeneity in respect of the economic and social situation. But a policy differentiating between regions need and should not stop at today's national frontiers.

Pressing for common objectives and similarity of instruments at one and the same time appears to be an almost impossible task, not only politically but also from the angle of economic analysis. During the period of transition to the final stage of European integration, there should be freedom to concentrate on one of the two approaches. A policy of common objectives,were it possible,would certainly do most to strengthen the sense of common European identity. But it is precisely the discrepancies between the European countries' views on economic and social objectives that today constitute an almost unsurmountable obstacle to further integration, at least as long as there is not the impact of unifying forces of a higher order. An examination should therefore be made of whether another serious attempt to use coordination and harmonization policy could not consist in unifying certain economic policy instruments. Not suitable for such an attemp are all those instruments which are too closely bound up with concrete objectives of economic and social policy; this includes the tax system and the pension insurance system.

A not quite unrealistic idea would be to try to unify the instruments of monetary and credit policy (including the character of the relationship between banks and central banks). A more difficult but not completely utopian proposition would be to try to induce the nine governments to present their draft budgets at roughly the same time, to keep the budgets uniform, to agree on a common functional structure for the budgets - or on joint functional processing of official budgets - and to work out a common system for the economic assessment of the individual budget items. A delicate but not unreasonable idea would be to achieve greater unification of the statistical methods of calculating figures such as the price indices and the national product. All this would and should not impringe upon the existing autonomy of national policies while throwing more light on the situation and developments in the individual countries. Coordination of economic policy measures - wherever and whenever the resolve is there - would be considerably facilitated and its effects easier to assess.

Should these modest efforts in the forecourt of coordination proper fail in the same way as did the attempts to harmonize objectives, then the strategy of coordination and harmonization should once and for all be regarded as abortive and dead and a new strategy would have to be found.

3. Alternatives to the strategy of the Wernerplan

The not very favourable assessment that must be made of the prospects for integration policy under the Wernerplan has made it expedient to look for approaches to integration which would suffer less from the dilemma proper of the Wernerplan, which is to presuppose an active general political will to unite, and not to focus attention on it expressly and not to accept it in its implications. Escape from this dilemma may be in two directions. There are two possible solutions to this dilemma.

One means finding effective integration measures believed to hinge as little as possible on the governments' active general political will to unit. This is the direction of the "common funds policy" and of the moves to speed up "monetary integration" - where necessary relieved by "economic integration" - and especially of the introduction in Europe of a common parallel currency. Both schemes, however, deserve the integration label only where they involve more than disguised claims of the partner countries on each other, without any readiness on the part of the beneficiaries to advance on the road to European unification.

a) The common funds policy

The establishment of European funds with Community tasks (e.g. monetary fund, regional fund, structural fund, social fund) could in principle have two positive effects on integration:

1) in providing assistance prompted by solidarity, the funds help to remove, in the member countries, existing sources of economic and social disruption and undesirable trends which upset the necessary equilibrium in Europe and prevent the countries from complying with common European requirements and rules (the regional problem in Southern Italy is one example);

2) within the framework set, the funds are administered by European Community institutions and therefore directly pursue European policy and take decisions from a European point of view. The less the states interfere in the current business of the funds and the more they see their interests safeguarded by the statutes laid down for them, the more these funds constitute European institutions taking their own action, and as such help shape the sense of European identity.

But the dilemma of these funds is that their practical effectiveness and their room for manoeuvre will be in inverse proportion to their political independence. If the monetary fund is assigned wide-ranging tasks in the field of foreign exchange policy, and if the regional fund is to initiate and finance comprehensive development programmes, then the strong influence on economic policy enjoyed by these funds and the large financial needs to be met from national resources will hardly make it possible for the states to

refrain from exerting political influence on them. The decisions on how to raise and use the resources of large funds will certainly put the resolve to further the European Community to the test and will show up the discrepancies in the views taken of the objectives. It will not be possible then to "depoliticize" the integration efforts. Should the states still be willing to pay large sums into regional, structural, social and other funds that took politically independent action, because they hoped that the belance of give and take would be in their favour, or because, in doing so, they wished to buy themselves out of more disagreeable political obligations, there would be the threat of a paradox of the common funds policy. The more successfully these funds worked in their special fields (for instance regional development or balance of payments adjustment), the more they would be likely to relieve the national states of their most pressing economic worries (with their sovereignty left intact), reducing the need for them to rely on help prompted by Community solidarity and giving them less incentive to surrender their sovereignty.

The awkward consequence is that it does not matter whether the common funds are allowed to operate in a "depoliticized" manner or not, for in either case they will fail to fulfil their true task. In one case they will help to consolidate the existence of the national states instead of overcoming it, and in the other they will founder on the same difficulties on which the strategy of the Wernerplan founders. Any number of funds will not bring forth a united Europe. However, assuming a comprehensive general political will to unit, funds could be extremely useful tools.

b) Bringing forward monetary integration

Member countries' short-term economic policies and growth policies have so far proved impossible to coordinate effectively. The order of priority for the various aims of economic policy - especially price stability and full employment - varies too sharply from one country to another. This means that the central element of what is being referred to as "economic union" is not capable of functioning. But this is by no means the only obstacle; if a compromise were struck over the objectives for short-term economic policy, there would soon be equally wide discrepancies between the views on how to attain these objectives. Regulative and procedural policy is also a matter in dispute.

In this awkward situation the hope had been that "monetary union" would have a better chance of making progress than "economic union". This hope implies the belief that it would be possible for "monetary integration" to be temporarily cut loose from "economic integration" together with its coordination and harmonization requirements which have so far proved impossible to meet. Another factor arguing for bringing forward monetary integration is that the instruments of monetary policy are easier to handle technically than those of wide-ranging "economic policy". Lastly, the emergence in recent years of a new recognition of the key role of money also helps to foster confidence that politically and technically uncomplicated "monetary integration" would not only facilitate "economic integration" but would virtually bring such

integration in its wake, or would at least lead to the establishment in Europe of a central "monetary authority; which would be a powerful focal point for all further integration processes. Fully in line with this thinking is the conviction that the introduction of a new common European currency would give a particularly effective impetus to such a development. This is the rationale of claiming priority for the procedure of "monetary integration", leaving out of account for a moment that in the political tug-of-war over this matter isolated national interests are also at work. Here too an attempt is being made to "depoliticize" integration as far as possible, which means dodging the central issue of the European Community, the degree of the readiness to go for general political integration. That this attempt too is bound to fail is obvious, more obvious still than in the case of the common funds policy.

The very idea underlying this strategy is odd enough. Monetary policy is an integral part of economic policy in the broad sense. The currency of a country can certainly not be manipulated in isolation from the other economic policy processes. This is particularly true if monetary policy is taken to mean "external monetary policy;", that is monetary and credit policy at home is deemed to belong to economic policy "shelved for the time being".

Hoping for this surgical separation to succeed becomes even more questionable when at the same time it is forecast that at a later stage of developments "monetary integration" will eventually entail "economic integration", or even bring it about by force. It would appear that these two theses are incompatible.

Added to this there is the strange view taken of politicians' psychology. If national governments are not prepared, in the foreseeable future, to coordinate the economic policies of their countries, how then should they be ready to initiate a development which in two years' time would force them into this very coordination? One cannot ask governments to pull the wool over their own eyes.

The plan for isolated "monetary integration" will be of little use to European unification, while, handled badly, it can be harmful to many Europeans. This is particularly true of the idea of a new European currency. What one is to think of it depends entirely on its practical shape. There are proposals for such a currency which give it little if any chance of really being traded throughout Europe but which make it the source of a torrent of additional inflationionary liquidity and confer upon it the doubtful merit of financing the European Community's budget and all European funds through the straight creation of money.

"Monetary integration" and "economic integration" must make parallel progress. Although this decision by the Paris Summit Conference is among other things a political compromise, it is not just a political compromise but a conclusion drawn from the interdependence of economic systems and processes. Monetary policy provides no occasion for depoliticizing the integration efforts.

c) Political union - ultimate goal or the next step?

Attempts to reduce European integration policy to technical arrangements glossing over the basic political divergencies between the countries are doomed to failure. It has become evident that "the economy" does not, as was once believed, produce mechanisms outside the realm of politics, which make for automatic progress in integration and eventually create, as a sheer imperative of reason and common interest, the general political will to unite.

The way out of the dilemma of today's integration policy should be sought in another direction: progress in general political unficiation must not be regarded as a last remote goal but must be viewed as the step to be taken next. There will have to be a general realization that, in the process of European unification, economic policy has by no means always and necessarily a claim to primacy and that it is not economic policy alone that must be held responsible for the stagnation in unification. In certain historical situations, for instance, external and defence policy will be able to exert stronger integrating effects than economic policy. But the real crux of the matter is that Europe must take the supposed last step before the supposed first. It is necessary to aim directly at a common European legislature and executive. This will certainly not be achieved immediately. But the thinking and action of politicians will be focused on the real centre of events which in any case controls all major developments in individual fields. This will be the parting of the ways. Should it become evident that there was no prospect for general political integration of this kind, then it would be certain that there was no prospect for economic and monetary union either. A key element of general political unification would be unified external and defence policy. Given the world political situation, this is an imperative of sheer reason, if there ever was one. At all times, defence agreements have been the most obvious and natural links between states. And such defence agreements have always involved obligations and reduced the parties' own room for manoeuvre. This has been accepted and would, on a higher level, have to be accepted by the European states as well. It seems absurd, not only from an external political but also, and especially so, from an economic point of view that following the failure to set up the first European defence community no new and serious attempt should have been made in this field. If the Member States in the Europe of the seventies are unable to agree on integrating their defence, how much more improbable is then a genuine economic and monetary union.

The picture of a politically united Europe should be kept free from certain repulsive features. United Europe should not be a centralized unitary state in which the pattern of economic, social and cultural policy is the same from Hamburg to Palermo. The political organization of Europe would certainly not have to be guided by the models of the nineteenth century. Today's national states will presumably defend their sovereignty the more vigorously the more unmistakably they are reduced to more administrative districts of a super-state that has all the features of a traditional centralized unitary state, including insistence on uniform arrangements for all re-

gions, the intolerance shown by majorities vis-à-vis minorities seeking to preserve their separate identity, preferential treatment of "metropolises" and discrimination against the "provinces". Europe's political scientists and specialists of public law are called upon to draw up new forms of political organization which meet the unique requirements of European integration and hence give the central authority the powers to pursue a unifying and community-shaping policy while leaving enough room for the special features people still cherish so that they do not have the feeling of being annexed.

Going directly for a European government or admitting that integration is impossible to achieve - is this not an invitation to confirm openly the failure of integration policy and to abandon the idea of a united Europe? Should political union turn out to be a utopian idea for present-day Europe, it would indeed be better to return to a policy of good enighbourly relations and sound alliances and wait for better times for Europe yet, implicitly, worse times for the European states.

But it would seem that precisely today political union for Europe is less of a utopian idea than it was in past years. After the end of the second World War the movement to create a united Europe was essentially impelled by two motives. First, there was the need to link the European states in a system of mutual dependence which would make new serious conflicts impossible from the outset. Secondly, fears of a military threat from the East caused the European states to draw closer together. Both motives for unification in Europe lost their political force in the 1950s and 1960s. Western Europe enjoyed a period of almost undisturbed calm so that the demanding job of welding the European stated into a system of mutual dependence did not seem worth the effort. The feeling of being threatened from the East diminished as the policy of détente was making progress.

In 1973 a situation has arisen which again favours integration and is curiously related to that immediately after the second World War. Europe again has the feeling of being put under pressure from the outside, by a world power: but this time by the USA. Both the economic challenge and the uncertainty surrounding the United States' future military presence on the continent make the political situation in Europe appear in a new light. The cooler climate in transatlantic relations has changed the thinking of Europe's politicians. Dissociation between the USA and western Europe was speeded by Franch policy. And the German government's Ostpolitik has given the partners in the European Community the impression - however unjustified - that the Federal Republic could be tempted to loosen its close links with western Europe in favour of a middle position between East and West. The threat of this unwelcome development for western Europe could be precluded by speeding up political union of the states in the European Community.

The strains which have thus developed in Europe's relationship with both West and East are a political novelty. They smooth the way for general political integration in Europe. These strains are a source of concern to many European politicians,

but removing them is not in the interest of European unification. This is because it is only under the pressure of strains and unrest, of crises and threats that the European national states' opposition change can be overcome. This being so, any political and economic consolidation in Europe means strengthening and perpetuating the national states. The European states will either choose European union as the lesser evil or it will be long in coming.

Monetary integration without economic integration - an opportunity for unification in Europe?

1. Introduction

In the final stage of economic and monetary union there will be a uniform economic policy in the broad sense, the task of which will be to coordinate the requirements of so-called "economic union" with those of "monetary union". Unless the allocation of responsibilities is unsuitable, this coordination will raise no problems other than those customary in a federal set-up.

But the problem at the moment is not the Community's organization in the final state. The discussion is about the integration strategy for the period of transition, i.e. for the next few years. Here, opinions diverge. One side argues that monetary integration should, at least where procedure was concerned, be given priority because this field offered better prospects of progress, as was borne out by developments. The extremely laborious measures to establish so-called "economic union" (common short-term economic policy, growth policy, incomes policy, social policy, competition policy, etc.) were, for the time being, urgent only because progress on the road to so-called monetary union had to be supported. Another side takes the view that isolated monetary integration is not practicable; where implemented it would do more economic harm than good. Progress on the road to "economic union" would have to come first. This progress, however, would have to be supported by common measures of monetary policy. Only substantial progress towards economic union would create the conditions essential to true monetary union.

In truth the gap between the two points of view is not very wide if the call for mutual support is taken seriously. For then the two views converge quite largely into what is the real economic and political substance of going for parallelism: into an integrated integration policy, which the Paris communiqué referred to - admittedly in quite general terms - when it laid down the "principle of parallel progress in the different fields of the economic and monetary union". This principle certainly has some features of a political compromise. It makes political business easier. Although an integrated integration policy may be more difficult to devise, the more things there are for the mutual give and take, the easier will it be to strike a balance between the interests of the states.

But the principle of parallel progress has much more serious implications still, for it draws the conclusions from the indisputable interdependence of systems and processes in the economic sphere.

As things stand, however, even a consistently applied policy of parallel progress cannot remove the obstacles which so obviously stand in the way of an integration policy confined to the economic and monetary field. The policy of parallel progress must be integrated into the process of general political unification (see the section above: integration policy today - alternatives to the Wernerplan).

2. What does monetary integration mean?

If monetary union is seen as the state of full monetary integration, its main features are:

a) in the field of external monetary policy (from the viewpoint of the national state), a common currency unit or at least fixed and immutable exchange rates between national currencies, with a fluctuation margin of zero; a uniform exchange rate policy towards non-member countries, looked after by a Community institution; completely free movement of capital inside the union and, should the national currencies be retained, full convertibility between the national currencies; and

b) in the field of internal monetary policy, a common system of central banks and a common monetary and credit policy which need not necessarily involve uniform solutions throughout.

Moves to come close to this final state could be started in the immediate future or are already under way. These include:

a) in the field of external monetary policy, a concerted balance of payments and exchange rate policy of the Community countries in their relations with each other and with non-member countries; possibly the introduction of a parallel currency for Europe; the development of a system of reciprocal monetary support among the Community countries; the establishment of a common monetary fund with monetary reserves of its own; progressive liberlization of capital movement; and

b) in the field of internal monetary policy, unification of the instruments of monetary and credit policy and of the relationship between the banking sector and the central bank; coordination of monetary and credit policy, institutionalized in the Committee of Central Bank Governors and the European Monetary Fund.

Monetary and credit policy is an important element of short-term economic policy. In the final analysis it is therefore no less difficult to coordinate than the other elements of short-term economic policy. This is one of the reasons why the proposal at the first has been made that monetary integration should be confined to the field of external monetary policy. Here one hopes for easier progress. This is a delusion, for monetary integration policy is indivisible. Experience - both past and present - shows that, despite all restrictions on capital movements, the capital accounts are time and again the source of delicate balance of payments problems which also exert pressure to alter exchange rates. This is the result, not only of deep-rooted capital export and import habits, but also of short-term differences in yields between the national capital markets, which in their turn owe much to measures by the independently acting national central banks. With capital movements in the Community being progressively liberalized, incomparably larger capital flows would no doubt be set in motion if the national central banks, for reasons of short-term economic or balance of payments policy, took wilful measures and changed the yield structure in Europe in their favour. In the countries affected this would give rise to balance of payments disequilibria which would provide a completely unjustified inducement to ad-

just the exchange rate or would make it necessary to undo liberalization of the capital market. The European monetary fund would see itself faced with unreasonable demands and be discredited. All this would run counter to the efforts to establish monetary union. In addition, the short-term economic policy of the countries affected would also be undermined, which would make the internal inconsistencies of such an integration policy still more obvious. Unfortunately,it is quite improbable that the prospect of such consequences would,by itself,deter the national central banks from pursuing their own wilful policy. The tendency will rather be for the states to keep invoking special situations and seeking short-term advantages. To be sure, there would be one means of reducing these dangers, though it would involve other disadvantages: the introduction of flexible exchange rates within the Community as well. But this solution is incompatible with the prevailing view of the adequate integration process.

If there are to be fixed exchange rates which require adjustment as seldom as possible and,if fluctuation margins are to be narrow, then monetary and credit policy must be included in the integration process that is to lead to monetary union. It would not make sense to ignore it deliberately.

A first step leading to coordination could be to unify the instruments of monetary and credit policy and the working of such policy. At the moment the various instruments are used in widely different measure in the various countries and play quite different roles in the working of monetary policy. Differences in the banking structure are a further complication. It is therefore very difficult to make a comparative assessment of the force and expected effects of measures of monetary and credit policy in the individual countries. In the circumstances, national monetary and credit policy would be impossible to coordinate continuously even where the political will existed. A minimum of common policy would consist in creating more transparency here. This transparency should also include the channels through which the public authorities receive central bank credit.

This would not affect existing national autonomy in the field of monetary policy. By contrast to the situation for budgetary policy, in the field of monetary and credit policy there already is a Community body which works and could increasingly take joint decisions: the Committee of Central Bank Governors. This Committee could be assisted by a secretariat attached to the European Monetary Fund, which would handle routine work independently. The Committee of Central Bank Governors could develop into the embryo of a common system of central banks. Great stress must be laid on the need for this European system of central banks to be allowed the highest possible degree of independence of the governments and of a future European executive.

3. <u>How far does the autonomy of monetary policy go?</u>

If, as some suggest, monetary integration is to be given priority over economic integration at least where procedure is concerned, it is necessary to examine beforehand:

(i) whether monetary policy is autonomous in that it can indeed function without feedback to economic policy; and (ii) whether, if it can be pursued in isolation, it does not have such serious and dangerous implications for economic policy that it must not be pursued in isolation. Unfortunately it must be said that it cannot be practised in isolation, and if it could, it should not.

There is general agreement, and the point does not require discussion, that it will be impossible in the foreseeable future for exchange rates in Europe to be "pegged" irrevocably, with the margin of fluctuation reduced to zero, and that it is consequently also impossible for the national currencies to be replaced by a Community currency. The reasons are admittedly reasons of "economic policy": if disequilibria in economic development, now reflected in the balance on current account, could no longer be offset by parity changes, today's devaluing countries would have to put up with an uncontrollable increase in unemployment, and today's revaluing countries with an uncontrollable increase in inflation. Neither implication can be accepted. If national currencies still existed in such a situation and had to be defended by the central banks, the deficit countries would not have sufficient reserves to maintain their exchange rates, and there would be unreasonably heavy strain on the monetary Fund and all the support agreements. Such an exchange rate policy could not be pursued.

At the same time this would also touch off large capital flows, with no obstacles to overcome in a system of liberalized capital movements. The deficit countries would be forced to pursue a low-interest policy because of unemployment, and the surplus countries a high-interest policy because of inflation. In addition, there would still be speculation on exchange rate changes, despite all assurances to the contrary. The capital flows would exacerbate the imbalance.

If there is a consensus that immutable exchange rates without fluctuation margins or a single currency are impossible to achieve in the foreseeable future because one cannot hope to remove economic imbalances in Europe rapidly, it is difficult to see a particularly promising approach to integration for the immediate future should consist in coming very close to immutable exchange rates and reducing the fluctuation margins very close to zero without serious efforts being made to remove the economic imbalances, that is, the real causes of monetary problems within Europe. This approach lacks practical consistency and credibility. It has resulted from the dismemberment of the Wernerplan, precisely at a time when, throughout the world, greater flexibility of the exchange rate system has been urged and established.

If monetary policy is overshadowed by economic imbalances in Europe to such an extent, then the nature of the imbalances must be examined more closely. Their real causes are large in number, while their symptoms are somewhat easier to group into a few large categories, although this excercise can certainly not be exhaustive. At a pinch they can be divided into short-term economic and structural disharmonies.

a) Discrepancies in economic trends

If Member States' economies move in different cycles, supply and demand differentials develop between the countries which may touch off quite considerable flows of goods and capital. Such a state of affairs will be viewed favourably if one has a high opinion of the balancing effect of the markets and attaches little if any importance to the help of deliberate short-term economic policy. However, if one relies on short-term economic policy and wants to pursue it at Community level by using the instruments of monetary and credit policy, fiscal policy and common exchange rate policy vis-à-vis non-member countries, then trade cycles which are out of phase are a serious impediment. If some countries experience a boom while others record a slump, a coordinated European monetary and credit policy will be unable to come round to either a restrictive or an expansionary line. Yet even if one of the two was adopted, the measures would stand little chance of producing the expected effect. An expansionary policy would be more likely to accelerate the boom than curb the slump, and a restrictive policy would be more likely to aggravate the slump than dampen the boom. The discrepancy in the trends would, if anything, widen. With capital movements liberalized, any attempt in such a situation to pursue a national monetary and credit policy that was geared to the situation in the countries would be doomed to failure. The aggregate effect of all national measures would be roughly the same as if the common institution had pursued a "middle" monetary and credit policy at European level. A "middle" monetary and credit policy would often mean a policy that was not countercyclical. The only short-term economic policy instrument actually being used at the moment would therefore be blocked.

Moreover, differences in the economic trend would quite often also involve a threat to exchange rates within the European Communities. If, in addition the countries experiencing the slump export proportionately less, the current account surplus which they ought to be able to achieve in such a situation will not be large enough to offset the deficit on capital account induced by the interest rate differential. Countries will lose monetary reserves even in a slump if they want to stick to the low-interest policy required by the economic situation and will possibly be forced either to stop capital exports by administrative measure or even to devalue. Either line is contrary to the spirit of monetary integration.

It would seem that the policy of monetary integration can be successful only if the trade cycles in the Community countries are sufficiently synchronized. For this to be achieved, use will have to be made of all instruments relevant to short-term economic policy, and most certainly of the "economic policy" instruments. Engaging in a doctrinal dispute over whether to give priority, as a matter of principle, to monetary policy or fiscal policy is pointless and politically harmful because it invariably provides some authority with a pretext for dodging its responsibility in the field of short-term economic policy. There can be no reliance, in the medium term, on economic trends in the Community coming into phase quite automatically.

b) Structural discrepancies

Major divergencies in cost and price trends in the European countries can be even more serious than conjunctural discrepancies. (Existing differences in cost and price levels can be compensated by one-for-all parity changes.) Their effects are felt over fairly long periods. Such divergencies may have an impact on employment (through the current balance) and on prices in the countries affected. In the absence of periodic exchange rate adjustments, such discrepancies in cost and price trends would tend to lead to an unacceptable "adjustment process", producing unemployment in the countries with sharply rising cost trends, and overemployment and inflation in the countries with originally more moderate cost trends. In addition to this direct effect on employment, the balances of payments can be thrown into disorder. If the induced balances on current account are not offset by equivalent balances on capital account, they work through to the monetary reserves and there also is an expansionary or contractive effect on liquidity. The conditions in which a given difference between the cost and price trends leads to an effect on employment or the balance of payments (or liquidity) of a specific size are impossible to describe in a few words. Factors include the growth rate of national product and import and export elasticities. It is not essential to equilibrium that all national cost and price trends be identical.

But this does not alter the fact that such divergencies frequently have major destabilizing effects. There are undoubtedly a number of impressive examples in Europe. There is no dowbt a monetary antidote to this type of disharmony: periodic exchange rate changes. But devaluing constantly is no lasting solution for the countries with more sharply rising cost trends, particularly since under a system of free capital movements capital would eventually begin to leave these countries. This flight of capital would be difficult to check even if the devaluing countries pursued a high-interest policy; in addition, with the burden of costs on these economies already heavy, they would not find it easy to purse such a policy.

Moreover, frequent parity changes run counter to the principles of a monetary union intended to lead to immutable parities. The critical point is above all that the necessary extent of these exchange rate adjustments is determined in the markets for goods and capital, rather than at monetary conferences. Exchange rate developments in recent months have been instructive enough.

There are two possibilities. One is to keep exchange rates much more flexible - through fluctuation margins or adjustment - than would correspond to the ideal of monetary integration. In this case one would have to admit that the proposed method of achieving monetary union is unsuitable. The other is to take "backing-up" measures, in the context of work towards economic union, in order to harmonize the trends of costs and prices. In this case one would have to admit that the "autonomy of monetary policy" is very limited and that there is no serious alternative to the policy of parallel progress.

But what measures towards "economic union" can harmonize the divergencies in the cost and price trends? As noted before, it is very difficult, in theory and in practice, to determine what differences in national cost and price trends must be considered to be harmful and what differences must be regarded as still tolerable or perhaps even helpful in the medium term. But even if it were possible to make a reasoned assessment, "economic policy" instruments for correcting these trends would in truth hardly be available.

In countries with unsatisfactory productivity growth it might be useful to encourage investment through tax incentives which help to make more rapid use of technical progress. Increasingly close investment links between member states would have the same effect.

Central importance attaches to the diverging trends in wage rates and profit demands. The obvious idea of urging harmonization of incomes policy is a non-starter because in most countries there are only rudiments of an official policy to influence the distribution of primary incomes (before redistribution). Free collective bargaining between unions and employers leaves the governments little room for direct intervention in wage formation. Maybe the dialogue between the two parties to collective agreements can be raised to a European level. But what will the result be? Aggressive unions which are not even prepared to assume responsibility for the common interests of their own national economy will hardly exercise restraint in order to serve the interests of other states, and perhaps even of governments of "bourgeois" persuasion. And employers from countries with moderate unions will hardly oblige the unions - and the employers, their competitors - in other countries and grant higher wages than demanded by workers at home.

The scope for incomes policy via redistribution is also very narrow. If the wage demands of aggressive unions are met through a cut in taxation, the countries concerned will have low tax receipts and will depend on revenue equalization at European level. The countries with high tax receipts, however, will consider their main duties to be to countries and regions where incomes are lowest in absolute terms, rather than to countries with aggressive unions. This type of harmonization will be made possible only through reducing the differences in economically relevant thinking and behaviour.

Structural imbalances in Europe may also have their origin in economically underdeveloped regions or economically weak and crisis-prone industries in a country. The governments concerned see their scope for action using economic policy - or stabilization policy - limited already at home. They may be unable to comply with monetary rules that have been devised for prosperous countries. For example, they are very vulnerable to revaluations against non-member countries which are a possibility under a common exchange rate policy towards the outside world. A restrictive monetary and credit policy by the Community could likewise have an unduly severe impact on the underpriviliged regions and groups. The governments concerned may be tempted into com-

bating regional and structural unemployment by pursuing a policy of national full employment. If this is followed by a rise in prices and costs, the result may be a divergency in national cost and price trends.

In the circumstances it will be necessary to have regional and structural development programmes in order to make the national economies involved "ready for integration". Responsibility for these programmes must be shared by the Community institutions. The instruments of monetary and credit policy (for instance low-interest loans) are only of limited use in making the underprivileged regions and groups competitive in a lasting manner. Elements of "economic union", such as the regional fund, would have to be brought in and help to press on with the necessary development programmes. In addition to financial support, great importance attaches to the selection and organization of the assisted projects. Establishing supranational investment companies and arranging direct investment also from other member countries might be of help. Liberalization of capital movements will pave the way for such direct investment and will therefore, on balance, be beneficial to the underprivileged regions.

Should the European Communites' regional and structural programme take on large proportions and require substantial funds - which would clearly have to come from member countries' real income - then a political link should be established from the outset between support from these programmes and progress in integration. In the absence of such a link, Community assistance prompted by solidarity could have a perverse effect on integration: the countries which have been relieved of their regional and structural problems might feel that they no longer depended on such assistance and might therefore be less prepared than before to surrender part of their sovereignty. This reservation must be understood correctly. Community assistance without conditions and requirements attached may perfectly well be a moral imperative of good neighbourly relations and common destiny. But it is not an imperative of integration. From this it can be seen that even those imbalances in Europe which are the results of weak regions and weak industries reduce the "autonomy of monetary policy" and cannot be eliminated by it alone.

The same is true of a number of structural imbalances of different origin. Because of the structure of their production and demand, some European countries for instance are major exporters while others export little, proportionately speaking. It would seem that even exchange rate adjustments can change little here in the short and medium term. Persistent balance-of-payments disequilibria are the result.

A policy of parallel progress in the real meaning of the term is indispensable. This policy cannot manage without the resolve to reach agreement on objectives and instruments. Short-term economic policy is one important field. Though one of the elements of "economic integration", the establishment of a variety of common funds is by itself in no way sufficient as an "economic" backing for "monetary integration". Only in combination with a genuine and comprehensive policy of parallel progress can the funds fulfil the hopes that many people pin on them.

But does the policy of parallel progress, such as it also figures in the Wernerplan, have a real chance? We have little reason to continue trusting that the integration strategy of giving priority to economic and monetary policy holds out the best prospects of success. Even the policy of parallel progress is blocked as long as today's barriers are not brought down by a resolve to achieve general political unification. Parallelism is a necessary but not a sufficient condition for the successful development of an economic and monetary union.

4. Current projects for monetary integration

a) Common exchange rate policy

For the foreseeable future, the system whereby the Community countries' exchange rates float jointly against the dollar but are fixed in terms of each other will remain the most reasonable solution unless unexpected complications in the end still make it necessary to introduce flexibility even between the member countries' currencies. The two countries still outside the joint float should join it as soon as there are signs of their currencies stabilizing sufficiently on the markets. No unduly rigid position should be adopted on the parity adjustments that might be called for between Community currencies and on the fluctuation margins, for there is a wide gap between the ideal and the reality of monetary integration.

Today's quite narrow margins of fluctuation between the Community currencies had their merits as long as the "snake" still moved in a "tunnel". The possible fluctuations between Community currencies were to be kept small compared with the possible fluctuations of the Community currencies against the dollar. It is indeed part of the logic of monetary integration that transactions between European currencies should be subject to smaller exchange rate risk than transactions between Community currencies and the dollar. Viewed in this way, it is obviously the relation between the fluctuation margins concerned rather than their absolute size that matters. With the dollar floating, however, there is now no longer any constraint to apply between Community currencies fluctuation margins that are narrow in absolute terms. Should it turn out - especially once the United Kingdom and Italy have joined the block float - that some countries are forced to intervene unduly frequently, one should not hesitate to widen the fluctuation margins, at least for a transitional period.

If market developments make it necessary for parities within the European Community to be realigned, this is a sign that coordination and harmonization in the fields of monetary and credit policy and "economic policy" have not produced the desired results. Such developments therefore provide food for thought. Serious consultations on the causes of the imbalance and on ways of removing them should then be obligatory. Rigidly automatic reaction to balance of payments disequilibria is not desirable. It would, however, be useful to have a system of indicators and rules making it easier to decide whether the reaction to a balance-of-payments disequilibrium should take the form of (a) exchange rate adjustments, (b) measures of monetary and credit policy, (c) standby credits and/or (d) measures of short-term economic and

structural policy producing effects over a longer period. It is difficult but important to make as clear a distinction as possible between the effects of "autonomous" capital flows and the effects of payments flows linked to the movement of goods.

If such an examination shows that exchange rate changes are called for, these should be made without delay and by the appropriate amount. There is no point in taking decisions now proclaiming rules on the permitted extent and the permitted frequency of exchange rate changes which would then be ignored by the markets. Such decisions would indicate that the autonomy of external monetary policy had been overestimated.

b) Pooling monetary reserves

Transferring part of the national monetary reserves to the European Monetary Fund with the effect of genuine pooling is a measure that has all the merits and drawbacks of the "common funds policy" (see European Integration Policy Today - Alternatives to the Wernerplan, sec.III(a) The common funds policy). Such a transfer is an act of solidarity vis-à-vis friendly neighbouring countries faced with balance of payments deficits. It assigns major practical functions to a Community institution, the European monetary fund.

It is hard to see, however, in how far pooling monetary reserves should, by itself, make a contribution to the integration of national economic and monetary policies and to coordination and harmonization. The urgency of establishing a European equilibrium in Europe is not increased but diminished, and persistent disequilibria are easier to finance out of common reserve assets. The pressure to observe balance of payments discipline and combat inflation, which today is still associated to some extent with the keeping of national reserves, disappears. Unless a mechanism is created which replaces this pressure, pooling monetary reserves will on balance have a disintegrating effect and will strengthen national self-interest - especially in those countries for which running a deficit is a non-vital means of deriving greater benefit from the international markets. The surplus countries will revalue more frequantly than today, which reduces the stability of the exchange rate system, increases the waves of speculation and makes countries with soft currencies suffer from increased capital flight, i.e., a drain on savings.

Like all common funds, pooled reserves may be an important instrument of European unification policy if they are a link in the chain of measures and arrangements making integration not only possible but imperative. Removed from this chain, they would be in danger of producing the opposite of what they are intended to achieve.

c) The European parallel currency

Even the advocates of isolated monetary integration do not consider its prospects to be particularly good. It is not least for this reason that special attention

has been paid to a plan which, instead of subjecting existing national arrangements to European control, provides for a new European arrangement alongside the national arrangements: the plan for common parallel currency in Europe.

There are a variety of proposals for such a parallel currency. They all involve the conviction, although there may be differences of degree, that such a new currency would offer the following advantages:

1) it would be of psychological importance for the development of a European identity;
2) it would have to facilitate European payments transactions between the states and replace the dollar in this role; the associated seigniorage would then accrue to Europe and not to the United States, and Europe's monetary dependence on the United States would decrease;
3) the common European currency would eventually have to displace the national currencies, with the European issuing institution becoming the sole authority responsible for European monetary and credit policy. This would also complete monetary integration.

Some authors in addition assign special functions to the European parallel currency, for example (a) to be money with a stable value thanks to an index link; (b) to simplify intervention on the foreign exchange markets; (c) to be a source of finance for European projects.

Under some proposals the common European currency is to be legal tender alongside the national currencies; under others the monetary function of the European currency unit is to be restricted (to transactions between central banks, banks and large enterprises); lastly the proposal has been made that for the time being such a currency unit should merely be a European accounting unit and that it should not be given the other monetary functions until a European system of central banks has been set up. The majority of authors think that the European currency unit should be given an abstract definition - similar to that for the special drawing rights; but it has also been suggested that it should be defined as a basket of a number of existing national currency units.

Most of these proposals leave major features of the European currency unit undefined, making it impossible to assess the implications sufficiently. All in all, one gains the impression that a parallel currency would be of doubtful real value, that it would not provide the key to monetary union, and that a fair number of the models proposed would even do harm.

There can be no disputing the need for a common European unit of account, but it is doubtful whether a unit can be found which can simultaneously serve all purposes (e.g. settlement of balances arising out of interventions on the foreign exchange markets, agricultural market, issue of European loans, etc.). Much greater importance, however, attaches to the plan for the introduction of a currency unit serving as a medium for trading and intervention and/or as a reserve asset. The success of such a

plan hinges on two conditions: (1) the European currency must be able to gain a footing on the markets of really all Community countries, and (2) its economic and monetary implications must be acceptable to all states and the European Community as a whole.

On the first condition: if the parallel currency were to be general legal tender, it would be necessary in day-to-day business to have separate tills for the two currencies,keep separate accounts and indicate prices in both currencies. These technical complications over payments would be enormous and beyond the grasp of most citizens, who are not versed in monetary theory. This would certainly run into firm opposition from the business world. It is difficult to argue the case for a common currency by prescribing that each country should use two types of legal tender for the foreseeable future. Flexible exchange rates between the common currency and the national currencies - another proposal - would quite certainly be impracticable: there would be endless opportunity for deceiving the uninitiated. Whenever a purchase was made, and for every product, prices would have to be converted in order to find out in which currency payment should best be made.

This means that compulsory acceptance would at any rate have to be waived. Under some proposals the common currency is to be made attractive by tying its rate of exchange against the national currencies to suitable price indices so that its purchasing power in terms of national currencies would remain stable while the national currencies would be subject to inflation. Such money would certainly offer major advantages as a store of value. Yielding a profit in terms of national currency, it would be hoarded (even under a system of flexible exchange rates) and would therefore have a low velocity of circulation as a payment medium. People would seek to make payments in national currency and receive them in European currency. This is unlikely to lead to a complete displacement of the national currencies. As a unit of account this type of money would place the inflationary risk on the debtor. "Strong" partners in the market would thus invoice in national currency where they are debtors and in European currency where they are creditors.

But in practice it would still be impossible to maintain the purchasing power of the European currency in terms of the direct ratio to goods, once this money was used for buying goods. Industrialists would certainly also raise their European currency prices. Inflation in terms of national currency might thus receive an additional impetus. Another exremely undesirable and inflationary effect would come from the index-link itself and probably also from the induced accumulation of highly liquid yet profitable funds, the holdings of European currency. Even though it is improbable for an index-linked currency to displace the national currencies in such a way, it would have a comparatively great chance of being held at least as a private reserve currency in all countries in which its value promised to be more stable than that of the national currency. Such general use of the parallel currency is improbable for all those models under which the value (exchange rate) of the common European currency vis-à-vis the national currencies is (i) always defined as an average of the exchange rates of

national currencies ("basket currency") or (ii) under which it would have to be fixed and defended in the same way as today's national parities.

The "Europa" proposed by G. Magnifico is on the pattern of type (ii).(See G. Magnifico:"European Monetary Unification for Balanced Growth: A New Approach" in: International Finance, 1971; G. Magnifico and J. Williams:"European Monetary Integration", a Report of the Federal Trust for Education and Research 1972; also see the proposals put forward in this report).

Magnifico's proposal is for fixed parities, with fluctuating margins, between the Europa and the national currencies. The national central banks defend the exchange rates for their currencies only against the Europa and adjust their parities where necessary. The European monetary fund issues the Europa and defends its parity - using pooled monetary reserves - against the dollar or all non-Community currencies. In line with the situation obtaining at the moment, the Europa rate against the dollar could also be flexible. The Europa is to have a "somewhat more stable value" than the average for the national currencies. This is presumably to mean that from time to time there is to be a minor revaluation of the Europa against the national currencies. Under these circumstances the Europa is obviously not the hardest currency in the Community. From time to time some countries will revalue against the Europa while others may devalue in addition. There will be a shift in the exchange rate pattern. In hard currency countries there will be little if any demand for a Community currency of this type. The soft currency countries will certainly be more inclined to use the Europa. "Well informed circles" in the soft currency countries, on the other hand, will continue to prefer the hardest national currency. If, as seems to be envisaged by Magnifico, there is to be a higher degree of convertibility between the Europa and the national currencies than between the national currencies in terms of one another, the Europa will be a vehicle of capital flight into the hard national currencies. It is an illusion to believe that this Europa could in effect become a commonly accepted European currency or could even displace all national currencies. The chances of this parallel currency could be just as great and just as small as the chances of workable "exchange rate union". As things stand, however, such exchange rate union cannot be achieved in the near future - at any rate not without "economic union". But this is precisely why one had resorted to the substitute plan for a parallel currency. This approach is a fata morgana.

Magnifico does not ignore these difficulties altogether. This is the reason behind the proposal that some pressure should be brought to bear on the states so that they do use the Europa. Banks, for instance, should be required to hold a portion of their reserves in Europas. This would amount more to taxation than to the introduction of a new currency. The parallel currency would have to be accepted voluntarily by the markets, or it would wither.

Then there is the second condition of the success of the parallel currency. Provided it is accepted by the markets, it should not have intolerable economic and monetary implications. This means, among other things:

Issuing the parallel currency should lead to zero, or at least an insubstantial increase in private liquidity and in reserve assets. The struggle against inflation must remain the first priority, now and in the foreseeable future. In this situation a flood of additional liquidity is too high a price for the benefits of such a parallel currency, highly doubtful as they are in any case. Yet a flood of additional liquidity would be the inevitable result especially if issuing the European currency amounted to the net creation of money and the money thus created were used to finance the European Funds and the European Community budget. This would really be an unfortunate and grotesque jump into the second state of European integration. Both the currency issued and the work of the funds would be discredited. The moral obligation on the governments to contribute to the sound financing of the funds would be annihilated by the policy of the Community itself. Such a link between the currency issue and financial tasks would make it impossible to trust any assurances that the fund would keep Europas tight. It would therefore be of the greates importance to introduce tough machinery containing the issue of the Europa currency within set limits. There would be additional uncontrollable monetary expansion if the banks accepted deposits and extended credit in Europa currency without being subject to any credit control, especially in the form of minimum reserve requirements. The outlook for common monetary and credit policy rules on Europa liquiditiy would be the more unfavourable the wider the use of the new currency. In a plan for the Europa currency it would at any rate be necessary to spell out in detail such rules.

There can be no relying on the issue of the parallel currency being accompanied by an offsetting drain on liquidity in other areas. In the field of monetary and credit policy Europe has no decision-making body which could fit the issue of the new currency into a comprehensive European liquidity policy and reduce the supply of national currencies accordingly. Nor is it clear how dollar liquidity could be fended-off by a European parallel currency. At the moment Europe is shielded from dollar liquidity by the float. Should the foreseeable fututre bring a return to a fixed dollar parity, a European parallel currency could be no dam against this source of liquidity. It does not matter in this context whether or not a European currency would then have taken over part of the dollar's role in private money transactions. There is little probability of this occurring. A second harmful implication of the parallel currency could concern balance of payments policy. If the European monetary fund is to maintain a fixed exchange rate for the European currency against the dollar, the national central banks must endow it with reserve assets. Assuming that unduly large amounts of Europas were issued and were not exchanged again for hard Community currencies, maintaining the exchange rate against the dollar could place a heavy burden on the pooled monetary reserves. Especially those countries in which there was hardly any demand for Europas would oppose such a drain on the pooled monetary reserves.

If the dollar rate against the European currency were flexible, the result under the same circumstances would be a devaluation of the common European currency, and consequently of all European currencies, against the dollar. A number of countries would oppose this development. The differences in the priorities for the various aims

of economic policy would show up again, and compensatory revaluations within the European Community by some countries might be triggered off.

Perhaps even more serious threats to the stability of the monetary system would arise within the Community. As long as in the European Community hard and soft currencies exist side by side, there is reason to expect that the Europas issued would be exchanged on a large scale for hard European currencies. If the degree of convertibility between the Europa and the national currencies is higher than that between the national currencies in terms of one another, or if there is far-reaching convertibility between all currencies, the main function of the parallel currency will be to give the soft currency countries easy access to hard currency balances without this placing a burden on the balances of payments of the capital-exporting countries. The hard currency countries would be forced to create money to an equivalent extent. Such a model would hardly meet with general approval. In the soft currency countries it would, of course, serve the owners of capital better than the national economy as a whole, for the outflow of savings to foreign countries would be stimulated further.

Moreover - and this is a particularly baleful aspect for monetary union - the European exchange rate system would be decidedly more unstable than it is today. Speculative switching between national currencies and the Europa would be a much more obvious proposition than is switching between national currencies today. Even relatively minor causes would touch off a serious flight of capital posing a threat to the Europa parities of the countries concerned. In the event of a flight into the Europa, the parity of a national currency is unfortunately the more difficult to maintain the more the Europa is in short supply. Consequently one would then have to choose between frequent and major falls in the exchange rate and an inflationary flood of Europas. Conversely, if there is a large volume of Europas a hard currency country might be able to defend itself against speculative inflows of Europas only by allowing its exchange rate to float. This, however, would fit least into the concept of monetary union. The same dilemma that would impede wider use of the Europa would also make it difficult to live with it: the imbalances entailed by hard and soft currencies cannot be overcome by any trick in the integration bag.

Whatever the aims pursued with the Europa, a key problem resides in the way it is issued and in the technique used to limit the size of the issue. Any plan for a parallel currency which failed to settle the two points in a dependable manner would be inadequate. It would be a fateful error to believe that the national currencies could be "displaced" the faster the more Europas were created.

Magnifico's model of a European currency is unfortunately open to objections from the angle of both stability policy and balance of payments and exchange rate policy. Where the link between the issue of the European currency and the financing of Community projects is concerned, it occupies an extreme position among the proposals published so far.

d) Liberalizing capital movements

Any monetary union worthy of its name is inconceivable without liberalization of capital movements between the member states. The past few years have shown, however, that in a situation of monetary disorder the free movement of capital may cease to be of benefit to the capital exporting and capital importing countries and may become a source of serious disruption. The advantages of free capital movements are not absolute. One can leave undecided whether freedom of capital movement is in itself something very desirable or not. One thing, however, is certain, the opportunities for liberalizing the capital markets are a measure of the opportunities for progressive monetary union. All the individual monetary integration measures discussed - the common exchange rate policy, the pooling of monetary reserves, the introduction of a parallel currency in Europe - presuppose an economic and monetary equilibrium in Europe which is also essential to the free movement of capital in the Community. Free movement of capital and the resulting investment links with other countries also presuppose that a country is free from distrust of its neighbours and free from fears of "foreign control". This, however, is also a condition of economic and monetary union. The degree of liberalization of the capital markets in the European Community is a sensitive indicator of direction and speed on the road to a united Europe.

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Foreword 1

Rather than trying to split ourselves into all-out supporters of an immediate monetary unification and sceptics about the whole idea of pushing monetary before political unification, we should denote our effort in evaluating all costs and benefits implied by the Werner Plan or any other proposal of steps to a full European Economic Union. The choice between alternative plans is up to the politicians, we must simply make tham as aware as possible of the economic and social implications of these plans.

Personally, I would feel rather distressed if, as a result of our discussions, we reinforced some critics' opinion (e.g. Cooper 1972, p. 5) that Europeans to-day need a "somewhat arcane subject" as a new symbol for spurring European political unification. If this is so, let us seriously reconsider the subject to make it less arcane and therefore more comprehensible to the minds of our present and forthcoming policy makers.

Foreword 2

My attention will be focussed upon short and medium-term problems, i.e. the so-called transition phase, since I feel rather unable to make plajsible and testable assertions about a world whose problems and constraints and political machinery are still largely unknown. This does not definitely imply a pledge for the status quo but rather a convinction that in a market economy long-range planning and options, being a very serious matter in technology and generally in physical sciences, is a much less reliable basis for serious investigation in the field of social sciences. I think long-run targets must indeed be discussed, much like political philosophies must give substance and motivation to histerical policy options, but we should care to be as articulate and pragmatic as possible when laying down proposals for to-day's policy makers. Likewise we should beware of undermining our governments' already stressed credibility by remaking on the international scene the same mistakes that have so often been made at the national level (I am thinking particularly of the recent Italian history of economic policy and programming), i.e., spurring public enthusiasm about ambitions goals and then taking contradictory steps as soon as the economic and political situation evolves in an unfavourable direction. Announcing currency agreements and then suspending them during periods of economic crises is a far worse risk than delaying the process of formal currency unification while gradually approaching (monetary, fiscal, etc.) policy coordination and fiscal institutional harmonisation (1).

1. The Issues

It is paradoxical that since the Barre report was issued at the beginning of 1969 EEC countries:

(1) Meade (1957), Snider (1967), Jay (1970), Willett Tower (1970), among others, put a similar emphasis in their discussion of the projects for a European money.

a) adjusted their reciprocal parities more frequently than ever before after WW II; and we observed Franc devaluation and DM revaluation in 1969, floating DM and Smithsonian realignment in 1971, floating pound sterling in 1972 (what is the 1973 forecast for the British pound and the Italian lira?) (1);

b) introduced capital controls, especially on short-term flows, more than ever before since 1958 convertibility. National governments may well be irrational but sometimes also economists and Eurocrats may be myopic (or too farsighted?), so we must understand what the proposal of European Monetary Union (EMU) is all about, how is the monetary sphere related to other domains, how intra-group payments disequilibria can be faced. In short: what is the best strategy for attaining an efficient and equitable European economic and political union.

I will try to investigate the following issues:

a) problems involved in defining an "equilibrium exchange rate" for the EEC area as a whole and for each EEC member, hence criteria for not discarding intra-group parity adjustments during the phase of transit to a full economic union; the argument will partly hinge upon the "optimum currency area" debate;

b) meaning and implications of the target "harmonisation of monetary policies" both as a step to and an aspect of a full-fledged monetary union; and

c) alternative approaches to capital account adjustment.

The gains from a European money (or, as a first step, from a committment to give up intra-group parity changes, i.e. irrevocable parity-fixation) are expounded by Mundell (1969) as follows:

1) restore government control upon economic policy which is inevitably wiped away when expectations of parity changes induce massive shifts of speculative funds (big Euro-companies have a larger balance sheet than most European control banks);

2) to recover seigniorage from money creation to European control banks: so long as the dollar is the major currency, the inherent tendency of the international community to use a common international money (see modern theories of money as a medium of exchange, stressing information and transaction costs) brings about a shift of seigniorage from governments to large multinational banks through the process of Eurocredit and Eurodeposit creation;

3) a strong incentive to curtail US balance of payments deficits, since foreign official and private demand for dollars would peter out as the dollar is replaced by Europa as transactions, intervention and reserve currency;

4) a sizable reserve saving by European member banks due to economies of scale in financial management (inventory principle), diminishing weight of foreign trade relative to the area GNP (internalisation principle), falling risk of reserve management (insurance principle).

(1) If we include parity-changes effected in the second half of 1969, it comes out that in the last three years the French franc has devalued vis-à-vis the Deutsche Mark by more than 20 % (almost 30 % if we take the for-Smithsonian parities at the end of September 1971).

A fifth argument is presented not so much as a gain from broadening national currency areas but rather as a <u>failure</u> of intra-group parity changes as an adjustment device due to the disappearance of money illusion.

Points 3) and 4) are secondary arguments since some gain from reserve-saving and a lessened role of the dollar as an intervention-currency can be brought about, perhaps more slowly, by a process of official intervention in European currencies, both steps which do not imply parity-locking as a necessary condition. Therefore the attention will be focussed upon points 1), 2) and 5). Here follow some counter-arguments.

2. <u>Monetary sovereignty and seigniorage</u>

It is obviously true that the growing size and oligopolistic structure of the Eurodollar market has created more and more difficulties to European monetary authorities in the pursuit of national targets and it is equally true that insofar as the process of Eurodeposit and Eurocredit creation is free from any traditional banking regulation increasing rents of intermediation are accrued to Eurobanks. But I fail to see how all these inconveniences can be eliminated by ratifying central banks' powerlessness to control the process of money creation. In Laffer (1970) and Mundell (1969, 1970) words' a fixed rate system can be defined as a rule by which governments control the price of money and let its quantity be freely determined by the market, as opposed to a flexible rate system in which the price is free to vary while the market is unable to alter the money-stock fixed by monetary authorities. (This definition is only partially satisfactory, in that it ignores how <u>real</u> variables adjust to parity changes, unless one strictly adheres to orthodox monetarist determinism, but is good for our purposes). What this definition implies for intra-EEC fixed exchange rates is that for each member country national monetary authorities give up any attempt to control money supply while the EEC area as a whole, by letting its exchange parity fluctuate vis-à-vis third currencies, can pursue the maintenance of a given money-stock target.

Two questions can then be raised. First, to whom should this monetary sovereignty be restored? To a truly European central bank. But, whereas present national central banks, at least for some EEC-countries, are more or less subject to governmental control, a new European central bank would be largely independent of political boundaries, due to the present absence of a common European government. The choice in favour of the independence of monetary authorities can be reasonable but is undoubtedly controversial and cannot be tacitly assumed as the "natural" solution (1). This raises the already old-fashioned issue of parallelism between monetary and economic - political union. Second, isn't the suggestion to give up intra-group parity changes a sort of therapy that kills the patient? The underlying philosophy is that, since re-

(1) The same argument applies as a serious reservation about Magnifico-Williamson's (1972, p. 8) proposal of giving priority to the establishment of a new European Bank with "significant power to influence member countries and a vested interest in promoting harmonisation" and the proviso that no national veto power can be exerted in determining the European monetary policy.

devaluation-induced rise in shareholders' earnings leads to outward shifts in the MEI schedule, increased investment, leading to increased employment, rising aggregate demand, accelerator effect and so on.

Textbooks generally ignore this distributional effect of devaluation and limit themselves to highlighting the employment effect. They fail to notice that, especially in recent years, low employment and low profitability are often positively related with each other. On the other hand, as French and American experiences (the Nixon tax surcharge!) show since 1969, stabilisation policy-makers are sensible to profit indicators as well as employment levels. This is a correct attitude to the extent that breaking a recessionary spiral often implies a decisive spur to profits and demand. Once the engine starts running at full speed again, many problems of cost-inflation and pessimistic expectations are rapidly solved. The export sector often represents a very good outlet for such a strategy of accelerating domestic production, given the relatively larger opportunities of meeting an expanding demand for an increasing level of output.

Of course these considerations do not open the way to competitive devaluations as an easy beggar-my-neighbour policy of promoting employment and production and increasing each country's share in foreign markets. What all this amounts to is that, even allowing for equal Phillips' curves (1) and equal marginal propensities to inflate throughout the area, one cannot assume a stable inflation-unemployment trade-off such that parity changes become unnecessary.

As profit margins and volume are growing unequally or even eroded, as among competing business firms within the EEC, due to the whole set of structural and cyclical asymmetries, national governments cannot be indifferent as to the potential competitiveness of business firms located within their own national boundaries, even before all this is dramatically shown by soaring export surpluses or deficits in the national trade balances. It could be that member governments cease to think in terms of domestic trade-balances and domestic business firms and become indifferent as to the location of economic activity throughout the Community area.

Here we face the issue of regional development and factor mobility, which will be discussed later.

4. Monetary illusion and effectiveness of parity changes

Since McKinnon (1963) stressed that for an open economy devaluation greatly impairs price stability, the "money illusion" argument has been increasingly called on by opponents of flexible rates, More traditional arguments (traders' uncertainty, risk of destabilising speculation, cost of resource reallocation between domestic and foreign sectors) have been invoked less frequently. The higher the ratio of tradable

(1) Here equal shifts in Phillips curves are also assumed. This was a point missed in Fleming's (1971 b) argument about costs and benefits of currency unification, where a stable schedule was postulated.

to non-tradable goods, i.e. the more open an economy, the less likely is money illusion to operate. With all probability any devaluation will raise domestic costs of production and costs of living simultaneously (higher prices of imported consumer and producer goods, hence pressures for nominal wage hikes in order to keep real wages from falling), so that the positive impact upon exporters' competitivity will be at least partially sterilised while inflationary expectations and the deteriorating of domestic money as a store of value will encourage capital flight towards more stable currency areas. These were the basic arguments leading McKinnon to suggest "openess" as a criterion for judging the optimality of a currency area.

More recently the arguments have been reexamined and refined by Laffer and Mundell. Despite their theoretical soundness, their practical relevance is subject to many reservations.

First, the whole notion of money illusion applied to devaluation does not apply symmetrically to <u>revaluation</u>, given price and wage downward stickiness. As a matter of fact, revaluation can be correctly thought of as an anti-inflationary device (e.g. Canada, Germany) in the presence of world inflationary pressures, especially for countries strongly dependent on foreign supply of raw materials and food staples.

Second, the argument hardly applies to many <u>invisibles</u> whose rôle may be crucial in the adjustment of balance of payments or current account. Perverse cost inflationary effects of devaluation upon the domestic economy are very unlikely to apply to items such as net investment, income, tourism, emigrants' remittances. While the empirical evidence about past devaluations in Europe is not clear-cut (1), one is at least allowed not to discard parity changes as an adjustment tool.

Third, the argument that benefits from devaluation are only of a short-run character is not very convincing, since:

a) many indirect positive effects (e.g. stimulus to rising demand expectations and to improving productivity for industry as a whole through fuller capacity utilisation) take place after somewhat longer delays and can trigger off a crucial turnaround in a period of cyclical sluggishness, as has already been mentioned above;

b) the boundary between short, medium and long run is quite blurred, as comes out very clearly when considering recent debates about British and Italian stagnation induced by wrong stabilisation policies or rather by "structural" deficiencies. (In reality we got a mixture of both causes, although most public opinion is easily deluded by "structuralist" interpretations, forgetting the lagged effects of monetary and fiscal policies of the wrong type and at the wrong time).

Fourth, one cannot, a priori, assume that the devaluation margin will be fully translated into prices uniformly through the industrial sector. Much depends on escalator mechanisms for wages, the raw material value added content of each industrial

(1) See NIESR, The Effects of the Davaluation of 1967 on the Current Balance of Payments, Economic Journal, March 1972 (supplement), p. 442-464.

sector, possible effects of appropriate measures of fiscal tuning (reduced taxation on food, gasoline, etc.), behaviour of non-wage inflationary pressures much too forgotten by Phillips' curve adepts (housing and retail distribution rents, bank intermediation margins, policy-induced rising cost of credit and so on).

Fifth, whereas it is reasonable to assume a fast disappearance of money illusion when a country approaches full employment and inflation (in this case trade unions, being real-income sensitive, will be ready to accept revaluations as Germany and Japan have done), it is likewise reasonable to assume that trade unions become more employment-sensitive than real-wage sensitive when a country faces high unemployment (i.e. UK, US) and therefore can still accept the cost of some money illusion if it is offset by the positive employment effect of devaluation.

In conclusion, much caution is in order when parity changes as an effective adjustment mechanism are to be ruled out even in a world of growing interdependence and struggle for income redistribution.

One closing remark can be raised concerning the McKinnon-Mundell argument of price-stability under fixed rates. Given what has been said about divergent economic performance of EEC members impairing the credibility of member governments' committment to a permanent maintenance of existing parities, is it really true that price instability would be greater under a system of frequent intra-group parity adjustments rather than under an officially-declared fixed rates system? So long as intra-group monetary relationships tend to be of an adjustable-peg type rather than of a full-flodged economic and monetary union one can be rather sceptical about price stability. Given the very low amount of correct information and the highly emotional attitude of most small-medium size firm managers in the presence of expectations of "monetary crises", it seems fair to assume that worse irrational price rises can be expected under a system of recurrent parity ralignments than under a sort of planned government coordinated crawling peg (see below for objections bases upon speculative capital flows).

5. Regional adjustment, factor mobility and monetary union

According to the traditional international and interregional trade theory, regional disequilibria which might arise within a given currency area are automatically adjusted through factor mobility. Short-term borrowing by banks in the deficit region will finance the deficit while price, employment and MEI schedule shift effects, brought about by labour and long-term capital flows from the deficit to the surplus regions, will ensure the process of adjustment.

Indeed, factor mobility was the crucial (sufficient) condition for defining an optimum currency area in Mundell's (1961) first pathbreaking contribution. Unfortunately, things get much more complicated when the model is tested against reality.

It is interesting to note that, among others, Meade (1957) and Yeager (1958) came to an almost opposite conclusion: free factor mobility implies flexible rates among regions until they are able to join in a full economic union. Although their arguement, based upon the traditional sticky prices-flexible rates trade-off does not appear very convincing in the light of modern monetary and inflation theory, I think it can re-read as follows. Unless some mechanism help keep production and purchasing power increases roughly equal throughout the area, free factor mobility will result in permanent shifts of capital and labour from regions of low productivity and deficit regions to regions of high productivity and surplus, with impoveristing consequences for the former and perhaps external diseconomies in the latter. Economists have long since realised that, coming from the timeless and spaceless world of perfect competition down to earth, free factor movements fail to ensure maximum social welfare in terms of optimum resource allocation because of the accumulation of causes of the resulting regional disequilibria. These points have been stressed in early works by Myrdal and Nurkse, as well as in more recent papers dealing with the process of economic and monetary unification: see, e.g., Scitovski (1957), Lanyi (1969, p. 18-21), Kaldor (1970), Fleming (1971b, p. 473-4, 481), Magnifico (1971). As I have already shown elsewhere in greater detail (Onida, 1972, p. 3-9), low productivity-deficit peripheral regions are likely to gradually worsen their own position vis-à-vis central regions following free factor movements in the absence of appropriate offsetting policies. The export of higher quality workers and long-term capital results in lagging productivity growth and downward shifts in the MEI schedule in the "periphery" areas. Falling production in the same areas in industries characterised by increasing returns to scale also means worsening competitivity (Verdoorn's law). Differences in input coefficients among industries make more advanced regions unable to fully absorb workers left unemployed by underdeveloped regions (this point was stressed by Kenon, 1968, p. 43, 49-50), and so on.

As Prof. Giersch stressed at our first meeting, there must be some reason why, despite the undoubtedly exceptional growth of trade and factor mobility brought about by European economic integration in the last two decades, we keep finding a strikingly regular geographical pattern of unemployment rates, rising as we go from central to more peripheral areas of the European Community. Fundamental disequilibria ("structural" external payments deficits) have far worse implications for underdeveloped regions, which do not manage to get short-term capital inflow, than for developing areas which draw productive investments.

The foregoing considerations have prompted some authors (e.g. Magnifico-Williamson, 1972) to stress a regional policy approach to the European economic and monetary union, relying upon fiscal transfers and credit facilities granted to the periphery in order to offset the undesirable implications of increasing factor mobility under a currency unification agreement. This approach indeed deserves full attention but an exclusive emphasis upon regional policies may be misleading in the light of recent experiences (I must refer to the Italian case but I assume there are many analogies with the UK and French situation).

First, in a market economy disguised protectionism of particular industries through special credit and fiscal arrangements or even through State-owned enterprises can be a highly risky choice, as is any type of infant-industry protectionism. Temporary facilities tend to become permanent features of a structurally underdeveloped economy, failure to struggle for productivity has disastrous effects upon the firms' ability to compete with unprotected ones, bad habits and inefficiencies tend to grow parallel to the increasing amount of transfers, innovations are lagging, and rising costs from wage settlements, far from becoming a challenge to improving efficiency, are passively thrust upon public financing of budgetary deficits.

Second, economies such as Italy affected by geographical and industrial dualism in their development can hope to gradually absorb unemployment only through a sustained growth of small and medium-size firms, given the inherent tendency to adopt capital-intensive techniques by large-size enterprises (impact of multinational competition, import or fixed-coefficients technology à la Eckhaus).

But small and medium-sized firms are less likely to get a growing or at least a stable share of regional policy facilities, as is proved by very recent developments in the State-sponsered financing of Southern Italian development (law 26 October 1971, no. 835 concerning new regulations of Cassa per il Mezzogiorno for the 1971-1975 period; see Graziani, 1972, p. 61-69), due to a lower lobby-power relative to beg firms and to a definite interest by industries located in central areas to keep a manpower reserve pool in peripheral regions from which to draw from their own expansion. Also small and medium-sized firms are more likely to be badly hit by the impact of monetary restraints (credit rationing) owing to their lesser ability to enter the security market for external financing (see also the following section for implications of monetary policy in a currency area) (1). The implications of the foregoing remarks are of both short-run and long-run character.

An all-out regional policy approach may hide substantial distorsions and may occasionally be much less relevant than a correct Keynesian policy or demand management. The Italian experience during the last decade shows that, despite a massive apparatus of legislative protectionism in favour of underdeveloped regions, the dualistic bias has gained strength and regional inequalities have grown. (Income per capita in Southern Italy has been falling as a percentage of the national average). Destabilising fiscal policy in 1964 and 1970, together with the lagged and long-term impact of two monetary restraints in 1963-64 and 1969-70 (both mainly motivated by balance of payments difficulties) bear some responsibility of such a state of affairs. The lack of correct stabilisation policies is bound to bring about distortions and to perpetuate asymmetries in regional development that no regional approach can realistically off-set. Factor mobility makes no miracles, or even worsens the inherent biases

(1) Magnifico-Williamson (1972, p. 19) acknowledge the asymetric regional impact of monetary tightening.

of regionally unbalanced growth. But then the important issue becomes not so much a general agreement about a centrally-controlled set of regional policy interventions but rather a correct understanding of what economic policy (and particularly monetary policy) harmonisation entails.

When assessing the prospects for a European currency area a question definitely arises the answer to which does not seem very simple. If we look at the recent history of the US, UK and Italy, how could we rate those currency areas in terms of overcoming regional disequilibria? Can the US experience of labour and capital mobility coupled with a federal system of unemployment compensation be assumed as a model for Europe? (1). Couldn't Appallachian deprivation and deep-South chronic unemployment be somewhat related to the very fact of free factor movements and currency unification? How about Wales and Scotland? How about the grievances of African governments belonging to the Franc zone (a currency area) about conservative economic policies followed by central authorities and the drain of local funds to the French financial and monetary market (see P. Fabra on Le Monde, 2 December 1972, p. 34)?

As far as I know the history of Southern Italy is rather instructive in this regard and none of us, for sure, would like to see Italy as a candidate for becoming the Mezzogiorno of a united Europe.

6. Harmonization of monetary policies

So far it has been stressed that neither automatic adjustment through factor mobility nor a program of regional incentives and investments can reasonably ensure the attainment of a balanced growth throughout the European Community. Policy mixes à la Mundell (1962) within a monetary union can easily become an unfeasible solution for ensuring for each member country the simulianeous external and internal equilibrium since perfect capital mobility prevents a particular country from keeping interest rates different to the Community level. Moreover, the policy mix model is subject to so many limitations that radically hamper its empirical relevance: its short run character rules out effects of a given budgetary and monetary mix upon accumulation and growth, its static assumptions overlook possible perverse lagged effect of monetary restraints (e.g., falling exports due to slowing foreign demand and trade deficit, monetary tightening as suggested by Mundell's assignment theory, rising cost of investment financing and credit rationing leading to cuts in the supply of output and, eventually, further loss of exports), the inability of many countries (e.g.,Italy) to use fiscal policy as a truly flexible instrument and the frequant lack of independence between budgetary and monetary policies are forgotten.

Therefore so long as the existence of separate national governments and institutions keeps alive the notion of national policy targets and balance of payments equilibria, any proposal of giving up a single policy instrument would be foolish unless it was matched by an appropriate scheme of compensating measures and coordinated

(1) According to Hartland (1949) such a system of federal transfers worked well during the 1930's.

within a priority list of steps to be taken. Think for instance of the present economic phase in the EEC, with Italy barely recovering from its worst post-war recession and facing costly wage settlements and VAT-induced disorderly price rises, Germany and France suffering from demand-pull inflation, UK affected by heavy unemployment and chronically sluggish growth and waiting for VAT-introduction. Harmonising national economic policies cannot reasonably mean to make them uniformly expansive or restrictive throughout the EEC but rather to prevent differentiated policies from becoming reciprocally incompatible. This might happen if, for instance, a sizable DM-revaluation vis-à-vis the US-dollar, coupled with tighter intra-area exchange margins, would force upon the Italian lira an equally sizable revaluation at a time when Italian exporters have already reached minimum profit margins. Or take the case of a restrictive stance taken by monetary authorities, concerned with demand-pull inflation in continental Europe, extended to the British and Italian economies with presumably disastrous effects upon an already poor performance of employment and growth.

Whereas harmonisation of budgetary, industrial, agricultural and social policies can be rather clearly defined throughout the Community, the meaning of harmonising monetary policies must be careful elaborated (1).

First we come across the difficulty of correctly defining targets and indicators (interest rates, quantity of money, quantity of credit outstanding, etc.). Owing to the lack of clear knowledge about the interaction between real and monetary variables, this is an already challening task at a national level. Differences in monetary and financial institutions among EEC members make kt an even harder task at the Community level.

Second, quantitative and qualitative differences in impact of monetary policy upon different economies tend to be overlooked by official arguments for monetary integration. On the contrary, it should not be forgotten that the pinch of monetary restraint is more heavily felt by economies characterised by:

1) greater registered and disguised unemployment;
2) a steeper rise in unit labour costs which brings about thinner profit margins;
3) a larger weight and a greater rigidity of public debt as a source of monetary base creation, since there is less leeway for channelling private savings to private investment and, on the whole, the monetary restraint brings about a reduction in the share of private economic activity (see Carli, 1972);

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(1) The following quotation from a recent speech of Governor Carli (1972, p. 11) acutely describes the circular reasoning which persistently underlines the economists vs. monetarists debate: "...*monetary union* is not a target per se but an *instrument to promote economic union*. The latter implies a *policy coordination* without which the monetary union has hardly any meaning and may even appear as a disturbance factor (...). Therefore we must be willing to accept the convergence of economic policies in terms of goals and instruments. But such policies' success is in its turn closely tied to the *disappearance of growth rate disequilibria* within the Community as well as of those discrepancies in living conditions that trigger off tensions while persistence in its turn would make economic policy coordination an impossible task. Here is why *a monetary union implies an economic union*". (Italics are mine).

4) a larger share of small and medium-sized firms whose investments are more heavily dependent on commercial bank credit and, in any case, bear most burden of credit rationing;

5) a lower overall degree of capital intensity, which allows for more limited opportunities of capital-labour substitution ;

6) a larger share of industrial production exported which implies a greater stress upon profits when rising borrowing costs cannot be charged to selling prices due to international competition.

Therefore, whatever opinion one is willing to hold concerning today's loss of national monetary sovereignty, the need for monetary fine tuning must be recognised unless many past mistakes of national stabilisation policies are to be repeated, presumably with more dangerous implications, at the level of forthcoming European monetary management. This point must not be overlooked by those who think the establishment of a supernational monetary authority is a catch-all solution (see, e.g., Davidson, 1972, p. 28-9).

7. Alternative approaches to capital account disequilibria

The balance on capital account has called for increased attention since the early 1960's in connection with recurrent monetary crises and the growing size of the Eurodollar market. No official reserve stock, however large in size, nor short term reciprocal credit network can massive daily flows such as those recently experienced by UK and Germany: suffice to remember that, given the present gross size of German foreign trade in goods and services (approximately 100 billion dollars, i.e., a weekly gross flow of about 2 billions) leads and lags alone can induce daily flows of several billions! (1). Therefore, whatever opinion is held concerning intra-EEC rigid or adjustable parities, the issue of how to deal with capital account disequilibria must be squarely faced.

As regards the intra-EEC flows the problems disappear if parities are definitely locked. There is no room for speculation within a currency area, and bankers' arbitrage automatically takes care of interregional interest rate differentials. But this is a sort of tail-wagging-the-dog solution, as it has earlier been argued, since short of a truly federal government and of an appropriate set of industrial and employment policies a currency area in Europe today may bring about irreparable losses for citizens of "peripheral" Europe. If some scope is left for intra-group parity adjustment, expectations of such changes may engender some intra-group speculative pressure, although in the past most problems have arisen from external EEC flows (US, Switzerland and so on) and therefore some financing and adjustment mechanism must be found. At any rate the problem has to be faced with regard to financial relations between the

(1) Merchandise trade between the EEC and the rest of the world reaches also a gross value of approximately 100 billion dollars on a yearly basis. (See GATT, Le commerce international en 1971, p. 127).

EEC and the rest of the world. There are four alternatives: capital controls, overall flexible rates, two-tier exchange market, recycling of private note flows through public loans and reciprocal credit arrangements (1). The first three are mutually exclusive, although in principle some rate flexibility and capital controls might go together, the last one can be complementary to the preceding three.

a) Capital controls

Without going into details (2), I am here referring mainly to direct controls upon illegal unregistered flows (e.g.,Italian suspension of banknote convertibility after June 1972) and central bank regulations upon commercial bank gross or net foreign position (again, Italy is an example). The present arguement implies, correctly in my view, that no monetary manoeuvering through the interest rate structure, with or without credit ceilings, can provide an efficient way out of dilemma situations (e.g., surplus inflation) dominated by capital account disequilibria since only a fraction (occasionally very small) of capital flows is interest-sensitive (3).

Of course, while any control upon the net bank foreign position can avoid undue stresses upon the liquidity of the single country it may add to the speculative potential for the whole area by expanding the gross size of the Eurodollar market (banks can attain a given net position by reducing or by expanding foreign assets and liabilities in the due amount). That is why a correct European approach to the problem must go through some sort of bank regulation of separate assets and liabilities (reserve coefficients, open market operations, quantitative ceilings and so on) so as to recover for European monetary authorities some power to control the source and uses of the "international monetary base", and its multiplicative potential, hence, more or less indirectly, the size and the composition of the Eurodollar market, as it is implied by most recent analyses on the subject (4). Then, to the extent that the market, besides its ability to multiply credits and deposits, is affected by sizable leakages (to and from the US banking system and European central bank official reserves) (5) a bank-regulation approach has to be integrated by direct controls upon those leakages and, as Group of Ten central banks realised by coming to the agreement of spring 1971, a careful policy or redepositing official reserves.

The main alleged drawbacks of capital controls are: unfeasibility of a commonly harmonised set of rules, inefficiency, incompatibility with a growing economic and monetary integration. These are, for sure, serious but in my opinion not decisive

(1) I assume everyone would agree that wider margins of the snake-in-the-tunnel-type are no efficient solution, as vicissitudes preceeding the floating of the pound have demonstrated in 1972.

(2) For a rather extensive survey of capital control instruments employed by OECD countries see, e.g., Gilbert-McClam (1970). See also OECD Economic Outlook, 12, December 1972, p. 71.

(3) This point seems forgotten in Argy's (1971) presentation of alternative policy options facing dilemma situation.

(4) See Fratianni-Savona (1972).

(5) See Mayer (1971).

arguments against trying to find new and better common control regulations. At least as temporary remedies they may represent a feasible alternative for stemling unbearable speculative pressures (1) which otherwise would seriously hamper the maintenance of orderly market conditions. To stubborn detractors of such solutions it should be recalled that

- Italy and France have a fairly good record of regulations of bank foreign position which occasionally worked as an additional tool for domestic monetary management;
- Germany and Italy have learned a lot from 1969-1971 experiences, so that analysis of past losses of monetary control cannot be taken as a definitely negative test about the efficiency of capital controls under given circumstances (2).

Central bankers' opinions keep changing according to the emerging needs of international monetary policy so that alternatives which, for a long time have been discarded as unfeasible or harmful, may gradually appear as second-best solutions to otherwise unsolvable problems (think of statements made not very long ago by Governor Carli against direct controls upon illegal banknote outflows, or by the German Government against any type of interference with free international movements of funds, or by IMF officials against any abandonment of the fixed-rates-philosophy at the international level, and confront all these with contrasting statements and policy making in the last tro or three years) (3).

One of the most intractable problems of capital disequilibria arises with speculation through leads and lags, as it was mentioned before. Multinationals are particularly sensitive to this type of speculative gain, given theire opportunity to operate in several currencies simultaneously. Although any regulation in this field can presumably create some hindrance to small traders, something can be done by manoeuvering administrative deadlines for trade credits, as the Bank of Italy has done repeatedly in recent years. Of course litte. if any, they can be done against sudden waves of speculation such as those triggered off by expectations of sizable parity changes; that is why a crawling peg seems a far more reasonable and radical answer to the rise of destabilising speculation, provided governments show enough strength and credibility in assuming only real factors (basic balance items) rather than purely financial factors as criteria for defining the equilibrium level of parities.

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(1) See Krause (1972).

(2) This holds also for Porter's (1972) econometric findings about the 1963-1970 German experience of monetary policy measures largely sterilized by capital flows.

(3) "Considering the degree of insulation against foreign funds achieved - at least for the time being - in the Federal Republic of Germany, the risk that an increase in the central bank's rates of interest would trigger off a new inflow of foreign funds was not very great for the Bundesbank....Given the present pattern of interest rates at home and abroad and the continuation of the insulating measures - which for the time being are indispensable - the effectiveness of domestic monetary policy does not appear to be in any danger from the external flank". (Monthly Report of the Deutsche Bundesbank, November 1972, p. 5 and 8; italics are mine).

It is probably true (1) that all capital controls keep their effectiveness only for a limited period of time, since circumventing devices are quickly discovered by the market. It does not follow from this that their use should be ruled out, provided it aims at protecting government policies against temporary speculative crises and, therefore, the fundamental equilibrium is simultaneously approached by the correct use of adjustment policies (including parity changes, if necessary, and harmonised stabilisation measures).

b) Flexible rates

Although this system is largely incompatible with intra-area relationships it might be taken into consideration for adjusting capital account disequilibrium between Europe and the rest of the world. To some extent it would represent the most radical solution to the problem of destabilising speculation although this point is highly controversial, as it evolues from the long debate between supporters of opposite exchange rate systems. Perhaps the most relevant drawback of flexible rates under present circumstances, given the strategic role which manufacturing export firms play in sustaining the level of European employment, is that our countries cannot afford the risk of impairing their exports following a revaluation forced upon them by, say, a persistent inflow of capital from the US induced by different monetary policies (2) on the two sides of the Atlantic. Remember, incidentally, that a similar caveat was in order when we earlier discussed the costs of the "snake-in-the-tunnel" solution for those members of the European currency union affected by heavy unemployment and at the same time more likely to be trailed by other member countries in terms of determination of the common central parity vis-à-vis the dollar.

A related shortcoming or flexible rates could be found, more generally, in the excessive burden upon international traders both in Europe and the US owing to undertainty and/or the cost of forward cover.

c) Two-tier exchange market

The breaking up of the foreign exchange market in two separate sections with a pegged commercial rate and a free financial rate is a solution adopted by Belgium, Luxemburg for more than 20 years and by France since August 1971. Its extension to other EEC countries deserves serious consideration with respect to financial relations between the EEC and other currency areas. In principle, its main attractive feature is the remarkable simplicity with which the targets of ensuring smooth trade flows and offsetting destabilising speculation are attained simultaneously. Capital controls become unnecessary, trade balance adjustments may be effected without the pressures stemming from speculative rushes, and administrative rules can occasionally be revised if for some reason governments desire to encourage or disencourage those transactions which do not clearly belong to either section (e.g., yields on foreign investment, private transfers, tourism).

(1) See Krause (1972).

(2) A similar problem has come to surface in the past and is still reappearing in Canada during period of the floating pound (1950-1962 and again since June 1970): "Within the context of a relatively balanced current account, then, the greatest upward pressure on the Canadian dollar is likely to arise from capital flows (..). The impact of a higher exchange rate would fall disproportionately on the relatively small manufacturing sector which must play a significant role in any attempt to fully employ Canada's rapidly growing labour force". (Clendenning, 1972, p. 15).

Critics of the two-tier system point out that it is bound to ball apart when heavy speculation determines too wide a differential between the commercial and the financial rate so that parallel money markets are revived and loopholes are resorted to. Besides, as regards the proposal of generalising the system to the whole EEC, it is observed that:

- agreeing upon a common set of administrative rules is too hard a task given the "bureaucratic gap" which allegedly exists, say, between France and Germany;
- the system would conflict with the tendency to pursue greater international capital market integration;
- leads and lags speculation following expectations of commercial rate parity adjustments cannot be prevented under this system (1).

All these are serious but by no means positively concluding criticisms against a solution which from many standpoints appears as the most simple and straighforward answer to the bewildering dilemma of spurring economic integration within the EEC without getting exposed to the risks of irremediable losses for member countries' monetary authorities, or harmful effects on trade and employment from flexible rates, or hindrances to financial integration from bureaucratic controls.

d) Recycling of intra-EEC net capital flows

While EEC governments have not yet reached an agreement about enacting a mechanism for automatic recycling of intra-group speculative flows, a policy of offsetting private net capital cutflows by inflows of public loans and portfolio investment has been already successfully implemented within the Community. During the first half of 1970 and again starting from June 1972, Italy has been able to considerably neutralise the impact on official reserves of speculative capital flights by inducing Italian public corporations and financial institutions to issue securities on the European capital market, with the publicly concerted support of European bank pools. These loans are generally provided with an exchange guarantee and are reimbursable at any time, according to the Italian central bank's assessment of the volume of official reserves.

Clearly, under this system the borrowing country undergoes a debt servicing cost which, however, creates little concern given the short run nature of the operations involved. In fact, as everybody agrees, this is a feasible and efficient approach only for dealing with temporary and even reversable capital account disequilibria. Even through, from the accounting viewpoint, it is a mechanism for adjusting imbalances, since flows get registered "above the line", it is actually a way of financing those imbalances analogous to reciprocal credit arrangements and reserve pooling. Permanent or "structural" deficits could not conceivably get permanent financing, unless we were willing to consider them as purely intraregional imbalances

(1) For a general assessment about the two-tier system see, among other, Fleming (1971) and Barattieri-Ragazzi (1971).

within a multiregional political and economic domain. The argument is even more stringent if a persistent current account imbalance is involved. Short of a full economic union, member surplus countries would hardly agree to finance member deficit countries on a permanent basis.

8. Europe and parity adjustment

Almost everything that has been written (see the Mertens de Wilmars report, 1 June 1972) about the European Fund for money co-operation, its functions and use, is perfectly compatible with the proposal of carrying on the process of monetary unification without giving excess priority to exchange rate rigidity and centralisation of monetary policies. As a matter of fact, to the extent that governments wish to enthance the attractiveness of Europa as a unit of account and reserve money by giving it some constancy of purchasing power through the EEC, then intra-group exchange rates presumably have to be revised. Assume that Europa is indexed to some quarterly or yearly average wholesale price index or cost-of-living index of EEC countries. Then, to the extent that such indexes move along a non-uniform pattern among member countries, exchange rates of each country vis-à-vis Europa must be redefined, with currencies of more inflationary countries being subject to revaluation (1). Indeed, this constant purchasing power of Europa in terms of goods produced and sold within Europe might offer the greatest incentive to savers and institutional investors to demand Europa-denominated bonds, as well as to traders to start quoting their contracts in Europas rather than dollars or pounds or DM (2).

Of course, any time intra-group parities are changed, quota subscriptions to the Fund should be adjusted. For instance, devaluing member countries should replenish the domestic currency share of their own quota by the exact amount of the devaluation.

Likewise, reciprocal credit arrangements and recycling operations, as it has been done in the past, might well contain an exchange rate guarantee.

(1) The Mertens de Wilmars report itself at par. 59 openly recognises the possibility of modifying the definition of the unit of account (revisionary clauses).

(2) In this regard, the well-known real-exchange-rate argument would apply in favour of intra-group parity adjustments: see Balassa in Mundell-Swoboda (1968, p. 153-154).

9. Summary and conclusions

Monetary integration in Europe can be defined as a process of exchange rate management leading to the full use of a common currency, as well as a progressive harmonisation of monetary policies leading to the establishment of a European central bank which will eventually issue and control the supply of this common currency.

The goals of monetary unification are unanimously:

a) to foster the construction of an economic, institutional and political union;

b) to restore governments' control upon their economic policy which is weakened by foreign exchange speculation through the Eurodollar market;

c) to gradually replace the dollar as medium of exchange, unit of account, intervention, reserve and vehicle currency so as: c1) to break Europe's dependence from US monetary policy, c2) to stem the process of dollar accumulation in European official reserves rectifying the US balance of payments deficit, and c3) to recover to European nations the gains from seigniorage, reserve saving and smaller transaction costs.

The means for reaching the above goals have been envisaged as an articulate and stepwise stragegy resting upon tighter margins plus external flexibility, monetary co-operation through periodical consultations, reserve pooling (Fund for Monetary Co-operation) and the related introduction of a new unit of account. It has been argued in this paper that so far an excessive emphasis has been placed upon tighter margins and monetary harmonisation.

Such a policy approach has been shown to be highly risky for the following reasons.

a) It tends to ratify the private market's power to allocate the stock of money throughout the Community by asking national central banks to abide by the traditional rules of the game; this contradicts recent evolution in monetary authorities' thinking while it is likely to foster discriminatory effects of monetary restraints against weaker regions.

b) In connection to point a) it puts an undue stress upon monetary phenomena while it overlooks budgetary constraints upon the supply of monetary base, the risk of increasing the independence of monetary authorities from political controls, the underlying real, rather than monetary, obstacles which prevent the US economic hegemony from being effectively challenged.

c) It disregards the crucial role that intra-group parity adjustments may play in terms of stemming inflationary pressures and correcting domestic distribution so as to induce a desirable regional impact upon profits, investment and recovery from economic stagnation; also it unduly overlooks a correct full-employment balance of payments approach and overstates the disappearance of money illusion in regions affected by persistent unemployment.

d) It fails to provide an effective mechanism for financing intra-group capital account imbalances and for preventing and correcting capital account disequilibria between the EEC and the rest of the world; an exclusive reliance upon free capital movements, possibly tempered by exchange rate fluctuations vis-à-vis third currencies, cannot effectively get rid of the long-standing subjection of European policy-makers to the disinterest of big business and bankers in channelling private saving towards socially-desirable investments.

Providing a detailed set of alternative proposals for pursuing monetary and economic integration, without unbearable social costs for some Community partners, is beyond the scope of this paper. Brief indications have been provided along with the discussion. Here follows a very sketchy summary of them.

a) With regard to exchange rate policy the "snake-in-the-tunnel" mechanism should be matched with a commonly agreed scheme for small and frequent intra-European parity adjustments whenever divergent unit cost trends are deemed to have a tangible effect upon exporters' profits and ability to invest. In general, especially during the initial stages of the process, any automatic rule will have to be rejected, in order to limit the risk of inflation-devaluation spirals.

If, however, the new unit of account (Europa) were to be endowed with constant purchasing power vis-à-vis a representative bunch of goods produced and sold within Europe, then intra-European parities could not avoid beging adjusted following divergent national price trends (1). A priori one feels a much more significant (and probably more feasible) test of governments' genuine willingness to co-operate would be provided by a system of discretionary rather than automatic parity changes.

b) The European budget should be tangibly expanded so as to cover a set of employment and investment policy actions aimed at offsetting the inherent tendencies towards growing regional disequalities. CAP and EIB intervention schemes should be revised as well. Section 5 of this paper has criticised an excessive reliance upon a regional approach to the EMU, partly because of inefficiencies and inconsistencies of past and present national attempts in this direction leading in some cases (see policies for the Italian Mezzogiorno) to perverse effects in terms of employment and industrialisation. From this standpoint considerable gains can be expected insofar as the centralisation of European regional policy and of economic policy in general will help to overcome those inefficiencies and to free policy-makers from local and sectoral lobbies' pressures (2).

(1) Of course, price trends should be seasonally adjusted so as to avoid dangerous ratchet-effect devaluations following seasonal price rises.

(2) A further important direction where the effects of the European budget could be usefully spent is the financing of R and D in European industries. The role of the dollar as an international currency rests upon real rather than purely monetary phenomena, i.e., the expansion of US affiliates in more or less strategic sectors. Therefore filling the US-European technological gap may well be a pre-condition for effectively replacing the Eurodollar market by a Eurocurrency (first national currencies, then gradually the new Europa) market. According to many experts' opinion this task can be undertaken only through a massive European public support of R and D expenses, given the heavy direct and indirect support provided by the US Government to US head companies' R and D programs.

c) If European governments are to learn from past experience of constraints imposed on their economic policies by recurrent speculative waves in the foreign exchange market, they should be ready to adopt a more radical approach to capital account disequilibria. As far as intra-group flows are concerned, the target of maintaining and improving capital mobility so as to get to full convertibility is acceptable only insofar as:

- this does not rule out intra-group parity adjustments that are requested by the need to maintain actual and potential competition among firms subject to divergent trends in unit costs;
- EEC members agree about undertaking recycling operations (both "below the line" reciprocal credit arrangements within the reserve pooling scheme and "above the line" intra-EEC publicly-sponsored bond issues) so as to provide an unlimited reciprocal financing of any member's net capital outflow due to intra-area interest differentials and/or speculative pressures.

On the other hand, with regard to the EEC financial account vis-à-vis external areas, European governments should clearly acknowledge that wider bands cannot be a reliable and durable response to the permanent threat of massive flows that have so often in the past put an unbearable pressure upon European monetary policies. Therefore either a generalised two-tier exchange system or a common set of direct controls upon legal and illegal capital flows, especially of the short-term type, has to be enacted. Rules governing EEC banks' net foreign position vis-à-vis the external banking system might be implemented. Checks upon illegal banknote remittances from "financial heavens" such as Switzerland and Liechtenstein should be reinforced and improved. At the same time, a consistent set of banking regulations upon Eurobanks' operations in the Eurodollar market (reserve coefficients, credit ceilings, open market operations and so on) should be laid down, in order to ensure some control upon the process of endogenous deposit and credit creation in the Eurodollar market. Discriminatory rules might be devised aiming at encouraging EEC-banks to gradually substitute Europa-denominated assets and liabilities for Eurodollars.

d) Maintaining some scope for intra-European parity changes, as in the Magnifico-Williamson proposal, should not delay the introduction of Europa as a new unit of account, official reserve and intervention money associated with the working of the Funds for monetary co-operation. Europa might be indexed to SDR's (therefore indirectly to gold) or to some representative average price index of EEC countries, although I share many authors' opinion that the latter solution might be too cumbersome, at least for the initial stages of the new scheme, and might impose a risky automatic rule for intra-EEC devaluations. Small and frequent reciprocal parity changes should rather be decided according to commonly-agreed estimates of trends in unit costs and prospects for the invisible items in each member country's balance on current account (or perhaps basic balance), since no price index can fully reflect actual comparative advantages, and even less the trends in potential (full-employment) external balance equilibrium.

The introduction of Europa in the official reserve domain should be accompanied by a governmental commitment to denominate in Europa all future bond issues by govern - ments themselves, public corporations and State-owned enterprises. This logically follows from the successful experience of European security issues with an exchange guarantee clause (denominated in European Payment Unit) started in December 1970.

In the meantime private business should be encouraged to to the same and to start making Europa-denominated contracts. Thus both the immediate operational and psychological impact of introducing a new unit of account would pave the way for a gradual replacement of the Eurodollar and eventually of national currencies by a new European money.

If the axiom "natura non facit saltus" applies to economics, then no plan for a monetary "Roi Soliveau" can be recommended.

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Notes about European Monetary Unification

Definition of Europa

1. While there is unanimous agreement, if I gather correctly from previous discussions within our study group, about a European unit of account defined in terms of actual currencies rather than indexed to some price index or material backing, I find myself less convinced by Meade's stress upon the "bag of currencies" formula.

The principles involved look pretty clear and correct (to leave options for intra-group parity changes, and let these affect both surplus and deficit member currencies) but the mechanics involved in defining and eventually changing the V's and Q's arouses some suspicion that governments will hardly buy it.

I wonder if, for all practical purposes, the same goal could be more simply achieved by setting 1 Europa = 1 SDR = x marks = y francs = z pound = ..., where initial parities (x,y,z,...) are adjustable according to any agreed upon criterion.

Meade's scheme would require each member country to exchange its own gold and dollar reserves with a given proportional amount of other member countries' currencies not closely related to the weight of its own trade flows with member countries.

The problem would not arise if the pattern of intra-EEC trade were equal throughout the Community. But, in fact, it differs. As shown in Tables 1 and 2, imports from, say, France, represent 30 % of all Italian imports from enlarged EEC, but only 13 % of Dutch imports; similarly, German goods cover 43 % of Italian imports but only 23 % of U.K. imports, and so on. Divergences would certainly appear even wider if invisible, and particularly emigrant remittances, were also taken into account.

2. Defining Europa in terms of SDR's, on the contrary, would leave each country free to convert its Europa holdings into any preferred bag of currencies, or maybe a single currency, at current parities. Thus national central banks would have more leeway for intervening with the appropriate member currencies whenever they have to defend EEC tighter margins.

So long as national balances of payments have any meaning within the EEC, which is unavoidable during the transition phase up to full-fledged currency integration, the need of national currencies for intervention purposes seems inescapable, and any scheme for a new common unit of account should avoid creating undue hindrances to a smooth process of central bank cooperation on the exchange market. The argument can be reinforced if one thinks that intra-EEC capital flows, due either to interest rate differentials or to speculative pressures (which are bound to pop up inasmuch as EEC governments' credibility about parity fixing is somewhat faint), will force discontinuous and massive interventions in order to avoid the "puncturing the snake" and to keep control upon, say, a joint fluctuation of EEC currencies vis-à-vis the dollar.

3. While both Meade's scheme and the Europa-SDR proposal boil down to introducing a new unit of account (eventually a medium of exchange) with a reciprocal <u>exchange guarantee</u> for EEC members, the latter could probably enhance the attractiveness for private operators of Europa-denominated <u>bonds and contracts</u> better than the former. Free convertibility in any of the EEC currencies (aside from the dollar) was in fact the main reason for the remarkable success achieved by several Eurobond floatations since the ECSC issues in European Payment Units of December, 1970.

Finally, the Europa-SDR link could offer a convenient opportunity, clearly understandable to everybody, for playing a European role in the international monetary reform in the right direction, i.e., emphasizing gradual gold demonetization and sustaining the process towards internationally-controlled money creation.

<u>Exchange Rate Policy</u>

1. The April 1972 agreement among EEC members ("snake in the tunnel" and related rules for interventions in dollar or Community currencies), much like its predecessor, the Werner Report, lacked any guidelines concerning two crucial issues:
a) conditions and technical means for revising intra-EEC parities;
b) relations between the Eurodollar and the new emerging European money. Forthcoming official commitments and plans can hardly dodge the responsibility of giving at least some initial answer to both problems. Silence on the first point was somewhat related to the abandonment of the snake by sterling after two months. Inadequate consideration of the second point has been highly responsible for the recent monetary crisis which has forced the Bundesbank to inflate its official reserves by more than 25 % in a few days with inconvertible dollars bound to depreciation.

2. The closure of exchange markets this week and the strong hesitation by some EEC governments to accept a joint fluctuation vis-à-vis the dollar provide the most recent evidence that exchange rate policy is still a wide-open issue for member governments, and therefore no hasty decision can be reasonably taken. Had these governments made more efforts in the past towards putting up an articulate proposal for exchange rate policy rather than giving a unilateral emphasis to tighter margins and to undefined policy coordination targets, they would probably find themselves today far ahead in the process of shaping an effective European monetary strategy.

No resounding declarations and pledges for a united European attitude towards the international monetary system can hide the fact that in terms of parity fixing, the interests of member countries are still divergent. This logically follows from a close examination of recent history and short-medium term prospects for European economies, given the crucial impact of parity changes upon employment, distribution and growth that have been recalled in my previous paper.

The challenging issue is a common strategy of small and frequant <u>intra-group parity corrections</u> and the amplitude of <u>intra-group margins</u> (width of the snake). An amplitude of 2 - 3 % would permit the maintenance of interest rate differentials of

the same amount between any two member countries. Such an amount appears reasonable enough for allowing justifiably different stances in monetary policy on the part of member governments during the transition to a full monetary union.

3. The strategy might include a concerted intervention by EEC central banks in the forward exchange market, so as to keep the well-known interest rate parity condition in presence of interest rate spreads amoung member countries. While spot rates would fluctuate within the 2-3 % margin, nothing should prevent monetary authorities from allowing wider oscillations in the forward rates, as well as forcing them upward or downward under given circumstances in order to influence intra-group short term capital movements. Were national central banks to incur net losses as a result of these coordinated forward interventions, the European Fund could assure an equitable distribution of gains and losses.

4. The other side of a European exchange rate policy concerns EEC parities vis-à-vis the dollar. First, it should be clear that a straight joint fluctuation implies the acceptance of the Smithsonian philosophy which defines a U.S. "fundamental disequilibrium" in terms of the U.S. basic balance, unlike Bretton Woods philosophy which was concerned with current account equilibrium. As the U.S. government has kept saying since August, 1971, the U.S. asks industrial countries (including the EEC) either:

a) to shift their current account from surplus to deficit in order to allow the U.S. to get a basic balance mix with current surplus - long term capital deficit, or
b) to absorb U.S. current account deficit while redressing the structural U.S. long term net capital outflow (military expenses abroad, direct investment of the multinationals).

The latter might be implemented through sharing of military expenditures and a fresh commitment to channel European long-term funds to the U.S. (direct and portfolio investments). (See also Rueff's proposal for a reversed Marshall Plan in favor of the U.S.).

Although the latter seems somewhat more interesting in terms of European net benefits, both alternatives are highly questionable. Moreover, in a joint fluctuation scheme the crucial variable would be the U.S. official settlements rather than the basic balance, since short-term capital (liquid and non-liquid plus errors and omissions) flows through the same exchange market where long-term capital flows. Therefore, the well-known impact of U.S. vs. European monetary policies upon capital flows, hence the dollar parity, can be expected at any time. E.g., U.S. fiscal and monetary restraint in 1973, which can be gathered from recent policy announcements (1), might play the 1969 experience again, with Eurodollar rates soaring under the pressure of heavy demand for credit by U.S. companies, bank deposits flowing out of EEC countries towards Switzerland and Liechtenstein, attracted by interest differentials.

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(1) See FNCB Monthly Letter, February 1973.

This would lead to a dollar appreciation which would contradict most recent parity ralignments and give spur to the US protectionist revival. Alternatively, European governments would be again induced to follow the tide of US monetary policy, tightening their own money supply in order to push European interest rates upward. Both alternatives are clearly unattractive.

On the whole, I stress again my sympathy towards a common external EEC double exchange system, coupled with an appropriate scheme for unlimited reciprocal financing of intra-group capital account imbalances (i.e., recycling through official swaps and open-term loans by state-owned enterprises). Technical objections seem to me far outweighed by the remarkable advantage of a scheme which protects traders from artificial and rough see-saw trends in the dollar rate.

Eurodollars and European Monetary Integration

1. Banking controls upon the Eurodollar market have been mentioned above as the second great issue which European governments can hardly dodge any more. Eurobanks' role as intermediaries in the international monetary market has been zooming in the past, bringing about sizable profits (or rents?) to European banking business within the EEC, particularly in Germany, the UK and Luxemburg. Fear of depriving these national banks of their incentive to involve themselves in this activity has probably checked national governments' willingness to enact a coherent system of controls on the process of deposit and credit creation in the international monetary market (1). Thus the dollar has increasingly come to serve both as a national and international monetary base, and therefore as a vehicle for transmitting the impact of US monetary policy to European countries.

No economic justification can be found for spurring the process of monetary policy harmonisation and devising all sorts of schemes for monetary co-operation among EEC members while at the same time restraining from any effective control upon sources and uses of the international monetary base. The only positive step was taken in June, 1971, when central banks of the Group of Ten took the official commitment at Basle to stop re-depositing their official dollar reserves in the Eurodollar market. This was a long overdue but inadequate decision. Only a full scheme for rediscounting dollar claims on Eurobanks and open market operations (2) (control on sources of international monetary base), required bank reserve coefficients and imposed quotas of Eurobank loans to residents outside the EEC area (control on uses of international monetary base) can lay down solid foundations for an effective European monetary policy. Putting all the emphasis on national money supplies and ignoring the supply of "stateless money" (Machlup) constitutes a perverse strategy.

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(1) See McClam W.D., Credit Substitution and the Eurocredit Market, BNL Quarterly Review, 3, 1972.

(2) See the US Treasury bills issued, starting April 1971, to absorb US private liquid liabilities on the Eurodollar market. In 1970 Eximbank had done similar operations.

2. Once European monetary authorities have gained this type of banking control on Eurodollar claims and liabilities, the way is open for discriminatory rules which might induce private operators to shift from Eurodollars to Europa-denominated claims and liabilities (say, reserve coefficients and rediscounting rules biased in favor of the latter). Discriminatory rules are a long-lived feature of monetary management (e.g., interest rate ceilings, different reserve coefficients for time and demand deposits, discount window practices, inclusion of given types of securities in the composition of required reserves; consumer credit, subsidized loans, etc.) and nothing should prevent European monetary authorities from using them for ensuring the proper success to the Europa scheme.

3. Given the large and unstable leakages (dollar flows into and out of the European banking system) which seem a permanent feature of the Eurodollar market, the above-mentioned instruments for controlling the international monetary base and its credit multiplier have probably to be matched by direct controls upon capital flows between the EEC and the rest of the world. True, many of them have proved to be ineffective (private business and banking tend to be flexible than governments and parallel money markets are strongly resilient), but on the whole their usefulness and practicability, at least in the short run, have been recognized by government officials and central bankers since last year (x). In the long run most of them are bound to disappear, provided the free floating of the dollar vis-à-vis European currencies and an effective management by European monetary authorities of the Eurodollar market are given a reasonable chance.

(x) See "The Economist", special issue, "The Year of the Barriers", January 27, 1973. See also quotations from the Bundesbank Monthly Bulletin in my previous paper,p.33.

Table 1
EEC Trade Flows, C.I.F., in 1971 (millions of dollars)

from/to	France	Germany	Italy	U.K.	Bel.-Lux.	Netherlands
France	-	4568	2255	1067	2289	1168
Germany	4749	-	3220	1562	3251	4118
Italy	2105	3649	-	685	508	652
U.K.	953	1258	581	-	795	849
Bel.-Lux.	2329	3344	586	486	-	1935
Netherlands	1357	4528	718	1223	2096	-
EEC Total (9 members)	11587	17840	7490	6722	9002	8843

Source : OECD, Trade by Commodities, Jan. Dec. 1971.

Table 2

EEC Import Flows, C.I.F., in 1971 (percentage composition)

from/to	France	Germany	Italy	U.K.	Bel.-Lux.	Netherlands
France	-	25.60	30.10	15.87	25.42	13.20
Germany	40.98	-	42.99	23.23	36.11	46.56
Italy	18.16	20.45	-	10.19	5.64	7.37
U.K.	8.22	7.05	7.75	-	8.83	9.60
Bel.-Lux.	20.10	18.74	7.82	7.22	-	21.88
Netherlands	11.71	25.38	9.58	18.19	23.28	-
EEC Total (6 countries)	100.00	100.00	100.00	100.00	100.00	100.00

Source: Table 1.

Monetary integration

1. "A monetary union.... is a guarantee for the free movement of goods, services and factors of production" (p. 10). While this statement correctly applies to the Union at its final stage, as far as the conditions for intra-group parity locking are not met (i.e., during the present transitional phase: see Report, p. 14-18) it should be emphasized that a monetary union is not a necessary condition for free factor movements. As a matter of fact a premature push towards internal exchange-rate rigidity may well force national governments to hamper goods and factor mobility through direct controls, ultimately leading to a delay of the final stage.

2. "For the Community cycle progress towards EMU along the lines advocated in this report offers the right instruments (monetary) to deal with the problem it brings about, namely, the consolidation of a Community cycle" (p. 63). If this statement were to imply a policy assignment rule (monetary instruments to deal with short run fluctuations in output and price level, fiscal instruments to take care of structural disequilibrium) I would disagree. Monetary policy harmonization is not a sufficient condition (though it may well be a necessary one) for generating a common cycle. National cycles are so frequently triggered off by shifts in demand and profit expectations owing to changes in wages and productivity which no monetary management can keep under control. So far we lack any evidence of the monetarist view coming out true in the recent history of the European business cycles. As to the correct meaning of "monetary policy harmonization" (p. 6,7) may I refer to the points emphasized in section VI of my notes of January 12.

3. In the light of the proposals set up in section B3 (early promotion of CEC as a transaction currency) I fail to see the rationale for limiting the private use of CEC to large transactions (p. 39). Why should benefits from holding purchasing-power-stable assets accrue only to big savers and investors leaving out small ones, that is precisely those most badly hit by monetary instability?

4. The whole issue of capital movements, both within and outside the Community borders, would have deserved a fuller treatment. While we lack any clear evidence about **equalization** of interest rates and the scope for covered and uncovered interest rate arbitrage among European financial markets (p. 11), the main issues could be ordered as follows:

a) How to make the intra-group parity structure credible? Answer: leaving enough scope for internal flexibility (p. 27).

b) Given intra-group exchange rate flexibility, how to avoid intra-group speculative capital flights? Answer: first, a scheme for small and frequent intra-group parity adjustments (snake coupled with frequent devaluations and revaluations vis-à-vis the CEC); second, to make this very scheme feasible enough, start with a large reserve pool and a strong official stand in favour of unlimited intra-group recycling of sudden speculative flows. This implies an agreement about the price of gold for inter-governmental clearings.

c) If, however, speculative waves do take place within and outside the CEC bloc, how to prevent them from upsetting national and common monetary management? Answer: flexible rates erga-extra (or may-be a common two-tier system erga-extra) plus a coordinated setup of policy tools for offsetting the impact of intra-group currency flows upon national and Community money supplies (e.g., ceilings to banks' net foreign claims/liabilities, such as those frequently and rather successfully implemented by the Italian Central Bank).

Non-monetary integration

5. Fiscal incentives for intra-Community stabilization policy and regional policy (p. 44,48) should have a specific favourable impact on employment: e.g., budgeting of payroll tax expenditures, investment subsidies proportional to total wage and salary outlays or to the number of new jobs created. This point follows from the observation of the perverse effect which many incentive schemes have had upon Southern Italy employment, due to their inherent bias against a higher labour/capital ratio.

6. "We might be on the threshold of a new concept of the "regional problem.... characterized by congestion and infra-structure run-down and decay" (p. 46). This tends to conflict with the need of "very few and very simple" criteria "perhaps put only in terms of income and unemployment levels"(p. 46). At the present initial stage of regional policy integration we should beware of defining regional imbalances such that 50 % or 60 % of the Community area is entitled to share common budgetary transfers.

At the same time a much stronger Community control should be put on the actual use of these transfers: nationalistic fears bear much responsibility for the failure of CAP in planning a balanced agricultural growth throughout the Community.

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Documents written by Professor T. PEETERS

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Start with the European currency: the next step towards monetary integration?

Monetary integration ranks high on the agenda of the (enlarged) European Communities. It will stay there for the foreseeable future. The impetus for a new effort in the EC to embark on closer cooperation in monetary matters and for more effective harmonization of economic policies came from the European summit meeting at the Hague in December 1969. The movement gained momentum through the Werner Report in October 1970 to the Council of Ministers of the EC recommending "the realization by stages of economic and monetary union (EMU) in the Community". The proposals spell out in some detail a plan by steps which should materialize the conclusion of the report that "economic and monetary union is an objective realizable in the course of the present decade". Although the report **caused a good deal of opposition and** scepticism, its philosophy was endorsed by the EC Council of Ministers in February 1971.

Agreement on the steps to be taken during the first three-years stage of the Werner plan have been overtaken initially by the international monetary events during 1971. The exchange rate realignement of the Smithsonian agreement of December 18, 1971 cleared the way to resume the move towards monetary integration. Indeed, in the spirit of the Werner approach, the agreed widening of the band made action among the Europeans even more urgent. As a result, and with almost a delay of one year, the narrowing of the margins of fluctuations among the EC currencies (the snake in the tunnel proposal) has been put into effect. In the meantime an agreement has been reached also for a (modest) start of a Fund for European Monetary Cooperation. Besides these steps in the monetary field, some initiatives have been taken to institutionalize high level discussion (coordination) of monetary and budgetary policies of the member countries.

The central problem

EMU is already on its way at a moment there is still widespread doubt in the economic profession about the feasibility and the opportunity of EMU in general and of the approach chosen in particular.

The scepticism among economists is easy to understand. It is sufficient to recall first principles already clearly spelled out in the pioneering work on the subject by J. Meade and T. Scitovsky during the fifties. The problem is how can governments of the EC members countries reconcile national balance of payments equilibrium (external balance) with full employment at stable prices (internal balance) when the process of economic and monetary integration (gradually) withdraws available instruments and/or reduces the autonomy of using them. If monetary union implies fixed exchange rates and freedom of capital movements among the member countries, each government has to give up the instruments of exchange rate variations and the control of capital movements for adjusting balance of payments disequilibria. As a result of the creation of the Common Market the national governments already abandonned the possibility to use trade policy instruments for external balance. However, under article 104 of the Rome Treaty each country is still held responsible for balancing its external accounts.

The central problem for the creation of a monetary union appears to be nothing else than the familiar adjustment problem which is plaguing the functioning of the international monetary system for more than a decade already. It looks paradoxical that, at a moment when at the international level agreement is forthcoming for greater flexibility in the exchange rate as

a necessary instrument of international adjustment, the EC countries decide to move in the opposite direction on a regional basis. The loss of the exchange rate instrument for payments adjustment by individual EC countries would not be too damaging if the major disequilibria were between the EC as a whole and the rest of the world and not between countries within the EC. Unfortunately experience offers some evidence in the other direction.

Therefore, if one is serious about the implications of monetary union other devices than exchange rate adjustments are called for to cope with balance of payments problems. It is at this point that the organic link between monetary and economic union becomes self-evident. Progress towards economic union is necessary as a complement and,progressively,as a substitute for the exchange rate instrument to preserve external balance of the member countries. In other words since monetary union means abandoning the exchange rate for adjustment of external disequilibria within the EC, it is necessary to avoid chronic disequilibria a priori. That is the task assigned to economic union in the current approach of EMU. Economic union is then a peculiar way to cope with the external adjustment problem by trying to avoid disequilibria from occuring at all. If successful, adjustment becomes superfluous and monetary union possible.

Whereas initiatives in the monetary field (a Common European Reserve Fund) are intended to create adequate financing of temporary disequilibria within the Community - and the instruments for a common external and internal monetary policy - it is the task of the coordination and harmonization of economic policy and policy goals to solve the adjustment problem of (potential) chronic disequilibria without upsetting the internal balance of the member countries.

Whether this is a feasible solution, at least for the time being, is what professional economists are doubtful about. It all dependes,of course,on what is meant by coordination and harmonization of economic policy and policy goals. The most sensible interpretation one can think of in the context of EMU appears to be those rates of inflation and growth rates in the different countries which are consistent with the maintenance of external balance. Given the structural differences among the EC countries which still exist, this may imply for members in (potential) balance of payments surplus to accept more inflationary policies and for those in (potential) deficit more deflationary policies than they might otherwise have chosen. Whether this will be considered compatible with the internal objectives in the different countries remains an open question.

If economic policy coordination cannot do the trick and external disequilibria within the Community cannot be ruled out, transfer payments among the member countries are in order if monetary union is to be preserved. Regional policies and policies of fiscal redistribution at the European level then become of overall importance in the intra-European balance of payments adjustment process.

All this of course has by now become almost conventional wisdom, and it looks like there is not much hope for the success of EMU in the near future. It is important to realize, however, that all that has been said so far is only relevant for the final stage of EMU. It is characteristic of the debate that scepticism over the process towards economic and monetary integration is mainly expressed in terms of a confrontation between the conditions which

have to be fulfilled in the final stage and the realities of today. This looks somewhat like rejecting the construction of the Common Market in 1958 because of the obstacles still in existence at that time. This should not obscure the fact that the abolition of barriers against the integration of markets involved in the formation of a common market might be an easier process than the integration of institutions and policies involved in the construction of an economic and monetary union.

Attention needs to be concentrated much more on the process of economic and monetary unification which can lead ultimately to full economic and monetary union. Of course, one has to be clear about the ultimate objective one is aiming for and its implications. What is, however, at least as much a subject for immediate concern is the process which can bring about the needed changes so as to make a feasible objective of what may still look like utopia. Against this background it is better to think in terms of economic and monetary unification as distinct from economic and monetary union.

One important practical conclusion so far is that economic and monetary unification will have to be a gradual process where action is undertaken over a large spectrum of complementary measures introducing the changes needed to create, ultimately, a viable monetary union. It should also be clear that the EC countries can only give up the possibility of modifying their exchange rate to the extent that other instruments and procedures are created that will cope with the intra-European adjustment problem. Although this means that monetary union is not possible for the time being, it does not imply that progress towards monetary unification becomes impossible.

EMU: what for?

The objective of monetary integration is not new. It exists since the start of the Common Market. What is of recent origin are alternative motivations and concrete proposals followed up by decisions for the realization of monetary integration.

1. The oldest plea for monetary integration derives from the philosophy of the Rome treaty itself. The creation of a Common Market includes not only the free movement of goods and services but also the free movement of factors of production. Only under these circumstances it is argued, will the EEC create conditions for the production, consumption and the exchange of goods and services that become comparable to those existing in a national market. Therefore, the need for capital market integration through a European capital market has been on the agenda of European unification already since 1957.

2. Of more recent vintage (1968) is the argument for monetary integration which is rationalized on the ground that it is necessary to preserve the achievement of the EC in the industrial and agricultural fields. The creation of adequate monetary arrangements are required to guarantee the continued functioning of the EC and even its survival. The problems created for the operation of the Common Agricultural Policy by exchange rate modifications stand out particularly in this respect. It is an illustration of a well-known strategy of pursuing European integration at a technical and functional level in the hope that in due time this will induce further action in other domains under the force of circumstance.

3. The need to domesticate the Euro-dollar market is, since 1969, another popular argument for closer monetary cooperation and integration among the countries of the EC.

4. The creation of a distinct unified European monetary zone is necessary to counteract the de facto dependence on the dollar, thereby creating the possibility of reestablishing European control of monetary conditions (69-71 experience). Implicit in this affirmation of European identity is some reform of the international monetary system that allows greater flexibility of exchange rates vis-à-vis the dollar than within the EC currency "bloc". Also implicit is the belief that common action can achieve positive effects not attainable for each country separately. In short, only a Europe unified in monetary matters can challenge the dollar and contribute to a more balanced reform of the international monetary system, thereby reducing the existing assymetry.

5. The need exists to create adequate instruments to fight inflation. This objective is closely related to point 3 and 4. Monetary unification is needed to gain better control over the European money supply. It is hereby assumed that short term capital movements and externally induced changes in the money supply are one of the causes of accelerating inflation in recent years.

This brief summary of some of the major arguments for EMU demonstrates that originally progress towards economic and monetary unification was seen as a logical step and as an integral part of the construction of a common market and as a necessary step to reach ultimately the stage of a full economic union. Internal Community building was the major driving force which inspired the proposals for economic and monetary unification antidating the Werner report. Capital market unification received most attention. Exchange-rate-unification was assumed to be agreed on implicitely through the decisions over the Common Agricultural Policy.

Repeated currency crises since 1967 shifted the emphasis from internal preoccupations towards a more externally-oriented approach. The preservation of the European identity and the desire to keep control over its own economic and, particularly, monetary situation are among the main motivations of the current proposals. It is Europe's position vis-à-vis the outside world which has become the driving force for economic and monetary unification. In this context attention is focussed first on exchange rate unification within Europe. This should at the same time enable differentiation with the rest of the world. Progress towards economic and monetary union is mainly forced on Europe by the developments in the international monetary situation. Action is needed to preserve Europe's decision-making capacity as well as the achievements of the Common Market. At the same time it is a dramatic goal able to mobilize imagination and to maintain the momentum for further progress towards unity during the seventies, in keeping with the role played by the construction of a common market during the sixties.

The meaning of EMU

The shift in emphasis of the motivations for EMU together with what is to be its central problem - the mechanism for intra-European balance of a payments adjustment - cannot be overlooked, if one tries to define more precisely the meaning of EMU. Also it has already been pointed out that it is meaningful to draw a distinction between monetary integration as a process or as a state of affairs.

Monetary integration as a state of affairs is essentially a static concept of the ultimate stage of monetary union. It has two essential components: exchange rate union and capital market integration. The former is an area within which exchange rates bear a permanently fixed relationship to each other, though the EC rates together may very relative to non-union currencies. The latter is an area within which there is the permanent absence of exchange controls for capital transactions, including interest and dividend payments. To maintain this state of affairs permanently it is necessary that a number of conditions be fulfilled. Summarized in a nutshel they are the conditions that will guarantee intra-European payments equilibrium. It is easy to observe that these conditions do not correspond to the realities of to-day. Monetary union as a state of affairs must, therefore, be considered as a logical impossibility under present circumstances. This, however, is not sufficient to claim that it is also a logical impossibility for the future, when conditions can change as a result of concrete policy action. Whether the conditions can be adjusted in the direction needed depends on the possibility of substituting socially and politically acceptable adjustment mechanisms for the loss of internal exchange rate variations.

From a policy point of view it is sensible only to speak of European monetary integration in terms of a dynamic process of change. That is why earlier in this paper the expression economic and monetary unification was preferred over economic and monetary union. As a process of change EMU should contribute to reduce intra-European exchange rate variations, substitute alternative adjustment mechanisms, promote capital market integration, improve the monetary management (internal and external) of the European economy, probably implying greater flexibility of exchange rates versus outside currencies.

EMU : how?

If the preceeding analysis comes close enough to the truth, EMU can only be brought into existence by simultaneous and complementary action over the whole range of issues which have to be dealt with. In this respect the early launching of a European currency (1) presents itself as a very attractive complement to fill some of gaps left by the Werner approach. One of the weak spots of the Werner plan is that although it addresses itself to practically all of the major problems and objectives involved in EMU and offers suggestions on what should be done, it is not sufficiently explicit on how it should be done.

The steps suggested for the first stage of EMU and adopted by the Council of Ministers (the snake in the tunnel, the European Fund for Monetary Cooperation, the new initiatives for the coordination and harmonization of economic policies, and for regional and social policies) still fall short of the wide-ranging, simultaneous and complementary action required by the dimension of the task under review. The narrowing of the intra-European exchange rate band is an important step but in the present context is operated through a rather complicated intervention mechanism. It is also a move towards greater exchange rate rigidity at a moment the

(1) The most articulated proposal has been explored by G. MAGNIFICO and J. WILLIAMSON, European Monetary Integration, A Report of the Federal Trust for Education and Research, London, January 1972, Other contributions include R.A. MUNDELL, A Plan for a European Currency in H.G. JOHNSON, A.K. SWOBODA, The Economic of Common Currencies, Proceedings of the Madrid Conference on Optimum Currency Areas, London, G. Allen & Unwin, forthcoming; F. ELSASSR, Pour une union monétaire européenne dès 1973, Chroniques d'Actualités, S.E.D.E.I.S., February 1972.

efficiency of the substitute adjustment mechanisms is still highly questionable. A new European currency (Europa) managed by the equivalant of a European central bank would greatly simplify intervention procedures. The European nations would peg the value of their currencies to the Europa within the permitted range of variation of intra-European exchange rates. The European Central Bank would be responsible for pegging the value of the Europa to the dollar.

A smaller intra-European band would necessarily be the result since the permittend range of variation of each national European currency in relation to the dollar would amount to the Europa-dollar band plus the full intra-European band. Not the least for this reason does the launching of the Europe need international approval.

The critical step for the early launching of a European currency is, of course, the creation of a European Central Bank responsible for the issue, the promotion and the management of the new currency. It implies a common pool of reserves (gold, dollars, SDR's) and a common external monetary policy. At the internal level the European bank would ensure effective control and continous policy-making in European monetary matters, thereby harmonising credit conditions in the Community to the extent required by the process of monetary unification. It is often claimed that a European Central Bank is only possible as the "couronnement" of the final stage of monetary unification, which means that the proposal is hardly realistic at an intermediate stage. Arguing against the Williamson-Magnifico proposal on this ground, however, overlooks its crucial feature of the still existing intra-European exchange rate adjustability, and of the fact that each national central bank is still required to peg its own currency to the Europa and finance deficits from its own reserve. There is no need for unlimited financing of national balance of payments deficits by the European Bank in this system. It is clear, however, that the European Central Bank will operate the system of (limited) mutual financial assistance forthcoming under the current proposals for a European Fund for Monetary Cooperation.

To be successful the Europa needs to become not only a new (intra-European) reserve currency. It must also become an intra-European intervention currency and therefore a sufficiently widely used trade currency. The success of the Europa as a private asset able to function as pan-European money will depend on whether it will succeed to fill the role that the Euro-dollar has performed for the past decade in acting as an instrument for the creation of unified European money and capital markets. In order to qualify as a desirable substitute for the Euro-dollar in the European Community, the most important single quality - outside government induced promotion - is probably whether the Europa will manifest greater stability in terms of the national European currencies than the dollar. This may prove to be a very severe test.

What is necessary for the smooth functioning of the Europa-system are smaller intra-European payments imbalances than the payments imbalances vis-à-vis the outside world. The launching of the European currency under the present circumstances can therefore be seen, not as a substitute, but only as a complement to the current Werner approach. It includes all the features of the first stage of the Werner proposals on the monetary side and carries them a decisive step further. It needs the proposed action on the economic side to reduce intra-European imbalances but adds at the same time through internal and external exchange rate flexibility an important additional instrument to obtain the given objectives in the interme-

diate stage.

It is not our purpose here to make a full analysis of all the implications, the procedures and the mechanisms that will accompany every initiative to start with a European currency now. There is one important, perhaps overriding ceveat, at least in my opinion, namely Gresham's law. To be successful, at least as a solution for the intermediate stage, it is imperative that the Europa circulates side by side with the national currencies. Otherwise it can technically no longer function as an intra-European intervention currency.

On the other hand to play its role in the integration of the European capital and money markets, full convertibility with the national currencies has to be guaranteed. How could the Europa survive say,another May 1968? What will happen when the olners of a national currency go for a massive and sudden conversion into Europa's? It is not clear, at least not in the writings on the subject so far, how speculation is going to be avoided, and if it occurs how it is going to be dealt with.

November 1972

The Europa scheme - Necessary Complementary actions

The comments set down in the following notes should be read as a complement to our paper circulated at the previous meeting of the group. They are, in the first place, intended to provoke further discussion.

A common currency needs a common monetary policy

What the process of monetary unification following the Europa scheme would look like, is more or less clear. It would be inaugurated with the creation of a European Bank, performing the functions of an embryonic reserve and currency issuing bank, having the following responsabilities (1):

(a) It would act as a European Reserve Fund operating the system for mutual financial assistance among the European countries,

(b) it would issue and promote the growth of the Europa as a private monetary asset, principally by acting as a central bank to commercial banks operating in the Europa market,

(c) it would intervene to stabilise the Europa/dollar exchange rate and assume major responsability for the external monetary policy of the Community by recommending changes in the parity of the Europa (in terms of gold/SDRs) to the Council of Ministers;

(d) being responsible for confidence in the Europa, it would control the internal monetary policy of the Community and ensure consistency between the general Community policy and the policies being pursued in individual states, including supervision of intra-European exchange rates.

What it, in fact, amounts to is a trully centralised Community monteray policy. Because of the convertibility between the national currencies and the Europa and, therefore, of the increased connections between financial markets, the European bank becomes the principal manager of the European money supply. If the scheme is to work in the sense that the member currencies are freely convertible, then the supply of each currency outstanding (including the Europa) must increase no more rapidly than the demand for that currency. This procedure works in the U.S. currency union, which comprises 12 Federal reserve districts, because the banks within each district are limited as to the rate at with they can expand their liabilities (deposits and currency notes), by the rate of growth of their reserves. If their liabilities grow too rapidly, that is, if money expansion is inflationary, they have a payments deficit and this deficit is settled by the loss of reserves.

The national central banks will have to obey strict balance of payments discipline, making adjustment policies more automatic, moving in the direction of the traditional equilibrating rules of the game. At least as far as the intra-European payments mechanism is concerned, the policy choice is between the functioning of an old-fashioned gold standard or a prompt adjustment of the exchange rate in the case of inconsistent price and cost trends in different national regions.

(1) G. MAGNIFICO and J. WILLIAMSON, European Monetary Integration, A Report of the Federal Trust for Education and Research, London, January 1972, pp. 8-9.

May-be at first sight this would be asking to much from national monetary sovereignty. It is important, however, to realize that the logic of the system restores at the European level the efficiency and independence of monetary policy for stabilisation purpose, in the first place anti-inflation policy, which the national central banks have lost a large extent.

Controlling inflation offers itself as the natural goal for the European central banking institution. What has been said so far must also have made clear that the Europa proposal, if it is to be effective, is not only an important step towards monetary unification. It is as much a step towards economic unification, because it creates a European decision-power in monetary matters, while at the same time maintaining the possibility of national exchange rate adjustability.

The meaning of economic union

The necessity for parallelism between progress towards economic and monetary unification is an officially accepted dogma. What this "dogma" really means is sometimes a matter of confusion. The definition of a monetary union is rather precise and generally agreed on. When it comes to define the concept of an economic union one is traditionally offered such loose expressions as the coordination and harminization of economic policies.

Coordination and harmonization are favorite concepts in the Community terminology but it is never clear what a commitment for coordination and harmonization of national economic policies at the Community level really amounts too. That is the reason (at least in my opinion - why there is so much talk in the Community institutions of the need for coordination and harmonization, that one so easily agrees on commitments to coordinate and harmonise, that the committees for making it work are florishing and that the answer to real difficulties is often yet another committee (the process of integrationthrough talk versus integration through policies).

Mure surprising even is that it is not always clear how to interpret the expression economic policies in the context of economic unification. In this respect it seems useful to distinguish at least between two possible interpretations of economic union.

First, there is the meaning of economic union in terms of the need for parallelism between progress towards economic and monetary unification. Second economic union can refer to the whole process designed to lead to ultimate political union.

1. In the framework of the current discussion over the need for parallelism between economic and monetary unification, progress towards economic union would then include the steps which have to be taken in order to make monetary unification feasible and visible under conditions where each national government is still held responsable for its balance of payments equilibrium. It has been argued sufficiently, and I believe convincingly, at the previous meeting of the group that the real issue in this respect is wage rate unification. With the Europa scheme and "monetary policy elevated to the level of the Community as a whole, new instruments will be required for stabilization of the economies of the present national members, and flexible use of fiscal policy naturally comes to mind.". Once unity of monetary control is established, fiscal independence is desirable. Governments will not, of course, have access to central banks to finance budgetary deficits; they will have to be financed on the

private (European) market. For that reason, fiscal independence will not always be sufficient to assure reasonable stabilization of the constituent parts of the Community; it should be supplemented by stabilizing fiscal transfers among regions that are experiencing different business conditions, much as is done by (the US) federal system of unemployment compensation, and indeed by the entire federal budget, among the regions within the United States (1)".

This quotation from an article by R.N. Cooper highlights sufficiently what, if anything, should be understood **about** progress towards economic unification as a complement to monetary unification. It amounts to the creation of a European budgetary "masse de manoeuvre" which in its revenue and expenditure characteristics should operate as an automatic built-in stabiliser, analogous to the fiscal transfers resulting from progressive income taxation and the operation of the social security system within the national states today.

Against this background one might suggest an alternative, more institutionally-oriented definition of an optimum currency area or, more precisely, of a feasible currency area in terms of a region within which government taxation and expenditures operate an automatic, although not necessarily full compensation of regional payments imbalances and within which trade union action, together with social security payments and transfers, guarantee sufficient wage rate unification. May be this is an anti-climax for the idea of a feasible currency union with the nation-state where a political authority exercises sufficient power for a unifying social-economic policy. It is still useful, however, at the European level to the extent that in this way one gets a clearer picture of the kind of actions necessary in the socio-economic field as a complement to action in monetary matters.

One point should be clear i.e., monetary union is compatible with a large degree of budgetary independence for the member-states. Perhaps one should even not attach **too much** weight to the need for fiscal transfers if the experience and the functioning of **e.g.** the Belgian-Luxemburg monetary union has some relevance for the European experiment. Or is the Belgian-Luxemburg monetary union just another illustration of the importance of being unimportant? Or is there a de facto sufficient degree of wage rate unification between the two countries which disposes of the need for fiscal transfers?

2. Holding the view that monetary union is only feasible as the "couronnementé" of a politically motivated integration process, progress towards economic union has to be approached in a rather different context. It then becomes the creation of the decision capacity and of the power to act in economic affairs necessary for the construction and the functioning of a European political union. Depending on the degree of political unification achieved or wanted the economic imperatives will differ and depend on the whole complex of socio-economic-political motivations which underly the European integration process. Under these circumstances the basic objective will be to substitute common rules and policies for national action in as many field as possible. What the possibilities are will depend on the nature of the political unification one wants and the degree of supra-nationalism one is willing to accept. This may go over a whole range from minimaliste to maximaliste solutions and accompanying transfers of power in the economic field. That in this context the meaning of economic unification gets

(1) R.N. COOPER, Monetary Unification in Europa; When and How? The Morgan Guaranty Survey, May 1972, pp. 4-11

confused can hardly be a surprise. One does not know what really the objectives are. Even if one knew, it appears generally that there does not exist a minimum consensus as to what Europe should ultimately look like, not as to the method for achieving it.

Therefore, the argument,"let us first make Europe and monetary union will not be a problem any more", is rather trivial and, under present circumstances, equal to a non-sequitur.