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EUROPEAN MONETARY UNIFICATION FOR BALANCED GROWTH: A NEW APPROACH

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Outline of the New Approach

In this essay I surmise that, sustained and regionally balanced growth being ultimately the main economic goal of integration, progress towards economic and monetary union in Europe ought to be enhanced by defining a number of large economic regions and regrouping them on the basis of their ability to realize their full growth potential. Although each group might include whole member countries, the border between the two would cut across national frontiers. Instead of having one general economic policy for the whole Community, with piecemeal measures for the weaker regions tacked on, twin "regional" policies should be defined and pursued at all times: respectively for the high-activity and the low-activity grouping. Policies for the former would continue to be implemented, in much the same way as up to now, mainly by national institutions. For the latter group, instead, existing machinery would be reinforced by setting up an *ad hoc* body: the Multi-role European Bank. As implied by the name, the MEB would be empowered to carry out a very wide variety of operations; it would be endowed with resources on a scale adequate to play a major role in raising the rates of growth in the laggard regions. Gradually, the MEB could be developed into the Community central-banking system and co-exist with the national systems. Its liabilities would serve as money and be issued in the form not only of deposits, but of notes also: the European Currency Units. These would circulate alongside the national currencies and thus meet the need for a common monetary standard in those economic sectors which by the nature of their activities are most open to integration.

It will appear from what follows that the arrangements here proposed should allay the fear that some countries, or parts thereof, may become large depressed areas as a result of the loss of freedom to change their exchange rates. This will make the commitment to rigid rates and absolute payments freedom acceptable to countries—and credible to markets. A differentiated regional policy will reduce the need for intra-Community flexibility of exchange rates. But resort to Community-supervised flexibility of all or some Community currencies might also not be ruled out altogether, at the outset. Flexible exchange rates within the Community

would after all mean only *partial* internal flexibility, since in each and every member country European Currency Units would circulate. While flexible national currencies, if and when necessary, would add room for adapting demand-management policies to local needs, the ECUs would be the instrument for maximizing benefits from freedom of trade and factor movements in the Community. Finally, the ECUs might, or might not, have a fixed parity in terms of dollars and/or gold.

Summary of the Werner Report

It is of the essence of an economic union that goods and factors of production should be allowed to circulate freely within it. As long as it remains a multi-currency area, total interconvertibility and irrevocably fixed rates help to secure unhampered freedom of circulation. Thereby, transactions across national borders are assimilated, in character and risk, to domestic ones: in neither case is a forward-exchange cover necessary.

It is, therefore, understandable that the authorities of the European Economic Community should be so much concerned with the monetary aspect of integration, as the emphasis put on it by the Werner Report suggests.

The "Report to the Council and Commission on the Realisation by Stages of Economic and Monetary Union in the Community" was drafted by a group of experts presided over by the Prime Minister and Minister of Finance of Luxemburg, Pierre Werner, by whose name the group and the report are usually designated. The Werner Group was set up in March 1970, in accordance with the directives issued by the Conference of EEC Heads of State and of Governments which took place at The Hague on 1st and 2nd December 1969. In the report the Werner Group submitted to the Council of the EEC in October 1970, the conclusion is reached that economic and monetary union is an objective attainable in the course of the present decade, and that a plan to that effect should be implemented by stages. At the end of the process, the principal decisions of economic policy would be taken at Community level, with consequent transfers of responsibility from the national governments to Community organs. The creation of a center of decision for economic policy, which would be politically responsible to a European Parliament, and of a Community system for the central banks are deemed indispensable. The steps to be taken would be interdependent and reinforce one another: standardization and, finally, unification of economic policies would accompany the process of monetary unification. For the latter, the Report states that it implies "the total and irreversi-

ble convertibility of currencies, the elimination of margins of fluctuation in rates of exchange, the irrevocable fixing of parity ratios and the total liberation of movements of capital."

The Report does not lay down a rigid timetable, nor does it indicate in detail the measures to be taken during any but the first stage. This will cover the three years from 1st January 1971 to 31st December 1973 and will entail *inter alia*:

(a) compulsory prior consultations in matters concerning principally medium-term economic policies, cyclical policy, budgetary and monetary policies;
(b) establishment of procedures for regular "concertation" at the Community level between the EEC Commission and the social partners (associations of employers and trade unions);
(c) formulation of the general lines of economic policy at Community level and determination of quantitative guidelines to be applied to the main components of public budgets; preparation of a Community survey before member governments draw up and adopt their budget proposals; synchronization of national budget procedures;
(d) fiscal standardization, and in particular adoption by *all* member countries of the value-added tax system, with "assimilation" of national rates; alignment of excise duties sufficient to allow suppression of controls at intra-Community frontiers;
(e) abolition of residual exchange controls and discriminatory administrative practices which still restrict capital movements between member countries; coordination of policies concerning current problems and structural aspects of capital markets;
(f) standardization of the instruments of monetary policy; obligatory consultations to be held by the Committee of Central Bank Governors, which will scrutinize at least twice a year monetary and credit conditions in each member country, and will issue guidelines concerning principally interest rates, bank liquidity, granting of credit to the private and public sectors.

Finally, the Report recommends that, from the start of the first stage, the central banks limit the fluctuations in the intragroup rates of exchange within bands narrower than those resulting from the application of the margins in force for the dollar. This would be achieved by concerted action on the dollar and, after an experimental period, would be announced officially.

Narrowing of the margins would be accompanied by interventions

on exchange markets in Community currencies. During the first stage, the mutual-credit facilities to which such interventions may give rise should not exceed those laid down for the mechanism of monetary support at short term. But it is proposed in the Report that possibly during the first stage, or in any event the second, a European fund for monetary cooperation should be created as a forerunner of the Community system of central banks to be established in the final stage. The fund would absorb the existing EEC mechanisms for monetary support, and for financial aid at medium term. It would gradually become the organ for common management of the reserves of external liquidity.

The Resolution and the two Decisions, which were adopted on 22nd March 1971 by the Council of Ministers of the Community concerning economic and monetary unification, embodied the substance of the proposals made in the Werner Report. Among other things, it was decided that, from 15th June of this year, member countries would narrow from 0.75 to 0.60 per cent the margins of fluctuation for intragroup exchange rates. Furthermore, a mechanism for the granting of financial aid at medium term (two to five years) was set up in the form of mutual-credit facilities adding up to the equivalent of two billion dollars (the French and German shares amount each to 30 per cent; Italy's to 20 per cent; Belgium, Luxemburg and the Netherlands participate with 10 per cent each). Finally, it was decided that the creation of the European Fund should again come up for consideration by the Council by mid-1972, with the aim of setting it up before expiration of the first stage.

However, on a point of principle the decisions taken by the Council did not follow Werner. In the Report's philosophy the transitions to the second and third stages were to be automatic. Acceptance of the Report was assumed to imply a commitment to participate in the whole process, leading eventually to the introduction of a common currency and the creation of a policy-making body to manage it. But at least one member country, France, was not willing to undertake that commitment, and argued that for the time being countries should commit themselves for the first stage only. Although the French request met with considerable opposition, in the end it was agreed to—but with an important proviso. It was laid down that the agreement on the narrowing of the margins, the machinery for medium-term financial aid, and the European Fund would at first be limited to five years from the beginning of the first stage. The life of the agreement would be extended for an indefinite period—as was originally intended—at the time of the transition to the second stage, the extension being contingent upon the progress made towards the "convergence" of national economic policies and the readiness

to accept the constraints put upon them by the measures proposed in the Werner Report for the second and the third stages.

The inclusion in the mentioned Resolution of the EEC Council of the "precautionary clause," as the proviso is now known, is meant to give the right to opt out of the venture to those countries which, in the absence of measures to check differentials in national propensities to inflate, might be called upon to make good other members' inflationary gaps. These latter, on the other hand, would not accept a firm commitment to the Werner Report *in toto*, being aware that rigid adherence to a common monetary standard could, under certain circumstances, and failing adoption of adequate counter policies on the part of the Community, thwart their process of growth.

The solution was (not) found by postponing the ultimate decision on the issue—while not questioning the basic assumptions in the Werner Report.

Growth as the Ultimate Economic Objective of Integration

One should not lose sight of the fact that unrestricted freedom of trade and factor movements is not the be-all and end-all of economic union. Because that freedom is not a sufficient condition for full employment and growth, it cannot be considered as more than an intermediate objective and it should be treated as such. Consequently, in the process of achieving the goal of economic union more attention should be paid to matters, other than freedom of circulation, which will secure for the Community a better employment and growth performance. There is, of course, growing awareness of the costs that growth involves for society and the individual—so that the growthmanship *à outrance* which has been fashionable in the past twenty years appears now to be almost obsolete. Yet the better "quality of life" towards which the emphasis has shifted is hardly to be attained without full employment of resources, progress of productivity, growth. By offering its members better prospects of performing well on that score the Community will be better placed to overcome the centrifugal forces which, no doubt, will time and again threaten progress towards unification. These prospects will have to measure up against the unprecedented achievements of Europe as a whole during the postwar period.

The growth of the European economy after 1945 was steeper and smoother than at any other period in modern times. The advance was not equally rapid in all countries, yet even the economic performance of the laggard ones represented an improvement when set against their record in the late nineteenth century and in the first four decades of the twentieth. The EEC itself contributed to this result. It has recently been

argued that the relevant trade and output statistics supply no substantial evidence that the EEC countries have become more competitive, more specialized, or faster-growing by reason of their membership and that, if anything, the evidence points the other way. But what would have happened both in member and nonmember countries if the Community had not been created could not be shown by these statistics. Be that as it may, there is scarcely any doubt that the EEC will not only have to keep overall growth rates high by international standards, but also see to it that no member country or large economic region lags too far behind.

There is, however, no built-in mechanism that would work quickly enough to prevent underemployment of resources and economic decline in some regions of a unified area, while the area as a whole was experiencing a period of rapid growth. In fact, one of the outstanding empirical regularities to be observed in the process of growth of countries which have long been unified is that some regions have persistently had higher unemployment and/or grown more slowly than others. And there is a school of thought that holds that regional inequalities, which may have at their origin an exogenous, accidental change, tend to perpetuate themselves. Gunnar Myrdal, among others, argues that:

> In the centres of expansion increased demand will spur investment, which in its turn will increase incomes and demand and cause a second round of investment, and so on. Saving will increase as a result of higher incomes but will tend to lag behind investment in the sense that the supply of capital will steadily meet a brisk demand for it. In the other regions the lack of new expansionary momentum has the implication that the demand for capital for investment remains relatively weak, even compared to the supply of savings which will be low as incomes are low and tending to fall. Studies in many countries have shown how the banking system, if not regulated to act differently, tends to become an instrument for siphoning off the savings from the poorer regions to the richer and more progressive ones where returns on capital are high and secure. (Gunnar Myrdal, *Economic Theory and Under Developed Regions*, London, 1957, p. 28).

For today's mixed economic systems, in which governmental influence and interventions are so farreaching, the relevant question is not whether the tendency to perpetuate regional inequalities is inherent in the play of market forces, but whether suitable policies are being pursued to prevent a region from falling behind. Europe's integration could not succeed if it promised to make the strong regions stronger and the weak ones weaker.

Payments in Semi-Integrated and in Fully Merged Economies

It should also be borne in mind that balance-of-payments problems of the traditional intercountry type continue to be difficult to solve only as long as the process of integration is only half accomplished. Once that process has gone as far as to bring about an effective merger of the national economies, such problems will generally recede into the background. For one thing, the formation of surpluses and deficits is the result of discrepancies in national economic trends. But in fully merged economies the economic cycle would no longer coincide with national frontiers; economically homogeneous regional groupings would emerge with common cyclical trends. Discrepancies would tend to form between the more dynamic regions, on one side, and the weaker ones, on the other.

Moreover, the settlement of payments would be made smoother, since, as in the case of imbalances within one and the same country, there would be much wider scope for inflows and outflows of securities to offset a country's excess of exports or imports. Given an adequate supply of marketable securities in people's and firms' portfolios, and fully integrated markets for monetary and financial securities, small changes in prices can bring about movements of securities sufficiently large to offset current-account imbalances. Thus, the adjustment process via changes in relative costs, employment, and income is made more gradual. Indeed, the achievement of economic and monetary union might be rendered less painful if already during the transition period the mechanism of equilibrating capital movements could be relied upon. Had that mechanism worked satisfactorily so far, balance-of-payments problems within the EEC would not have acquired quite the disturbing connotation that they did. In fact, the liberalization of capital movements made remarkable progress, but did not go far enough to create a unified market, nor did it elicit, at least until recently, the follow-up of initiatives in the private sector needed to create truly integrated and efficient security markets. Furthermore, the size of external payments problems which one or two countries had to face at times compelled them to suspend and partly revoke capital-liberalization measures. Finally, fixed exchange rates came to be equated in people's minds with an adjustable-peg system, that is, a system in which rates are subject to revisions taking place at long irregular intervals and resulting in large parity changes. Had there been no grounds for expecting such changes and had the margins of fluctuation around the parity (which in any case do not help materially in the adjustment process) been done away with, small interest-rate differentials would have brought about equilibrating short-term capital

movements which, as under the classical system, would have been an important element in the adjustment process.

Under fixed exchange rates, faltering credibility deprives the system of the mechanism which tends to smooth out payments in a unified market. In fact, that mechanism's working can be made to swing in a perverse direction and this may of itself force a change of parity or restrictions to freedom of payments, or both. It is therefore essential, *if a system of regulated, internal flexibility is held to be incompatible with Europe's economic integration*, that the commitment to irrevocably fixed rates and absolutely free capital movements be at all times beyond doubt. Rightly it is pointed out in the Werner Report that the firmest guarantee to that effect could be given by replacing national currencies with a European currency:

> Monetary union . . . may be accompanied by the maintenance of national monetary symbols or the establishment of a sole Community currency. From the technical point of view the choice between these two solutions may seem immaterial, but considerations of a psychological and political nature militate in favour of the *adoption of a sole currency which would confirm the irreversibility of the venture.* (The italics are mine.)

Before adoption of a European currency is within reach, that commitment will be taken in earnest if member countries can be satisfied as to the prospects for growth of their economies. But countries with a higher vulnerability to inflationary pressures and/or to shifts of overall demand away from certain products will tend to lose competitiveness and payments equilibrium. In order to restore them, without parity changes of the type that has been resorted to in recent years or a succession of small downward rate adjustments, a more severe restriction of demand will be necessary, which in turn will discourage investment activity. Given full convertibility, there will be an outflow of capital in search of profitable investment elsewhere. The process tending to slow down the rate of growth in some member countries could go on long enough to transform them into industrially depressed areas, such as are still to be found at present within certain member countries. But the process of integration today simply cannot afford to repeat old *laissez faire* patterns and, as Kaldor has recently commented, "nations do not commit hara-kiri for the sake of international treaties, however solemnly and sincerely entered into." (Nicholas Kaldor, "The Price of Europe: 3, The Truth about the 'Dynamic Effects,'" *The New Statesman*, Vol. 81 [12th March 1971], p. 35.)

Different National Propensities to Inflation as an Obstacle to an Acceptable Pattern of Unified Policies

Under the rules of the International Monetary Fund, measures relating to exchange rates cannot be taken as isolated acts of national sovereignty, those rules resting on the lessons drawn from interwar experience that individual exchange rates will not automatically add up to an equilibrium system. The IMF system of fixed rates and freedom of trade and payments benefits from a built-in adjustment mechanism. A strong demand pressure in one country will tend fairly promptly to spill over; in the inflating country prices and costs will not rise to the full extent of the excess demand, while prices abroad will by the same token be pulled upward. As a result, prices and cost levels in mutually trading countries should be prevented from getting too far out of line, and balance-of-payments problems from becoming unmanageable. The mechanical element in the adjustment process needs, however, the support of appropriate policies.

But countries having broken loose from the gold standard would not readily accept being bound by a new set of rules. No matter how much of an improvement the latter may represent, the coordination of policies aiming at a mutually acceptable equilibrium in each member's balance of payments has proved an elusive goal. No doubt the task of maintaining domestic and external equilibrium has been made more intractable by the fact that, while not much has been added to the range of effective institutions and policy instruments, there has been a multiplication of objectives. Full employment and growth have been throughout the postwar period the major objectives of governmental policies, but they have been pursued along with a number of other objectives, each being sought in turn with important qualifications. Growth should be smooth over time and space; the economic and social costs of heavy congestion in certain areas find less and less acceptance, while the raising of the tempo of economic activity in the weaker regions has come to be recognized as a primary objective. Growth policies should not be pursued at the expense of, but promote, a more equitable distribution of income and wealth; they should bring forth an adequate supply of social goods and services, and secure the desired balance between the private and public sectors in today's mixed economies. And so on.

The increase in the number of objectives, without a corresponding one for policy instruments, has augmented the possibility of conflicts among them. When conflicts have arisen, a certain goal has been attained by not fully achieving others. In other words, the partial sacrifice of the latter has been accepted, or "traded-off" against attainment of another goal.

Because the readiness to sacrifice related objectives differs from country to country, and so does the trade-off relationship between GNP, unemployment, and prices, it is not surprising that in actual fact discrepancies in the national price and cost levels have become so large as to require parity changes. And since the parities of EEC currencies have undergone changes of opposite sign vis-à-vis the dollar, it would appear that such discrepancies grew larger within the Community, at any rate in relation to the imbalances that member countries could sustain.

The functional relationship between the rate of change of prices and changes in aggregate demand relative to potential output, as measured by the rate of change of unemployment, is emphasized in the approach based on the "Phillips curve." But, given the multiplicity of forces which combine and alternate to bring about changes in the price levels, the trade-off relationship between inflation and unemployment does not emerge from empirical analysis as consistently as some tend to assume. In fact, recent experience suggests that the trade-off is not stable and may not be of much help in certain circumstances, such as when forcing "changes of gear" in economic activity to fight an inflation in which the cost-push element has become predominant.

But experience seems also to indicate that countries possess to different degrees what I shall call *national propensity to inflation* (NPI). Differences in the NPI would seem to depend *inter alia* on historical and social factors, on the system of industrial relations and the militancy of trade unions, on the structure of industry and its regional deployment, as well as on the building into the general public psychology of expectations of inflation or price stability generated by demand-management policies, which in the past consistently may, or may not, have aimed at guaranteeing the full-employment level of monetary demand, with little regard to changes in external competitiveness and payments balance. In other words, historical patterns may not tell us what level of unemployment would be necessary for a given country to attain the desired degree of price stability, but they would indicate that, in order to prevent prices from rising faster than at a specified rate, higher unemployment would be needed in certain countries, less of it in others.

The foregoing argument suggests that member countries fail to keep broadly in line as regards the rate of inflation not just because governments decide in favor of different policy options, but perhaps more importantly as a result of the economies themselves having a different inflation-unemployment trade-off relationship. If that is so, readiness to agree on a common order of priorities among the main objectives will not suffice and no pattern of unified economic and financial policies is going to be both practicable and acceptable within an area where NPIs

vary considerably. To contain price increases within the same range would mean either stagnation and waste in the economies which would have to bring about higher unemployment than the economies with a lower NPI, or a relatively high rate of inflation in the latter—which not being needed would hardly be accepted.

Differentiated Regional Policies as a Way out of the Deadlock

The way out of the impasse ought perhaps to be sought by gradually closing the gaps in the member countries' trade-off patterns and by following two different policies tailored to the needs of the two categories in which countries, or rather the homogeneous economic regions of the Community, would be regrouped.

Advances on the path to integration should of themselves help to restrain some of the elements responsible for the gaps in the trade-off pattern. Since we are today as much on a labor standard as on any monetary standard, wage trends have strategic importance. The growing integration of the economies is bound to bring more uniformity in these trends by increasing labor mobility, as well as by making the pressure of competition stronger and thereby setting more effective limits to cost divergences.

As a result of this and of the fact that a growing share of consumption in each member country will be made up of goods and services supplied by other members, it is likely that trade unions will adopt a common measure in their wage and other claims.

Further, to the extent that national inflation propensities incorporate lessons from past inflationary experience and the expectations that they breed, a more uniform pattern should be brought about also by the shrinking room for national autonomous demand-management and employment policies. These policies have often shown an inflationary bias in countries with sizeable regional problems. As with a regional unemployment gap the national average of unemployment tends to be low only when the high-activity regions experience pressure of excess demand, accompanied by rising costs and prices, governments have been inhibited in their fight against inflation lest unemployment in the weak regions should rise to socially and politically intolerable levels. "Fine tuning" in particular has been made nearly unworkable, since the disinflationary impact of restrictive measures tends to concentrate in the weak regions, where unemployment is already high, and to affect high-activity regions less and later. But while in the latter wage rises are, however loosely, correlated to the demand for labor, as measured by the level and rate of change of unemployment, in the high-unemployment areas wage increases depend largely upon those in the former

group. Thus, the wage spiral, which starts where there is a labor shortage, eventually extends to the low-activity regions, as a result of external cyclical conditions.

If, therefore, a more even pattern of demand and employment could be brought about, the unemployment-inflation trade-off would be improved. In other words, less unemployment and more price stability would be attained by countries which, suffering from large regional problems and being inflation-prone, have run into payments difficulties because they have tended to get too much out of line with the Community's external payments equilibrium. Thereby the gaps in the trade-off pattern of member countries would tend to close.

In the United Kingdom, the case for a full-fledged regional policy was recently set out as follows:

> Regional policy has a key role to play in the achievement of faster growth. One of its major aims is to make use of the reserves of unused labour in some regions of the country and so speed up industrial growth where it is lagging. . . . National unemployment has only been relatively low when the prosperous areas have been experiencing pressure of excess demand and all the disadvantages of shortages, delays and inflation of costs and prices. When measures have been taken to reduce this inflationary pressure, unemployment in the less prosperous regions has risen to high levels, leading to a waste of resources. This loss to national output would be avoided if the levels of unemployment in the less prosperous regions were nearer the national average. . . . A policy of stimulating economic growth in regions with under-employed resources will therefore help to avoid regional concentrations of excess demand which set the pace in driving up costs and prices. . . . ("The National Plan" Cmnd. 2764, Her Majesty's Stationery Office, London, September 1965.)
>
> For most of the time since the war manpower has been a scarce commodity in Britain as a whole. If it has been in surplus supply in the Development Areas, that is because of the uneven distribution of demand for labour. When the level of national economic activity has been relatively high, the pressure of demand for labour in the centres of maximum employment, especially in the South and the Midlands has built up from time to time to very high levels, with consequent and well known inflationary effects and damage to the balance of payments. Even at these times the degree of unemployment in the Development Areas has represented a waste of scarce human resources. When action has become imperative to restrain the pressure of demand in the areas of high employment—and because this has involved meas-

ures affecting the whole economy—then unemployment in the Development Areas has been pushed up to an extent which has not proved acceptable for any length of time. This has led to a reaction against the measures of restraint and to pressure for relaxations. (*The Development Areas*, Department of Economic Affairs, H.M. Treasury, London, Her Majesty's Stationery Office, April 1967, p. 11.)

The notion that a more balanced pattern of employment helps to attain both more growth and monetary stability underlies also the analysis in the Report concerning Italy's national economic program for 1971-75 (see *Rapporto Preliminare al Programma Economico Nazionale 1971-75*, Ministero del Bilancio e della Programmazione Economica, April 1969, Rome, p. 82).

The foregoing argument points to the advantages of a regionally differentiated policy of demand management. Such a policy conceived and implemented at the European level would help to raise the overall rate of growth in the Community and to fight inflation, which is bedeviling governments in their pursuit of expansion. It would afford an escape from the trade-off mechanism implied by the Phillips curve, or at least bring about a shift of that curve by improving the terms of the trade-off (a result which some governments and some economists also expect from incomes policy). The process of economic integration would be more likely to take place in conditions of expanding output and monetary stability, which would be of great assistance from the political point of view. In a perspective which gives economic integration the role of a launching pad towards political unification, it is difficult to envisage the effective acceptance in the meantime of unified economic policies, if those policies have to aim at unemployment for attaining and maintaining internal and external equilibrium; indeed, it can hardly be envisaged without the backing of democratic Community institutions.

Regional problems have dominated the history of Europe's development. In *Growth and Stagnation in the European Economy*, Svennilson convincingly argues that, in all likelihood, the arbitrary combination of resources within the national units slowed down not only the growth of less favored countries, but also the general development of Europe's joint resources after World War I. Further, Europe would have been unable to maintain its still prominent place in the world economy, because of the failure to achieve a redeployment of industry offering to the backward peripheral regions sufficient opportunities to industrialize in an open system. In the absence of a European regional policy, the far-reaching reorientation of production and industrial structure required

by the changing structure of the world economy did not take place in the interwar period. (See Ingvar Svennilson, *Growth and Stagnation in the European Economy*, United Nations Economic Commission for Europe, Geneva 1954, p. 26.)

The fact that a very high proportion of the trade of European countries is with one another does not suffice to bring about a geographically balanced pattern of development and growth. In the interwar period, in fact, countries turned away from free trade and an open economic system, because the mere absence of obstacles to trade and payments was not enough to provide Europe's economy and each of its constituent parts with adequate opportunities for full employment and growth. As it was, intra-European trade fell more sharply than trade with non-European countries.

Limited Scope for "Locally" Financed Expansionary Policies in a Fully Integrated Area.

Today growing strains are appearing in the postwar fabric of free trade and payments. Lately, that fabric could not be spared the contradictory reintroduction of however subtly disguised administrative controls, nor the jolts of devaluation and revaluation of member currencies. Not surprisingly, countries are loath to surrender the right ultimately to decide in matters of exchange-rate policy. They regret the already mentioned inadequacy of the available instruments in view of the proliferation of policy objectives; and it has been forcefully argued that by using too sparingly the exchange-rate weapon, countries (with a high national inflation propensity) have hindered their process of growth. Main reliance on management of internal demand for dealing with full employment and growth problems, which should be treated—so it is argued—as problems of international competitiveness and thus center on export performance, would have led to the formation of an economic structure involving a slower rate of growth of productive potential.

By permanently relinquishing the right to resort to exchange-rate changes *and* by adding to full interconvertibility of their currencies the undertaking to eliminate totally all sorts of obstacles to freedom of trade and capital movements, countries see the scope for autonomous policies substantially reduced. The more open an economy, the greater the balance-of-payments effects of an autonomous expansionary policy financed "locally." As far as an autonomous fiscal policy is concerned, the multiplier effects on income and employment of government spending tend to leak into other regions of the integrated area. Autonomy in taxation meets a limitation in the mobility of people and enterprises.

In fact, because of contiguity in the industrial heart of Europe, where industry closely adjoins industry and the social and cultural environment is fairly homogeneous, that limitation would soon start to be felt. As to monetary policy, since the cost of interregional transfer of monetary and financial assets is negligible, the pervasive opening of the national markets is bound to equalize prices for the same categories of risk. The creation of monetary base by a *national* central bank in excess of a "common norm" would have little effect on securities prices and interest rates within the country, because it would quickly spread over the whole integrated area: the impact on the balance of payments would be very strong.

It should, however, be noted that the speed and pervasiveness with which these mechanisms work depend on the degree of integration reached, that is, on the success in transforming national economic entities into an *interregional* system, with a highly developed institutional and operational linkage network for impulse transmission through space. It is this type of integration that sharpens the sensitivities of member regions to changes in credit, tax, and fiscal policies in any of them. But it cannot be attained at one stroke and the EEC will for some time still operate as a semi-integrated system, in which it will not be impracticable and pointless to pursue autonomous policies—to a certain degree.

The loss of autonomy will tend to vary from country to country according to size and strength; some of them will be in a position, say, to raise or lower the interest rate and see the increase or decline gradually spread to the rest of the Community. People and businesses in the weaker areas will have to adjust to this rate level and, if the country happens to be in current-account deficit, they will have to offer fractionally higher rates in order to activate an offsetting capital inflow. As pointed out above, this tends to make the settlement of payments imbalances smoother. But, although spread over time, the adjustment process still takes place via income and employment changes. Higher interest rates tend to depress the prices of capital goods, investment activity, and production, and this would lead in the end to a worsening of the terms of trade. The fact that settlements would take place in a more automatic fashion does not make the plight of members with prospective payments and growth problems less serious.

Because effective integration is unavoidably going to be accompanied by a reallocation of economic-policy powers, the real issue is actually whether one or two countries should emerge from it with the ability to influence the rest of the Community. Or should the basic economic strategy—the priority which from time to time is to be given to the main objectives—be defined and agreed upon collectively, by means of

Community procedures and organs? In the latter case, the scope for autonomous policies allowed by imperfect integration could be harnessed in favor of a Community policy for the low-activity regions.

Twin Economic Policies, for the High- and the Low-Activity Regional Groups Respectively

To this end, a number of major economic regions should be defined, which would be divided into two different groups. One group would embrace the high-activity regions, where demand for factors of production has tended to outrun supply, while in the other the low-activity regions would be brought together. The latter would include regions experiencing difficulties in feeding a self-sustaining full-employment rate of growth and, therefore, failing to maintain the actual rate close to the potential rate over a period of time. The contour line between the two groups would cut across national frontiers, but might at times include whole member countries; it would be kept flexible in order to allow for the passage from one group to the other (and eventually back again) according to a region's, or country's, growth performance.

As countries with experience in regional development policy have found out, it is far from easy to define unambiguously criteria for allocating a region to either group, and apply them neatly. Some countries have had to change the yardstick (rate of growth of GNP, rate of unemployment, and so forth) and have deemed it opportune to introduce a third category: the grey areas. The suggestions made here are intended to provide only an indication of the criteria that might be followed.

A differentiated policy for each of the two groupings should at the limit imply that two different policies would be formulated and implemented at all times. One indiscriminate policy for the whole Community might be as prejudicial to growth and the integration process as six or ten inconsistent national policies would be. One general economic policy with some regional measures tacked on would not measure up to the task envisaged here.

The usefulness of the two-policy device lies in the fact that it would imply a radical departure from old-style regional policies, a "jump from quantity into quality." With a few exceptions, these policies have been inadequate to meet (reasonable) expectations, largely because they have been relegated to an ancillary role vis-à-vis general economic policies. If some economic policy measures are tagged "general" and others "sectorial," subordination of the latter to the former follows almost by definition. Yet the measures taken as part and parcel of overall counter-

cyclical policies that can be said not to have a regionally differentiated impact are very few.

The differential regional impact is implicit even in monetary measures of "quantitative and general" character, depending *inter alia* on the varying geographic concentration of different industries. *Ceteris paribus*, a tight-money policy is likely to affect most seriously regions where building represents a higher share of overall economic activity. Measures taken in order to deal with changes in "general business conditions," that is, with the business cycle over time, tend to disregard changes through space.

Because in the arrangement proposed here the Community policy for the low-activity regions would constitute a policy in its own right, it is more appropriate—if "regional" is to be retained—to think and speak in terms of twin regional policies. They would be placed on an equal footing and possible conflicts between them would not be settled by having the same one usually yield to the "general" needs of the other.

The two policies would not need to be harmonized in actual detail. They might even diverge, for achievement of a common strategic aim might require action in opposite directions. In conditions usually described as "overheating of the economy," it might be appropriate to switch to restriction in the high-activity group, while pursuing more or less moderate stimulation in the group in need of economic invigoration.

Still, the danger of conflicts arising from the policy dichotomy would be there. As far as objectives are concerned, the Community might be faced with the choice between fast growth on one side, and regionally balanced development on the other. However, in the light of what was earlier pointed out, it would appear that the trade-off between different objectives might be improved: if a more uniform pattern of employment tends to curb inflationary tensions, then it should be possible to carry policies of expansion further than is possible under policies which do not discriminate as between regions.

Be it noted, in passing, that politically the task of coordinating the two policies would be facilitated by the growing solidarity of interests that would link the economic regions of different countries belonging to the same group, and by not having to argue the case for or against certain measures in a context which would see countries as a whole in the position of supporters or opponents.

Means of Implementation of a Centrally Financed Policy for the Low-Activity Regional Group

As far as the implementation of the twin regional policies is concerned, the problem is one of the inadequacy of the instruments available to

carry out the policy for the low-activity regions. National governments can avail themselves of a well diversified armory, that includes administrative controls. They make large use of measures such as regionally differentiated payroll taxes, unemployment-compensation payments, interest-rate subsidies, and other income-transfer payments, in order to mitigate the tendency of incomes in the weaker regions to lag or to fall. In addition to *ad hoc* measures, there are built-in stabilizers. In a system of progressive taxation, as incomes fall, the share absorbed by taxes falls more than proportionally, while that part of government expenditure in these regions that is not linked to the level of economic activity will remain unchanged. If any action is taken, it will very likely be in the direction of raising it. The experience of countries with a federal political structure shows that there is no need to unify *in toto* national systems of taxation and centralize public expenditure. But fiscal instruments can be used in a meaningful and effective way to promote regional balance if the central authorities share adequately (say, from one-third to one-half of the total) in the proceeds of taxation and in the process of expenditure.

The existence of a centralized share helps to create room for "local" autonomy: a region receiving fiscal aid through the central bodies, because of a fall in its level of employment and income, is thereby enabled to lower its taxes and/or increase expenditure. Furthermore, uniformity of federal income-tax rates dilutes the importance of discrepancies in national tax rates and weakens their disruptive effects. This explains perhaps the excessive tendency to ask detailed harmonization of national tax systems in cases such as the European Economic Community, where an important centralized fiscal share cannot be reckoned with, in a short-term perspective. This will be so till further substantial progress towards outright political unification introduces some form of effective democratic representation and control in the Community. In this paper it is assumed that the political thrust behind the drive for unification will not be strong enough to bring about such progress.

As to monetary and credit instruments, the difficulty of implementing by these means a regionally differentiated countercyclical policy lies with the tendency of money created for the low-activity regions to flow into the high-activity areas, thus defeating the very object of a differentiated policy. It is often held that this difficulty cannot be surmounted without introducing control on interregional capital flows. But this would not be necessary, since it would appear that even in countries which have long been unified compartmentalization of regional markets would allow room for a regionally differentiated management of money. A scholar of regional economics has questioned, with reference to the experience

within the United States, the general assumption that open-market operations have pervasive and uniform effect throughout the entire American economy and argued in favor of a regionally oriented monetary policy. According to him:

> Reserves put into or drawn from the central money market are postulated to flow out to or away from every Reserve area both automatically and uniformly. Yet experience suggests that this assumption is invalid, that lags of different magnitudes exist, and that regional effects are not of the same intensity. These findings imply that open market operations are offset by other factors to different degrees in the several Reserve districts. . . . Furthermore, in view of the imperfect mechanism by which funds flow from one district to another, and in view of the unique characteristics of each regional organism, it would seem that a more effective national discount rate policy ought to embody differentials in discount rates among districts. This hypothesis finds support in empirical materials. For example, the existence of excess reserves nationally is not typically associated with the existence of the same amount of excess reserves in each district. Rather, at any given time the extent to which excess reserves are present in each district varies considerably; and in some instances a district's reserves may be under pressure when substantial excess reserves persist nationally. This suggests that a policy based on national aggregates alone is an inferior one. (Walter Isard, "The Value of the Regional Approach in Economic Analysis," *Regional Income*, National Bureau of Economic Research, Studies in Income and Wealth, Vol. 21, Princeton, 1954, pp. 76-77.)

Compartmentalization of money and capital markets exists, of course, also within the countries that are members of the EEC (especially those with substantially different regional economic structures), as well as between them. These imperfections, which are typical of semi-integrated economies, are not going to disappear overnight. As was pointed out earlier, they represent a drawback for the smooth working of the mechanisms of interregional settlement; but they also tend to check leakages.

Leakages might still represent a major problem if a differentiated policy were to be pursued by purely *monetary* means; that is, with injections of liquidity by a lender of last resort through advances against the security of bills of member countries' governments, through open-market operations of the conventional type, and so forth.

But that would not be so if the differentiated policy were implemented through credit operations and instruments of the type used in various countries by regional and interregional banks. In fact, territorial special-

ization in credit granting was a feature of banking long before governmental regional policies were developed. Banks, including large ones, have tended to establish a special connection with locally based industrial and commercial firms, and that connection has been an important factor in determining the availability of credit for those firms. In Italy, regional and multi-regional banks in the North, in the Center, and in the South have represented a very substantial part of the banking system. Although there was no administrative control over interregional money flows (these banks could do business with residents outside the regions covered by their network of branches) leakages do not seem to have represented a problem. In the case of the two ancient Southern banks (Banco di Napoli and Banco di Sicilia), which until 1926 shared with the Banca d'Italia the privilege of issuing notes, the limit to the contribution they could make to the development of economic activity in that part of Italy was set instead by factors such as dearth of entrepreneurial resources, low volume of local savings, absence of an outside supply of (subsidized) funds.

In more recent times, Italy has been endowed with regional, multiregional, and national industrial-credit institutions. Their territorially directed credit granting, and financing extended by the "Cassa per il Mezzogiorno," have tended to secure for economic activity in the Southern regions of the country a larger amount of financial resources, flowing at a steadier pace, or at any rate one less sensitive to changes in the country's overall economic trends and policies. In this connection, it is worth quoting the following passages from the annual reports of the Banca d'Italia for the years 1962-64, which embrace an unusually strong cyclical fluctuation—an inflationary outburst accompanied by a serious balance-of-payments crisis having been followed by internal stabilization and large surpluses in external payments.

> From a territorial aspect, in 1962 the salient feature of the activity of the system of industrial credit institutions was a larger injection of funds into the process of industrialization of the South. These credit flows, already significant in the two preceding years, have produced a marked increase in the share of the Southern and Insular regions in the outstanding total of such loans: 24.8 per cent at the end of 1962, while three years before the share was 20.4 per cent. During the same period the share of the North-Western regions has been static (40.1 per cent), while those of the North-Eastern and Central regions have decreased respectively from 20.9 and 18.6 to 18.2 and 16.9 per cent.
>
> The influence of the credit-control authorities on investment has be-

come somewhat more important through the regulation of the activities of industrial-credit institutions and their coordination with the security issues floated directly by companies. The directives to be followed have been more closely defined in geographical and sectorial terms, but within these directives the institutions remain free to conduct their credit business according to their own judgment. Geographically speaking, the results would appear satisfactory. . . . Credits to Southern industry expanded about twice as fast last year as in 1961.

In 1963 loans to productive activities in Southern and Insular Italy also grew considerably. . . . Out of Lire 623 milliard of new loans, 246, that is nearly 40 per cent (35 per cent in 1962) were allotted to the South, where the process of development is being stimulated in an increasing degree by the system of industrial credit and by the large institutions with a national field of action . . . . the North-Western and North-Eastern regions have received new loans in amounts considerably lower than those of the year before . . . . . the intensity of the financial flows which have been directed towards the South through the industrial-credit system becomes evident.

In 1964, the activity of the industrial-credit institutions has been directed, more than in the two preceding years, to accelerating the process of industrialization of the South; the large institutions with a national field of action have contributed more than in the past to this objective. . . . The three Southern institutions (Istituto per lo sviluppo economico dell'Italia Meridionale, Istituto regionale per il finanziamento alle industrie in Sicilia, and Credito industriale Sardo) having increased their receipts from bond issues and having received, albeit in a smaller measure than in 1963, fresh Government funds and loans from abroad, show an increase in the loans they granted that is larger than in 1963 in absolute value, but not in relative terms. None the less, their loans show a rate of growth (32.4 per cent in 1964 and 40.5 per cent in 1963) much higher than the average of the system. . . . Industrial-credit operations both increased and underwent some change in geographical distribution, in so far as the share of credits extended to industries within the regional competence of the Cassa per il Mezzogiorno rose from 49 per cent in 1963 to 61 per cent in 1965.

Finally the Italian Central Bank's Report for 1970, a year which was marked again by money and credit tightness, points out that the loans by the special credit institutions continued to rise considerably. The largest single share in the increase was accounted for by loans to the South, mainly to finance industrial investment.

While tax and fiscal measures would appear to be in principle more suitable instruments for a differentiated regional policy (in combination with administrative controls, they have been largely used by the United Kingdom for coping with its regional problems), Italy is a case in which territorial direction of credit has played a salient role. Government subsidies have also been dovetailed into the system of "directed credit." Although they have been an important factor in its working, differential availability *per se* should not be underrated.

The Federal Republic of Germany, where of course regional disparities represent much less of a problem, seems to have followed an approach similar to Italy's. There the Kreditanstalt fuer Wiederaufbau has been used at least since the mid-fifties also as an instrument of regional policies. The Kreditanstalt fuer Wiederaufbau has channelled considerable resources towards investment in areas where regional-development schemes have been in operation. And it is interesting to note that the Kreditanstalt fuer Wiederaufbau has tried to manage its affairs in close harmony with the Bundesbank, its objective being to establish itself as the nation's "second central bank." Wilhelm Hankel has in fact suggested that a second central bank should be set up as a "market solution" for the problems of long-term financing in Germany. (See Wilhelm Hankel, *Die Zweite Kapitalverteilung*, Berlin; Knapp Verlag, 1961, p. 132 and following.)

The directional maneuver of credit (*Kreditsteuerungsfunktion*, as it is called in Germany) is a device with which Continental Europe is perhaps best acquainted. It can be resorted to in order to implement a differentiated policy for the Community's low-activity regions, until the time when political unification permits resort to tax and fiscal instruments.

Credit can be directed to particular regions of a unified area by financing local firms and projects to be carried out in these regions, and it can also be linked to the finance of investments in housing, and economic and social infrastructures being undertaken by local authorities. If operations are on a large enough scale, they will have a *conjunctural* impact and will thus lend themselves to use as an instrument for a differentiated policy of demand management. This means that dynamic firms happening to need an expansion of their productive capacity while investment activity is being discouraged by restrictive credit policies will have the option of getting the necessary finance by building new plant in the low-activity regions. Furthermore, if there are reasons to assume that the supply of credit for the current needs of industrial plants located in these regions will be shielded from the restrictions enforced periodically for fighting inflationary tensions generated by the high-activity regions, then this of itself might be an incentive for big

and old-established companies to move some of their operations into the low-activity regions. Therefore, community credit-granting in those regions would not have to be confined to medium and small firms, nor to "lame ducks," large or small.

The tied loan and other technical devices would curb, not totally prevent, leakages. Such leakages as still took place would not be likely to jeopardize the effectiveness of restrictive policies in the high-activity regional group: at most, authorities would have to take into account their impact when deciding the degree of restrictiveness. After all, national money and credit markets have been fairly widely open for over a decade now; their interdependence is lopsided because of the huge differences in size, and yet monetary authorities have managed, except during a few periods of unusual stress, to keep a degree of autonomy in their policies, even vis-à-vis the influence of conditions in the United States.

Finally, an autonomous policy of support of levels of production and employment would put an unbearable burden on interregional payments balance, if it were to be financed out of local resources. That would not be the case, however, if a large-scale credit institution were set up with funds contributed by all member countries and empowered to tap the Community's monetary and financial markets. The availability, through the intermediation of a European credit institution, of an external supply of funds would go a long way towards solving payments difficulties due to leakages filtering through a "directed credit" system. And, of course, the payments problem would be felt still less, once the status of that institution had so evolved as to allow its liabilities not to be "withdrawn" in any conventional sense. In other words, they would remain outstanding in circulation in order to serve as money in the Community. At that stage, it would no longer have to worry about its liquidity in the way an ordinary commercial or industrial-credit bank does.

Structure and Operations of a Multi-Role European Bank

The institution envisaged here for making a start towards a differentiated demand-management policy for the low-activity regions would represent a departure from anything so far achieved or attempted in the European Community, both because of the size of the resources with which it would be endowed and the range of operations in which it would be allowed to engage.

The initial resources, in gold, would have to be of an order of magnitude comparable with the average amount of the external liquidity reserves held by the major central banks in the Community. They would form the basis on which, by applying in a flexible fashion the frac-

tional-reserve principle, a credit pyramid would gradually be created. The credit-granting activity would mainly take the form of loans which would be "directed" in the sense outlined in the preceding section, and would be carried out with the help of branches—at least one would have to be set up in each of the regions belonging to the group—as well as through the network of branches of the national central banks. It is generally held that an *ad hoc* credit policy for the less favored regions needs an element of subsidization in order to work. This might be done in the case of the European credit institution by having the governments create for it an "endowment fund" out of which subsidies on interest-rate account would be paid. But, it will be seen from what follows that the envisaged credit institution may be able to raise funds on cheaper terms than the going market rates, and in turn channel them on preferential conditions towards the low-activity regions. Furthermore, it should be noted that the differentiated policy for these regions would hinge mainly on differential *availability* rather than on *cost* differential.

The new European credit institution would naturally have to operate in harmony with national central banks to fulfil its basic function of giving the extra stimulus needed to secure full use of productive resources in the regions which would otherwise fail to do so. But it would not be subordinate to them and it would have as a matter of principle full access to national money and capital markets. Indeed, the objection so often raised in different contexts, that the operations of an "outsider" are bound to upset monetary and financial markets, except as they may have previously been agreed upon (authorized) by national authorities, would be very hard to justify here. That objection would make a mockery of the undertaking, envisaged in the Werner Report, to maintain full and unhampered freedom of money and capital flows within the Community. Honoring that undertaking implies that individuals and business firms would be allowed to make massive shifts of funds across national frontiers within the Community, if they so desired, in response to changes in the economic and political outlook of member countries. In view of this, there would be little room for concern that an accountable institution could cause disruption with its day-to-day operations.

The new European credit institution would bring under the same roof the operations of commercial and development banks, as well as certain operations more typical of central banking. In many ways it would resemble the "universal" central banks which developing countries all over the world have discovered they need.

It would absorb the existing European Investment Bank, as well as

the proposed European Fund for Monetary Cooperation. If it should be decided to create, as a further tool for enhancing integration in a general context of balanced growth and stability, a "Community fund for conjunctural stabilization," more or less along the lines of those existing in some countries, the new European credit institution could be entrusted with its management.

Among EEC member countries, the Federal Republic of Germany in June 1967 passed a "law for promoting stability and growth of the economy," by virtue of which the Federal Government and those of the *Länder* may be called to constitute "reserves for conjunctural equalization" (*Konjunkturausgleichsrücklagen*), in the form of deposits with the Deutsche Bundesbank. These deposits can be withdrawn only after overheating of the economy has disappeared.

The amounts paid into the conjunctural fund by member countries, on the basis of a formula which would take into account the degree of "overheating" in their economies, the payments position of the central government and local authorities, and the current requirements of public debt management, would be credited to them in a special interest-bearing account. Against these liabilities the account would show loans and investments in the regions where it was appropriate to stimulate economic activity. The amounts deposited in the special account would be returned once overheating had subsided.

For the purpose of this essay, I shall call the credit institution I am suggesting the "Multi-role European Bank."

The Multi-role European Bank would be entitled to accept deposits from Community, governmental and other public bodies, banks, industrial and commercial companies, and perhaps from individuals—provided each account and/or depositing and withdrawing operation did not go below a minimum amount, to be established and varied in accordance with the Bank's organizational development. The deposits might be expressed in units having their own parity directly linked to gold or to any other suitable noncurrency yardstick. They would be transferred for settlement of debts among holders of such deposits, as well as of debts expressed in national currencies, on the basis of respective cross-rates. Banks would be authorized to use and deal in them. Companies, especially those with large export business, would be allowed to use them for paying salaries. Eventually, they would generally be used alongside member countries' currencies and enter circulation in the form of notes: the MEB would issue European IOUs.

Indeed, this might be the sequence for the creation of a European currency unit (ECU). Its main strength would lie in the fact that the institution issuing it would have a functional role in the differentiated

credit policy for the low-activity regions, the monetary functions emerging as an outgrowth of that role. Since new means of payment need creation of the demand to hold and use them, the MEB would have the advantage of being able to put them into the payments circuit through its own lending operations to businesses. Furthermore, by extending rediscount and other credit facilities to regional banks, and to other banks in a form that would not jeopardize the fulfilment of its institutional role, it would encourage the banking systems to hold ECUs.

By circulating alongside the national currencies, a gradual process of acclimatization would take place, during which markets in ECUs would be started, develop, and settle down. Thus, they would not be an abstraction, such as the various units of account which have been resorted to so far, and would have a link with reality which is thin and indirect, because they can be used in a few categories of operations only, and then with reference to some other monetary units. They would not have the character of a monetary artifact either, as would be the case if the creation of a European currency were to take place as a sort of one-act play, in which a new, ready-made, perfect monetary symbol was bestowed upon the Community to replace at one stroke the old-established national currencies.

As already implied, the ECUs would at some stage be declared legal tender; anyway, they would be backed by the initial gold subscriptions to the MEB's capital, as well as by the bank's access to national central-bank credit, which would have to be regulated as warranted by circumstances. Their direct link to gold would of course not imply a gold guarantee for holders; but the undertaking to maintain a given parity if the present fixed-exchange-rate system were to continue would very likely carry more weight than would be the case with the currency of any single member. If on the other hand external flexibility were chosen, the ECUs would crawl in a more predictable way, as they would be less liable to jerky variations than single national currencies, which these days have their parities threatened increasingly by the consequences of sudden outbursts of social violence.

The European Currency Unit and National Currencies: the Management of a Dual Monetary System

The ECUs would, therefore, afford a diversification of the risks inherent in any one national currency, and ultimately this would in many cases minimize exchange risks. This might make them attractive to hold, in preference to members' currencies and to Eurodollars. The "pull" exerted on residents would be regulated by means of variable interest-rate differentials; but at the height of a full-fledged social or political

crisis in a member country, interest differentials would not be of much use. The occurrence of such emergencies has at times compelled countries to suspend exchange liberalization, with noticeable damage to the credibility of integration as an irreversible process. The only alternative to suspension of freedom of payments might be afforded by recycling of funds. In this respect, the MEB and its IOUs might be of great help. Easy access to a Community-based, stable monetary asset would prevent, or at least reduce, an outflow of hot money outside the Community altogether; it would thereby facilitate recycling. The recycling of funds which flowed into the MEB as a result of a "flight" from a member currency would be easier also than in the case of a member country's central bank being the main recipient. For in a Community institution the crisis-stricken country would be represented and there would be less reason for excessive displays of national loyalty.

A number of alternative intervention techniques and procedures can be envisaged for managing the sort of dual monetary arrangement considered in this essay. It would appear, however, that the task of maintaining the parity of the European currency unit would have to be assigned to the MEB, while responsibility for the currencies of member countries would rest primarily with national monetary authorities. Starting from the present position, in which operations in support of exchange rates are conducted in U.S. dollars, central banks would gradually diversify interventions by adding Community currencies and ECUs. They would have to acquire a supply of one another's currencies, which would be done through setting up a network of swap agreements centralized in the MEB. They would have also to obtain an adequate supply of European currency units from the MEB. The gradual shift from the dollar to the members' currencies and ECUs as means of intervention would contribute to the assimilation of trade and payments between member countries to "internal transactions." Indeed, the fact that the EEC has gone in several respects beyond the customs-union stage, while the ultimate media of settlement within it are dollars and (less and less) gold, means that parts of a semi-integrated area use a currency external to them to manage internal exchange rates, and settle balances not cleared by transfers of assets on private account. This arrangement, which may have been the only one practicable to date, has of course had a number of advantages; but it would become more and more an anomaly as the Community proceeded towards full economic union.

As the ECUs came into full use, the MEB would continue to be responsible for the ECU-dollar rate, by intervening in accordance with current international arrangements. On the other hand, member countries would now fix the parities of their currencies in terms of ECU-

and central banks would find it practical to conduct their interventions in ECUs, for maintaining rates in narrow bands or 100-per-cent fixed.

Distribution of responsibility between the MEB and national central banks could not ignore the facts that: (a) the latter's gold and foreign-exchange reserves would be depleted by the amount each would have to contribute by way of subscription to the MEB's capital, (b) the payments position of each member country would be affected by the MEB's operations. This means that the MEB would have to make its resources available to support member currencies. In principle, it would try to improve the payments position of a country through its credit operations in the low-activity regions. Because the MEB would not be primarily a reserve fund, it would help to prevent formation of deficits and thereby reduce the scope for official settlements.

In so far as this was not practicable the MEB in deciding the amount of balance-of-payments assistance would take into account, among other things: (a) the impact of its own operations in that country, (b) the Community's overall external payments position, (c) the degree of restrictiveness that would appear appropriate for the policies pursued by the national monetary authorities concerned.

An overall Community deficit vis-à-vis third countries would, of course, be the algebraic sum of members' surpluses and deficits towards those countries, and would be met jointly by the MEB and by the national central banks. But, once the stage was reached when the latter would intervene in support of national currencies using exclusively ECUs, their holdings of gold, foreign exchange, and special drawing rights would be centralized in the MEB. The settlement of balances vis-à-vis third countries would then become the responsibility of the MEB, which in parallel to that external function would organize and run a system of intra-Community clearing, possibly along the lines of that existing in the United States of America. The Interdistrict Settlement Fund, formerly known as the Gold Settlement Fund, is the instrument through which the Federal Reserve System operates an efficient system of clearing payments between the twelve Districts, each of which has a distinct regional orientation. Daily the district banks wire to the Fund's management the total of their claims against one another, arising for example from the sale in one district of a good produced in another, or from a shift of funds by a corporation to the district where the plants producing goods sold all over the United States are located, or from "migration" of notes issued by a district bank and spent in other districts. Clearing takes place through credit and debit entries on the books of the Interdistrict Settlement Fund, with which each Federal Reserve Bank

has to maintain a certain amount of reserves in the form of gold certificates.

It seems safe to predict that, in a framework of the type sketched in this essay, policies relating to the Community's overall payments equilibrium would give rise to the most questions. By contrast, situations in which national monetary authorities would get too far out of line with one another will become less and less likely to arise. Because the MEB's main domestic task would be to take care of the problems of the low-activity regions, an important cause of gaps in member countries' inflation-unemployment trade-off patterns would subside. With the MEB pursuing appropriate demand management in these regions, a central bank having to cope with overheating in the high-activity regions and showing a tendency to lose reserves would be expected to cut credit—or slow down its expansion. In general, central banks would now be expected to pay more regard to the principles of private banking. Their behavior would have to draw gradually closer to that of commercial banks, which are not allowed by market reactions to create money in violation of the rules of the game.

To put it in another way: if countries can be satisfied as to the ability of a Community institution, such as the proposed MEB, to meet their growth problems, their behavior can be expected to be consistent with the requirements of a multi-currency area based on a rigid exchange-rate system. This has been the general assumption so far in this essay. But parity changes of member countries' currencies in terms of each other (and of ECUs and third currencies) are not ruled out from the outset even in the Werner Report. The Report states in this regard:

> Progress in the convergence of economic and monetary policies should be such in the course of the second stage that the member States no longer have to resort on an autonomous basis to the instrument of parity adjustment. In any case, it will be necessary further to reinforce the consultation procedures laid down for the first stage. *Only at the moment of transition to the final stage will autonomous parity adjustments be totally excluded.* (The italics are mine.)

The method and scope of parity changes in the EEC will be discussed in the following and final section.

Partial Internal Flexibility of Exchange Rates in the Process of Integration

The many distinctive features of the European case recommend caution when drawing upon the experiences of other nations. And yet one

can hardly ignore the fact that economic and monetary union was not free from tensions in the case of the United States, where for a number of reasons one would have expected adjustment and settlement mechanisms to be at work effectively and smoothly. The stream of bank failures and suspensions in the troubled years of 1891-97, which were regionally concentrated among national, state, and private banks mainly in the West and the South, could be regarded as the outcome largely of imbalances which the built-in equilibrating mechanisms could not rectify.

Again, the insistent demand in the last decade of the nineteenth century, by restive political organizations such as the American Populist Party, for free and unlimited coinage of silver was an attempt by silver-producing regions and by agricultural ones in deficit vis-à-vis the Eastern regions, to improve their terms of trade within the Union and to regain a degree of monetary independence. Still, it is worth recalling that prior to the Civil War notes of different banks circulated at discounts or at premiums that varied according to whether they happened to be nearer to, or further from, the issuing banks; and that the economy coped with the phenomenon by employing "bank-note detectors" to determine the value of such notes. Finally, flexibility of internal rates was again experienced in the United States in 1893 when currency and bank deposits were for a period no longer interchangeable at a fixed rate. And this was followed by no less interesting episodes in the first years of this century, until the assumption of growing monetary powers by the U.S. Treasury and finally the creation, in 1913, of the Federal Reserve System.

It is not surprising that the appeal of internal-rate flexibility should keep lurking in so many minds when considering ways and means of furthering the process of economic integration in Europe.

It is felt that, as long as the integration process of both official policies and market structures is only half accomplished, too rigid a system of exchange rates would cause breakdowns which, even if they were of a temporary nature, psychologically might do permanent damage to that process. And if exchange-rate changes are bound to be part of the adjustment process anyway during the transitional period, it is argued that moderate Community-supervised flexibility could be better accommodated into the mechanism of integration than the spasmodic parity changes that have recently taken place in the EEC. Those who oppose regulated internal flexibility fear at bottom that what is recommended as a temporary measure might last forever, that regulated flexibility might drift towards widely floating rates, and that, as a result, the trend towards growing intra-Community trade and payments might be checked and even reversed.

The monetary arrangement outlined in this essay could perhaps make it possible to adopt a compromise solution, in that internal flexibility would find only partial application. It would be left as an option open at any time to national monetary authorities; but disincentives would be built in against its abuse.

When considering internal flexibility of member countries' currencies, the hypothesis in which an irrevocably-fixed-rate link would be provided to a partial extent by a common monetary medium circulating alongside them has never been made. But this is exactly the situation which would obtain once the ECUs came into their own. They would circumscribe the operational area in which flexible national currencies would continue to be used and where freedom of circulation, which at any rate should be viewed as a means to the end of achieving fast and balanced growth, might possibly be affected. They would do so because their use would quickly spread to sectors and in categories of transactions where the need for a stable and widely based monetary standard is strongest.

The large industrial corporations and business firms, whose operations with companies in other member countries (and third countries) represent a large share of total turnover, would find a suitable monetary medium in the ECUs. They belong to sectors of the economy which are most exposed to competition from outside. They tend on the whole to move together as regards technological innovation, evolution of costs, and changes in prices and profitability, because the markets for their products and their inputs truly cut across national borders. They are most in need of a common monetary standard, and in fact they already use one to the extent that it is vital to them. Large companies manage their operations in national currencies—and in U.S. dollars. They therefore are already on a dual monetary standard. If in the meantime national currencies experience some degree of rate flexibility vis-à-vis the dollar, the change would simply be a switch from the dollar —or one of its market variants—to the European currency units. European companies would be using a monetary standard in whose management they—through the Community and their governments— would participate and whose reliability would in the end depend on their own performance.

Thus, the impact of a national currency resorting to regulated flexibility would fall mainly on sectors and firms more closely geared to local economic conditions. These are less exposed to outside competition and are the ones where so often divergent trends arise, making the maintenance of a rigid monetary link in the long run very difficult, unless

in the meantime full integration, with the accompanying high mobility of products and productive factors, has been achieved.

The option to choose flexibility would be open to governments, as well as to people and businesses. The latter would be in a position constantly to optimize the ratios in which holdings of (actually or potentially) crawling national currencies would be combined with holdings of ECUs, a stable asset easily accessible to them. This means that the kind of partial internal flexibility of exchange rates envisaged here would itself be governed by flexible criteria. In addition, the easy ECU option for the markets would build a powerful factor of discipline into the system. Governments could not overlook the fact that the use of a national currency, as against ECUs or other members' currencies, would tend to increase or decrease dependence also on the performance of the currency itself as a stable standard. Because that performance might be the decisive differential in determining the fate of national currencies (and central-banking systems), it is likely that member countries would not abuse flexibility in a context in which the dual articulation of policies in the Community would in fact reduce the need for it. In addition, the increasing share of goods and services supplied by other member countries will make it difficult, as hinted earlier, not to take fully into account their price variations in national currencies when negotiating wage increases. "Money illusion" is going to count even less than it now does. The wage link to a cost-of-living index, in which Community goods and services would weigh heavily, on the one hand, would reduce the usefulness and attraction of exchange-rate depreciation and, on the other, would tend to equalize rates of wage increases in member countries and thereby facilitate the task of sticking to a given rate.

For these (and other) reasons it is also unlikely that partial internal flexibility would constitute the centerpiece of the adjustment mechanism. But it would make an addition to the instruments for dealing with stubborn imbalances, such as might persist for a time while discrepancies in national propensities to inflation have not narrowed and effective integration of markets has not been fully achieved. By official fiat one can change overnight the ritualism of policy-making, but one cannot do away with the constraints placed on policies by the different ways in which the national economies themselves, with their long-standing segmentation and deeply rooted differences in habits and attitudes, would react to unified policies. Realism requires that allowance be made for differential behavior of the economies by not excluding altogether available market mechanisms. The integration process needs to be nursed by the markets to a larger extent than is often allowed for; in fact, one could envisage it as a succession of official measures and market responses

interacting. And this is the reason why integral monetary unification in the sense of one country, one currency only, does not lend itself easily to accommodation into a rigid timetable. Yet, once under way, that process might quickly gather momentum and meet the Community's internal and external monetary aspirations sooner than one would now be inclined to expect.

The design I have ventured in the preceding pages is only sketched: many points still need to be hammered out. But the main purpose of this essay is to start off exploration of the possibilities for a novel approach. There seems to be too strong a tendency to what basically amounts to transposing in a European key procedures, methods, and institutions which have successfully been resorted to in the postwar period on a world scale. But to propose for Europe a miniature, albeit strengthened, version of the solutions tried by general international cooperation in the economic and monetary field will be of diminishing avail as integration progresses. Truly to break through the national diaphragms, new trails need to be blazed and the prerequisite for that is, to paraphrase the nineteenth century nonconformist economist, a frame of mind which does not allow opinions and experiences to crystallize into dogmas.

POSTSCRIPT

This essay was written before the latest flare-up in exchange markets at the beginning of May, immediate consequences of which have been the suspension of the intervention limits for the Deutschemark and the Dutch florin and the revaluation of the Swiss franc by 7 per cent and of the Austrian schilling by just over 5 per cent. Finally, Belgium, the only EEC country that operates a two-tier exchange market, announced that capital inflows would thenceforth be handled "solely on the free market," while on the official market only current-account transactions would be admitted.

The flare-up took place against a background of general and persistent weakness of the dollar. This reached crisis point with respect to the Deutschemark when, in response to a precipitous fall in interest rates in the United States and, therefore, also in the Eurodollar market, huge amounts of funds were channeled through that market into the German Federal Republic. In order to buttress its restrictive stance, the Deutsche Bundesbank, in the spring of last year and then again in the autumn, imposed a 30 per cent special reserve requirement on the growth of foreign liabilities, making it less profitable for German banks to borrow abroad the additional liquid resources needed to meet their customers' expanding credit demand. Not surprisingly, however, the Bundesbank's

move brought about the disintermediation of the German commercial banks and the diversion of the most mobile segment of credit operations away from the circuit controlled by the central bank. In other words, German industrial companies raised funds no longer available from German banks by borrowing directly in the Eurodollar market. Given German reluctance to resort to administrative controls like those in force to check industry's direct foreign borrowing in other EEC countries, it was eventually realized that the exchange rate had to give way. From the second half of April, huge speculative funds started to pour into Germany, and this inflow continued until the Bundesbank stopped buying dollars, on May 5th.

At the emergency meeting of the Council of Ministers of the Community, which was called for the following weekend, sharp disagreement arose as to the ways and means of dealing with the problem. According to press reports, the attempt of the West German representatives to secure their partners' agreement to a "European solution"—implying a joint upward flotation or outright revaluation of the EEC currencies against the dollar—failed in the face of firm opposition by France and Italy. The Commission sided against floating and in favor of an extension and harmonization of administrative controls on capital movements with third countries, penalizing of nonresidents' short-term investment of funds by means of a negative interest rate, and regulation of the Eurodollar operations of the banks. These measures were proposed apparently with the end in view of making the process of creation of a monetary base within the Community less dependent on external factors (mainly of American origin), and thus reducing the disproportionate disturbances they are apt to cause in Europe's still fragmented monetary systems. However, the Commission had in the end to accept a compromise which, although upholding the principle that the inflow of capital from third countries should be controlled administratively, allowed the enlargement of the band for two Community currencies "during a limited period."

In view of the support which the Commission has all along given the approach to monetary unification outlined in the Werner Report, one may wonder whether it would not have been more consistent for it to seek a compromise along lines which would have prevented the breakdown of monetary "solidarity" between the Six so short a time before the experiment in the narrowing of the margins was due to start. More specifically, the Commission might have oriented their negotiation towards an agreement on the terms of the "European solution" put forward by the Germans, so as to make them acceptable to all member countries.

It is not known whether a compromise along those lines was sought, and how hard; nor is it easy to form a judgment as to what the chances were that in the end it would have been accepted. Be that as it may, in favor of it one could argue that an upward exchange-rate adjustment of a few percentage points vis-à-vis the U.S. dollar and other non-EEC currencies would not have changed materially the position of those member countries which have opposed such adjustment because of a weakening of their competitiveness and because of the difficulties they are experiencing in bringing about a revival of economic activity. A uniform increase in the exchange rate would have left unchanged the intra-group competitive relationship and therefore would not have affected directly that chunk of "foreign" trade which is in fact member countries' mutual trade. But it would have been appropriate in view of the claim so frequently heard that the United States should produce a surplus on goods and services account of a few billion dollars, given the role it plays in the world. Finally, in favor of the adjustment it should have been considered that greater rate flexibility is bound to imply both upward and downward movements against the dollar if the United States, consistent with the view that international monetary relations are in fact on a dollar standard, holds that only the others can be "off course" and, therefore, responsible for adjusting to the standard.

The case for a joint upward adjustment of the EEC currencies appeared less cogent since, in an immediate causal relationship to the crisis, there was an inflow of funds into the Federal Republic of Germany which was due, not to an unmanageable current-account surplus, but to Germany's aiming at an interest rate that was out of line with that in the United States and in the international money and capital market. The immediate cause was, then, of a monetary nature—and of external origin, at that. In some people's view this may weaken the conclusiveness of the episode as an indication of the higher vulnerability which an approach hinging on rigid exchange rates as a *conditio sine qua non* needlessly brings to the process of European integration at a time when the business world is gradually learning how to take flexibility in its stride. On the other hand, the crisis has stressed how difficult it is to harmonize the priorities which member countries give to policy objectives and instruments. While the Germans, with their consistent policy posture that aims at a different business cycle (less demand pull, more price stability) but leaves their economy more open than others, concentrate adjustment on one price, the exchange rate, their partners in the EEC tend to lean towards controls.

Administrative controls may after all be used in the instrument mix for checking monetary disturbances originating outside the EEC, but

they can hardly be reconciled with monetary unification. The latter would not make much sense, if intra-Community capital movements were to be hindered through administrative limitations to the interconvertibility of member currencies. If European integration is to go ahead, capital movements must be expected to get larger, not smaller. The problem is how to make sure that they do not disturb, but enhance, the process of balanced growth: that is, that they facilitate mobility of enterprise capital in a direction not conflicting with that aim, and that they prevent speculative outbursts from putting severe strains on intra-group payments.

In this essay I have suggested some ways and means in which this might be done either under a system of fixed internal rates, or under a system of moderately flexible ones. If the analysis of current facts points to the balance of advantages lying *at least for the time being* with the latter system, one should be ready to draw the conclusions. From this point of view, it is interesting to note that, since the margins for the Deutschemark were suspended, there have been no wild fluctuations of the exchange rate. That rate has hovered around 3 to 4 per cent above parity. This has happened, up to the end of May, while the central bank is said not to have intervened, directly or indirectly—a point which is confirmed by the modest volume of Deutschemark operations in exchange markets.

Finally, the May exchange crisis also suggests that the assumption, sometimes made, that powerful forces are at work pushing in the direction of a national currency to take up the role of a European money is not without foundation. A great deal of deliberate (political) action will be needed in order to check that tendency, which will only be reinforced as full freedom of internal capital movements comes into its own. These are bound to add momentum to a process that has been set in motion primarily through the quick succession of events on the front of the member countries' external monetary relations. These events have brought one member's currency close to the status of a major international-reserve currency and thus added further weight to its bid to play the central monetary role for the Community itself.

The most effective way of opposing this course would perhaps be to make timely progress towards the introduction of the European Currency Unit, as proposed in this essay. From this point of view, however, the attitude of those countries on which, for the time being, the orderly working of the international monetary system depends is crucial. Even under the best assumptions as to the speed of action (or reaction ?) by the Community, time will be needed before a European monetary medium will be in a position to compete successfully with the national

currencies—or, at any rate, some of them. And events will follow the course charted with the consensus of all parties concerned only if, in the next few years, it proves possible to steer clear of major storms. Failing this, and before the chances of the United Kingdom joining the Community started to look brighter, one might have assumed that pressure, hard to resist, would have built up to upgrade the Deutschemark as the *de facto* European currency, while granting the French Franc some (politically motivated) standing. Now that it seems safe to assume membership of the United Kingdom, it is more likely that, if sufficient time is not allowed for the creation and acclimatization of a European common unit, the role will be shared by the Deutschemark and the pound sterling. They are complementary in that the Federal Republic of Germany has so far proved to be best suited to generate surplus capital resources, as a banker must do if he is to retain the confidence of his customers and if his job is not to be confined to mere intermediation of funds, while the City of London possesses the expertise and machinery to build on the basis of those resources a Community system of monetary relations in Deutschemarks. Such an arrangement would have many attractions; but it is not the one which would most certainly be conducive to regionally balanced growth.

But am I reading too much, too badly, in a clouded crystal ball?

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