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ON THE MEANING AND FUTURE OF THE EUROPEAN MONETARY SYSTEM

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CONTENTS

On the Meaning and Future of the European Monetary System

The European Monetary System entered into force on March 13, 1979. Active negotiations on its completion are likely to resume in 1981. The time is ripe to attempt an assessment of this important scheme and the ways to complete it, and to consider its possible future contribution to European and worldwide monetary relations as well as to European integration.

In what follows attention is paid to both political and economic factors since the basic purpose of the Common Market is the political goal of bringing about a European federation. None of its activities can be properly understood without keeping this objective in mind. "We are not in business, we are in politics," Walter Hallstein, the first President of the European Commission, used to say. While it is true that with the passing of time the objective has shifted, temporarily at least, to a confederation of nations rather than full federation, the political aspect remains.

In undertaking such a broad task, I must of necessity confine myself to some main issues and avoid comment on the discussions of intricate detail to which the new arrangement has also given rise. Moreover, in the present early and still very fluid state of the EMS, the basic issues are of far greater importance.

1. A Brief Retrospect on European Integration

a. Early Efforts

We often lose sight of the simple fact that all fundamental difficulties with European integration flow from an unfortunate truth: for more than thirty years, European governments have consistently rejected any real transfer of sovereignty to European federal institutions, while claiming at the same time to be pursuing the ultimate objective of European unity. They did this for the first time on the occasion of the U.S. offer of Mar-

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An advanced version of this essay was discussed in a seminar at the European University Institute in Florence and benefited from comments by Professors Peter Ludlow and Sir Andrew Shonfield. My appreciation of the way political factors influence economic decisions has been greatly deepened by intensive discussions with my colleagues at the School of Advanced International Studies, and in particular by the seminars of the Johns Hopkins Foreign Policy Institute. Professors David P. Calleo and Simon Serfaty commented on parts of the manuscript. I am also grateful for comments by Sir Joseph Gold, for many years the General Counsel of the International Monetary Fund.

shall Aid in 1947. The recipient organization, the OEEC, remained a classic intergovernmental conference, in spite of efforts on the part of "Europeans" to turn it into a customs union that might evolve in the direction of a European political federation. Such a federation had been called for by Churchill and de Gaulle during and after World War II, by Churchill as early as 1943.[1] The same attitude became apparent once again when France failed to ratify the European Defense Community (EDC) in 1954. This failure also meant the end of the European Political Community (EPC), on which official work had been proceeding since September 1952. In retrospect, the defeat of the EDC stands out as a decisive setback for European federation; up to that time its early realization had seemed a distinct possibility.

The central attributes of a state are its powers in the domains of defense, foreign policy, and money. Hence, integration through a European Defense Community and a European Political Community, covering all three areas, was indeed the logical approach. But this route proved impassable from a very early stage. As a consequence, European federation may have been condemned for many decades to come. I shall deal more fully with the driving forces of the European movement in section 8. Here we need to note only that one of its purposes had been to achieve a more independent role for Western Europe in the collaboration with the United States. But in the absence of timely and effective action to that end, the temporary military division of Europe between East and West at the end of World War II was institutionalized in the early 1950s by the cold war into a new and stable European system. Arrangements were made in all three areas—political, military, and economic—that confirmed the predominance of the Soviet Union and the United States in their respective spheres of influence in Europe. The rearmament of West Germany in the Atlantic framework of NATO rather than in the European setting of the EDC was symptomatic in this respect, and contributed to similar arrangements in other fields. As a result, it has proved more effective to settle most important questions directly within the Atlantic framework, rather than trying to tackle them first in the European setting. The outcome of these forces has been that today the basic political arrangements in the Atlantic system are almost identical to those arrived at by 1955, twenty-five years ago (see DePorte, 1979, pp. ix-x). Even the completion of a European customs union has not led so far to fundamental political change.

After the failure of the EDC and EPC, Europe fell back on what is

[1] For a concise historical survey of the idea of European unity, which can be traced back at least to the fourteenth century and has its origin in the Roman Empire of antiquity, see Hallstein (1962, pp. 1-17).

called in political jargon the "neo-functional" approach to integration. Put plainly, this approach amounts to trying to trick governments into doing in a complicated way what they refuse to do in a straightforward way. According to this strategy, a politically motivated bureaucracy tries to identify sectors which are politically symbolic but sufficiently uncontroversial and technical in nature that the political authorities will leave much of the decision-making to experts. The sectors selected must be related functionally to other areas of economic, social, and ultimately political importance, so that decisions in one area will produce a spillover effect into these other areas. Pressures will then be created for common action in the new sectors, leading to further integration. The functional theory holds that the process of integration will gather its own momentum once it gets started. In the light of experience, the later neo-functional strategy has been formulated based on the conviction that a dedicated and politically motivated secretariat is needed to push the process along.[2]

b. The Common Market

For twenty years the Common Market relied mainly on this neo-functional strategy. Of necessity, therefore, its method has been one of moving toward integration and the ultimate objective of political unification by small steps. When Dutch Minister J. W. Beyen proposed this route in Messina in 1955, he had the European Coal and Steel Community of Robert Schuman and Konrad Adenauer to build on. But these two men had in mind *both* the direct approach—from coal and steel to defense and on to politics—*and* the indirect one of bringing about integration first in one sector, then in another. However, with the direct avenue blocked, it was logical to try the alternative, and set up the Common Market and Euratom. This was an imaginative response in 1955, in the aftermath of the failure of the EDC, and it led to a great step forward. As a result of the conference in Messina, the Treaty of Rome, setting up the Common Market, could be signed within less than two years, on March 25, 1957, and enter into force on January 1, 1958.

But the limitations of this approach have since become apparent. As we have seen, there has been no basic change in the fundamental political arrangements affecting Western Europe since 1955. Governments have refused to be tricked into doing what they do not want to do. And although functional relationships do exist among the various fields covered by the Common Market, they have not necessarily resulted in a forward movement as a result of spillover; they have also led to spillback.

[2] Jean Monnet was, of course, one of the earliest and most persistent proponents of this strategy. For a more detailed analysis see Tsoukalis (1977, pp. 21-30).

When a conflict arose between the demands of the Common Agricultural Policy, based on fixed exchange rates, and the necessity of changes in exchange rates as a result of divergent economic policies, the outcome was not a spillover into greater integration of economic policies but a spillback into a slow disintegration of the Common Agricultural Policy.

Europe must now face the fact that its cozy hope of achieving economic and political unity by imperceptible small steps, as the result of spillover and without any real effort, is in no way supported by the experience of the past twenty years. Insofar as there was any movement in the monetary field in the decade preceding the negotiations leading up to the EMS in 1978, it was backward rather than forward. It has become clear that the present piecemeal approach, while it does produce intensive consultation and cooperation between sovereign states, is not leading in any relevant time frame to European unity and the ultimate goal of European federation. Progress toward these goals will require a deliberate political decision to transfer real powers to European federal institutions. The crisis of Europe lies in the fact that the European nation-states go on withholding consent to such transfers of sovereignty while continuing to attach importance to the original goals. Yet in many fields the inadequacy of national policies confined to the limited geographical area of even the larger European nation-states is becoming ever more evident. The time for rhetoric has passed, and Europe must make up its mind. This is the central message of both the Tindemans and Marjolin reports (1975, p. 4, and pp. 1 and 5 respectively).

The basic trouble is that the European movement lacks a strong motivating purpose, for it has become obvious that even European federation will not restore to Europe what it lost in the years 1914-44, during what might be called its Thirty Years' Civil War:

> What was lost to Europe between 1900 and 1950, and above all between 1939 and 1945, was the sense of predestined leadership which had been taken for granted since the days of Plato and Virgil, Charlemagne and the builders of Chartres Cathedral.[3]

A federation encompassing the whole of Europe, East and West, would have been a credible superpower. But the Western half of Europe alone is less convincing. However, as a "half-Europe" is the only practical choice given the outcome of two world wars and the cold war, it is clear that some new thinking is required on the purpose of European unity and the ways to achieve it. I shall come back to this question in section 8.

For the moment, the best that European unity can promise is a role of some influence for Western Europe between the three superpowers and

[3] John Russell, *A Lost Leadership*, quoted in DePorte (1979, p. 229).

the Third World. In the eyes of the "Europeans," this is a goal eminently worth striving for when compared with the alternative, but—at any rate until very recently—it was not really felt to be a pressing objective by the whole of European society. At least, this is the conclusion that must be drawn from the actions of the European countries to date.

While the European countries are contemplating these unpleasant truths, running the risk in the meantime that inaction will allow the tide in favor of European unity to recede further, the choice is between doing nothing, with the chance of distintegration of what *has* after all been achieved, or trying to squeeze an extra mile out of the policy of small steps. The latter is what the European Monetary System is all about.

2. Past Problems with Monetary Union

a. Money versus Foreign Policy and Defense

While reasons can thus be advanced for continuing to make the best of the basically inadequate policy of small steps, it is by no means obvious why these steps should again be taken in the monetary field. If the European movement wants to make the influence of European thought and culture more strongly felt in the world, it requires a common foreign policy. A closely related field is defense. "Can one conceive, over the long term, of a Europe growing together . . . in an increasing number of ways and yet not trying to provide coherently for its own defence?" British Prime Minister Edward Heath already asked a decade ago (Heath, 1970, p. 72). Given the central roles of foreign policy, defense, and money in any political structure Europe may yet build, why not concentrate on foreign policy and defense after the failures in the domain of money?

The answer to this question in the field of defense is, of course, that post-Gaullist France, and to a lesser degree also Britain, are not ready to merge their armed forces in a European Defense Community. But this amounts to saying that they are not ready for European federation or even confederation. What, then, is the point of trying to merge money?

Europe's economic strength has certainly been sufficient for many years to enable it to provide for its own defense in alliance with the United States, including an autonomous nuclear capability of sufficient force to be a credible deterrent. But the fractionalization of the European defense effort has resulted in tremendous waste. While European defense expenditures are considerable ($35 billion a year),

> . . . what is negligible is the amount of power (deterring or coercive) that is being purchased by the EEC countries for this price, as they remain subjected to the whims of their ally in the West, their main foe in the East, and

> their former colonies in the South. There seems to be hardly any historical precedent of a state, or group of states, with both comparable defense expenditures combined with similar physical and human resources, and such total dependence on external support for security from physical aggression or economic strangulation (Serfaty, 1979, pp. 38-39; see also p. 40).

Obviously, Europe will have to address its defense problem in the coming decade, if not in the next few years.

It is even more difficult to explain why money was chosen again over foreign policy. There were specific reasons, described below in section 3b, for the birth of the EMS. Furthermore, the Treaty of Rome, creating the Common Market, deals with economic policy, not foreign policy. But this is a legal, not a political, explanation. Obviously, a common foreign policy would further Europe's ends in the world more directly than a common monetary policy. And in spite of an impressive increase in foreign-policy cooperation in the past few years, achievements in this sector still lag behind those achieved in the economic field. Moreover, the average citizen is much less directly affected by foreign policy than by economic policy, so that progress in the foreign-policy domain might well be easier.

It might thus have been wiser to select foreign policy and defense rather than money as the next main area for European action.

b. A Plan Born in Confusion

Indeed, the record in the monetary field is hardly encouraging. In 1969 the Heads of State or Government of the Community, known today as the European Council, decided to create an Economic and Monetary Union (EMU) to be completed by 1980. But the Council failed to indicate clearly by what measures this objective was to be achieved. It acted almost as though the solemn decision to establish such a union would suffice to bring it about.

The Marjolin Study Group has stated that this decision was taken without a precise idea of what was involved, an exact description of what occurred. To those unfamiliar with a few plain truths, money is an arcane and highly technical subject. At the same time money is obviously of political importance. This combination makes it an ideal candidate for the neo-functional approach. In monarchies the image of the sovereign appears on the coins. In all countries the government seems to have a great deal to do with money, along with that awesome and mysterious institution, the Central Bank. Thus by unifying the monetary systems of the countries of the Community, something important would obviously be achieved without having to face many troublesome questions about national sovereignty. Such, at any rate, was the prevailing political opinion at the time.

This confusion was fully compatible with the neo-functional strategy, and money must have seemed a godsend to the Commission and its staff. Indeed, there is good reason to believe that the European Commission was partly deceived by its own strategy. As money was primarily an affair of the central banks, it ought to be possible, according to Commission thinking, to wrest basic powers from those banks by convincing governments that they were taking an important step toward European integration without giving up vital sovereign powers themselves.

If the Council and the Commission did not have "any precise idea of what was being undertaken" (Marjolin, 1975, p. 4), it was not for want of information on the subject. The Werner Committee, whose specific task it was to enlighten them on this very question, was clear enough on the matter. It mentioned the necessity of creating two "Community organs to which powers until then exercised by the national governments will have to be transferred. . . . The *centre of decision for economic policy* will exercise independently . . . a decisive influence over the general economic policy of the Community . . ." and a "Community system for the central banks [possibly] of the type of the U.S. Federal Reserve System" would have to be set up. "The essential features . . . of the public budgets . . . will be decided at the Community level; . . . the creation of liquidity throughout the area and monetary and credit policy will be centralized; monetary policy in relation to the outside world will be within the jurisdiction of the Community . . ." (Werner Report, 1970, pp. 12-13). In short, it was pointed out clearly that an Economic and Monetary Union requires the transfer to Community organs of vital sovereign powers in the budgetary and monetary fields.

The view expressed by the Werner Committee was widely supported by academic analysis. Giving up the freedom to follow independent budgetary and monetary policies and to vary the exchange rate was of the essence of an Economic and Monetary Union, which required that these vital powers of economic management be transferred to Community institutions. But this would directly affect policies concerning employment, wages, prices, and social welfare. Sharing the management of a nation's finances means sharing the management of its economy as a whole. Thus a transfer of sovereignty was involved that would affect the daily life of the citizen in a clear and direct manner. The power of the purse and sovereignty are intimately connected. Or, to put this old adage into modern words, the Minister of Finance is involved in almost all government decisions since practically everything the government decides costs money.

To embark on an Economic and Monetary Union without confronting these fundamental issues was like embarking on an ocean crossing aboard a ship without a rudder. Accordingly, failure of the EMU was widely predicted at the time.[4]

c. The Moral for the Future

In view of these facts it is remarkable—and perhaps an outstanding example of how modern society is now so complicated that it is becoming harder and harder for politicians to lead and for the electorate to understand—that the Community went ahead with its project for an Economic and Monetary Union without any intention of effectuating the transfer of sovereignty indispensable for its success. Instead, the Community seemed to rely on bringing about such a union through the simple act of legislating it into existence.

The result is well known. Failure followed upon failure until the project was no longer taken seriously by anybody and the process of spillback set in. Its place was then taken by the hazy idea of creating a "European Union" by 1980, the content of which has never become clear. It is to be hoped that this experience has made two things evident: (1) the problems at hand cannot be solved without institutions adequate to the task, and (2) supranational objectives require the transfer of sovereign powers to Community institutions.

3. Political Forces

In the malaise created by the failures of the European Monetary Union as a result of denying these truths, the December 1978 decision of the European Council to set up a European Monetary System came as a welcome surprise. In spite of what I said in section 2a about choosing the monetary sector once again as a field for action, the decision was welcome because the EMS has been well designed, with a large dose of realism, and because it seems to open new doors to monetary cooperation.

The decisions putting the EMS into operation were taken after initia-

[4] See Nye, "The Political Context," and Cooper, "Implications for Integration of the World Economy," both in Krause and Salant, eds. (1973). These two articles are singled out because they are conveniently grouped in one interesting volume on the subject. But this view was and is widely held; the present author may perhaps be allowed to mention that he unsuccessfully argued a similar position when involved in the preparation of these plans as a member of the Commission's staff. A clear and basic statement of this position and the reasons for it dates back at least to the mid-1950s; see the reprinting of some of his previous work in Scitovsky (1958, esp. pp. 95-101).

tives by German Chancellor Helmut Schmidt and French President Valéry Giscard d'Estaing at the April and July 1978 meetings of the European Council in Copenhagen and Bremen. The initiatives resulted in a detailed *Resolution of the European Council,* adopted at the December 1978 meeting in Brussels.[5] This procedure is not in conformity with the Treaty of Rome, which provides for a proposal by the Commission and decisions by the prescribed organs of the Community, which do not include the European Council. Concrete and detailed actions such as this by the European Council are therefore opposed in principle by some members of the Community as a departure from the Treaty and its supranational elements. But in the renewed optimism that the agreement on the EMS brought about in European circles, this point was almost overlooked—and probably rightly so.

a. Germany's Fundamental Turnaround

It is a well-known though neglected historical fact that important initiatives in the domain of monetary relations, which are often regarded as technical, take place only when new political factors are at work. What, then, were the specific political forces that prompted the setting up of the EMS?

All the efforts of General de Gaulle to give Europe an independent monetary personality failed in the end because of the refusal of Germany, with its large reserves, to support a policy that would estrange it from the United States. Yet in 1978, for the first time, the German government thought and acted on semi-Gaullist principles, and began to display political initiatives tending to match its economic ascendancy. The German Chancellor was ready to make proposals that—while not anti-American—would nevertheless make Western Europe more independent of U.S. monetary policy, and to push them through. Two or three years earlier, Bonn would not have dared to embark on anything so independent from American policy as the EMS (cf. Watt, 1979). It should be noted, however, that this German assertiveness was cloaked in a European coat. Since this particular constraint on German policy is likely to persist for a number of years, it provides a unique opportunity that all those interested in promoting European unity cannot afford to miss.

A number of factors played a role in bringing about this fundamental change in the German attitude toward closer European monetary col-

[5] *Resolution of the European Council of 5 December 1978 on the establishment of the European Monetary System (EMS) and related matters,* reprinted as Annex I to this essay. Two other documents of the European Council related to the EMS are reprinted as Annexes II and III.