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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.