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The Case for European Monetary Integration

The elder statesmen and architects of the European Economic Community foresaw its eventual evolution into a full common market, with complete monetary and economic integration. Their vision included ultimate creation of a common currency, or at least a system of irrevocably fixed exchange rates, but they wisely refrained from specifying a timetable for the final stages. In the euphoria of the early 1960's, proposals for immediate movement toward monetary union came to the fore, as in the *Action Programme for the Second Stage* (1962), but the veto of British entry and the emergence of difficult issues of trade policy for which a consensus had to be worked out caused interest in monetary integration to subside. This issue was merely dormant, however, and new initiatives have appeared in recent years. These have found clearest official expression in the Werner Report, submitted to the Council of Ministers in October 1970, and the subsequent Resolution and Decisions issued by the Council in February 1971.

Although the Council avoided, in its "precautionary clause," a final political commitment to proceed all the way to complete monetary union, its resolution implies acceptance of such a union as the ultimate goal, with irrevocably fixed exchange rates, complete freedom for labor and capital movements, and a sufficient transfer of authority from national to Community institutions to permit the main economic-policy decisions to be made at the Community level. In present thinking, this goal is to be achieved by stages in about a decade. The Council resolution states that in the first three-year stage—beginning January 1, 1971—steps will be taken to strengthen coordination of short-term economic policies, to allow greater freedom of movement for labor and capital, to narrow the range of fluctuations between Community currencies, to harmonize tax systems, and generally to develop mechanisms for formulating Community-wide economic policies. The question of further action, including the drastic and "final" decision to accept a binding and irrevocable commitment to create a full monetary union, will presumably come up toward the end of the first stage. (For an historical account of the movement toward European monetary integration, see the recent paper by Bloomfield, forthcoming.)

Economists tend to be skeptical about the merits of monetary integration, and doubtful that it is either desirable or workable in the European

Economic Community, at least in the near future. Corden's recent essay (1972) in this series is a notable example. In assessing the benefits and costs of monetary integration, he found few, if any, benefits, and one major drawback—the losses arising from "enforced departure from internal balance." In view of the apparent strength of the forces pushing Europe toward more integration, one wonders whether political leaders are simply ill-informed, whether they are assigning more weight to non-economic considerations than are the economists, or whether economic analysis is itself deficient in some way. Perhaps the modes of thought used by economists cause them to neglect important economic aspects of the changing institutional structure of Europe. We should not forget that economists were also skeptical about the European Common Market, and most advance estimates of its net benefits to members were close to zero. While the final verdict is not in, and the net benefit of the Common Market per se is as difficult to measure as ever, the EEC has certainly prospered since 1958, and the Community structure has survived a number of severe tests of its unity and cohesion.

It now seems quite possible that the tide of events and the political momentum in the European Community will cause it to adopt monetary integration despite the pessimistic appraisals of economists. If it does, and if the new system proves to be successful, it will not be the first time that economic analysis has lagged behind the course of events.

The purpose of this essay is to set forth the positive side of monetary integration in the European Community, and, in the process, to question the basis of the negative case that seems to be the majority view among economists. This emphasis on the positive side does not mean, however, that monetary integration will be easy and painless. It is no panacea, and difficult economic problems will remain. The argument for integration is largely pragmatic—that monetary integration has some advantages over practicable alternatives, that it is logically consistent with the trend toward economic integration in Europe, and that it can be made to work.

The Logic of Economic Integration

Creation of a single market for goods, services, and financial assets implies the existence of common prices and of a common money, whether a single currency or several currencies linked by rigid exchange rates. Since 1958, the European Community has substantially completed the formation of such a unified market, though labor mobility is of course far from perfect (as it is even within a nation or region) and numerous obstacles still impede trade in financial assets. The virtual elimination of national tariffs and other barriers to intra-Community trade in indus-

trial goods has tended to create common prices for such goods, while adoption of the Common Agricultural Policy has entailed explicit acceptance of common prices for farm products. These common prices serve as signals for the allocation of resources and for the determination of comparative-advantage positions in the several member nations.

At the same time, the acceptance of full currency convertibility for current-account transactions and successive steps to liberalize capital movements, both long- and short-term, have greatly limited the ability of a single nation to pursue a monetary policy that differs appreciably from the rest of the Community. An attempt by a single central bank to expand the money supply, reduce interest rates, and increase aggregate demand would lead quickly to payments pressures on both current and capital accounts. A restrictive monetary policy, on the other hand, would simply invite an inflow of funds, as Germany has found. The development of the Eurodollar market has accentuated the interdependence of the monetary systems and their sensitivity to divergences from a Community norm. It now seems generally agreed that member nations have so many close links among their economies that national autonomy in monetary policy is seriously eroded if exchange rates remain fixed.

One reaction has been to conclude that these developments make it even more imperative to retain exchange-rate variability in order to permit nations to pursue separate monetary policies and thus to preserve national autonomy. This view, however, seems fundamentally antipathetic to the evolutionary trend toward economic integration. Once the member nations have forged all these links among their economies, worked their way through the delicate and difficult negotiations and compromises necessary to reach consensus, and even accepted and accomplished many of the adjustments required of them, they can hardly allow the solutions reached to be basically and perhaps drastically altered by exchange-rate changes. Economic integration leads logically toward fixed rates, monetary union, and ultimately a common currency. Advocacy of flexible exchange rates within the European Community is essentially an expression of opposition to economic integration.

It appears that Europe has reached a halfway house, a point at which it cannot stand still. Creation of a common market for agricultural and manufactured products and integration of money and capital markets have already gone so far that, with *fixed* exchange rates, nations can no longer pursue divergent monetary policies. Their effort to do so, in the mistaken belief that they still possess national autonomy with respect to monetary policy, will lead to trade deficits and massive short-term capital movements, and will thus precipitate balance-of-payments crises. Exchange controls can have some influence on capital flows, but not

enough to alter the outcome. Either exchange rates will be forced to change or extensive restrictions on trade and payments must be introduced, subverting economic integration.

On the other hand, if European exchange rates are made flexible, the degree of economic integration already achieved will be undermined, as suggested above. Exchange-rate changes would undermine the network of agreements and the consensus for integration that have evolved since 1958. Perhaps the most dramatic example concerns the Common Agricultural Policy, according to which Community-wide prices are set for major agricultural products. Devaluations, revaluations, and floating exchange rates have disrupted the political compromises underlying this scheme. In the Common Agricultural Policy, common prices were set in terms of the "unit of account" (equal to U.S. $1), with prices in each country obtained by converting common prices into domestic currency at the par exchange rate. The initial set of prices was agreed to after a long, hard series of negotiations among the Six, in which each country's problems and special interests were taken into account. Once this delicate political balance was struck, it was understood that no member could unilaterally change its agricultural prices, although the common prices in dollars were subject to change by the Council of Ministers. If a member changes the par value of its currency, however, it automatically changes its domestic agricultural prices, given unchanged *dollar* prices.

The first such instance occurred in August 1969, when France devalued the franc by 11.1 per cent. With dollar prices unchanged, the new franc parity implied a proportionate rise in the franc prices of agricultural products. France disliked this outcome because it would increase the cost of living in France (and thus offset the favorable effect of the devaluation), and other members disliked it because it would favor French farmers and encourage them to expand production. For example, the common price of soft wheat ($106.25 per metric ton) had been a hard-fought compromise, especially between France and Germany; it had entailed a fall in the German price and a rise in the French price. German output declined as small, high-cost farmers were squeezed out, while French output expanded. The franc devaluation upset the compromise, and the Council of Ministers had to achieve a new one. It was that France would increase the franc price of wheat in two stages over a two-year period and, in the interim, was required to levy border taxes on wheat exported to other members and to subsidize imports from other members. This solution involved not only a departure from common prices but also a temporary nullification of one of the primary purposes of the French devaluation—to improve the trade balance by increasing exports and reducing imports.

In September 1969, Germany allowed the DM to float briefly and

then revalued it by 9.3 per cent. During the float, Germany levied border taxes on imports and subsidies on exports, but these were opposed by other member nations. When the new parity was set, German agricultural prices in DM were reduced proportionately, and Germany made lump-sum compensation payments to its farmers. The long-run effect, however, was to weaken still further the competitive position of German agriculture. Taken together, the franc devaluation and DM revaluation comprised a major alteration in the accord on agricultural prices that was negotiated in December 1964.

In May 1971, when the DM was again allowed to float, Germany did not change its intervention prices but levied taxes on imports and gave subsidies on exports to offset the effect of the rising value of the DM. This meant, in effect, a suspension of the common market in agricultural products as far as Germany was concerned, and the suspension became general after August 15, 1971, when all Community currencies changed in value relative to the U.S. dollar. Compensatory taxes and subsidies have been the principal device used to offset the effect of exchange-rate changes, and most agricultural products are now subject to a complex system of border controls, instead of flowing freely within the Community. Practical problems have been numerous, such as the difficulties traders face when exchange rates change daily but the levels of compensatory taxes and subsidies are fixed weekly or at other intervals by each member country.

A primary objective of the Common Agricultural Policy was to prevent deliberate alterations in the conditions of competition by individual member countries. Producers in all countries were supposed to adjust to the common prices that were set jointly. Currency devaluation, which alters prices to domestic producers in the devaluing country, alters the agreed terms of competition. Even when exchange rates are allowed to float, there is a suspicion that governments may manipulate them to seek an advantage, because the float can never be completely "clean."

Similar problems arise with other aspects of the Common Market, and we conclude that, whether exchange rates are changed intermittently, via the IMF adjustable-parity method, or allowed to fluctuate more freely, the result will be a retreat from the degree of economic integration achieved so far. The choice Europe faces is between (a) further steps toward economic integration, including monetary union, and (b) a retreat from economic integration and toward the separation of national economies, through either exchange-rate flexibility or restrictions on trade and payments.

This choice is basically political. The political judgment, however, will turn in large part on the economic feasibility of monetary integration. Will it impose unacceptably heavy costs and burdens, or will the member

nations still retain policy tools that enable them to achieve a satisfactory level of domestic economic activity?

The Meaning of Monetary Integration

The Werner Report states that "a monetary union implies inside its boundaries the total and irreversible convertibility of currencies, the elimination of margins of fluctuation in exchange rates, the irrevocable fixing of parity rates and the complete liberation of movements of capital" (p. 10). This definition was incorporated in the Resolution of the Council of Ministers and listed as an objective to be achieved within ten years (from January 1, 1971), by which time the Community ". . . shall constitute a zone within which persons, goods, services and capital will move freely and without distortion of competition . . . ."

The Werner Report also calls for harmonization of fiscal policies, but in this essay we shall draw a distinction between monetary and fiscal integration. Although harmonization of some taxes may be necessary to avoid distortions of competition, we shall assume that member nations retain a considerable degree of fiscal autonomy. They can finance their activities, when necessary, through competitive access to Community capital markets. Much of what the Werner Report calls "regional policy" and assigns to the Community government can be undertaken by an individual nation at its own initiative, as will be discussed below. Consequently, the Werner Report implies a considerably larger degree of political integration than does the present essay.

Monetary integration does require the unification and joint management of both monetary policy and external exchange-rate policy. The Werner Report does not provide a detailed plan to accomplish this unification, but it does contain some suggestions from which a general idea of the Committee's intent may be surmised. Power to determine monetary policy for the European Community must be centralized, leaving the individual central banks in a position somewhat similar to that of the individual Federal Reserve Banks in the United States. A Committee of Central Bank Governors might be given the authority to set monetary policy. The rate of increase in the money supply would be decided jointly, and individual central banks would have to abide by that decision. The *mechanism* of credit expansion could itself be centralized, or it could remain in the individual central banks. That is, once the Community decision-making body has decided how much credit expansion to aim for, each central bank could be allocated a share, thus distributing the seigniorage. Beyond that agreed amount of credit expansion, a national government would have to finance any budget deficit in the Community capital market at the going rate of interest.

Such a unified monetary policy would remove one of the main reasons for disparate movements in members' price levels, and for intra-Community payments imbalances. Some variations in the rates of change in prices could still exist, however, just as they do among regions of the United States.

Under monetary integration, the balance of payments of the entire Community with the outside world must also be regulated at the Community level. A single member nation, indeed, may no longer be able even to compute its individual balance of payments with the outside world. (Who knows what part of the U.S. deficit is accounted for by the Southeastern states, the Boston Federal Reserve district, or California?)

It follows that the European Community must have a common pool of exchange reserves and that exchange rates with outside currencies must be regulated on a Community-wide basis. Member nations could agree, for example, to turn over prescribed amounts of their gold and foreign-exchange reserves to a Community reserve fund that would be charged with management of exchange-rate policy. If the exchange rate between Community currencies ("Europa," for short) and the U.S. dollar were pegged, the manager of the Community Reserve Fund could be made responsible for maintaining the rate within the authorized margins. Decisions to change the par value of the Europa or to adopt some form of flexible exchange-rate system would have to be made jointly.

If the dollar-Europa rate were pegged, but capable of change, all the problems of uncertainty, speculation, reserve adequacy, and threats of massive hot-money movements would remain. Reserves could scarcely be large enough to protect against a serious crisis of confidence and hot-money movements on a massive scale, and exchange controls would be difficult to administer. Consequently, the dollar-Europa exchange rate might instead be left to float. This would impair somewhat the effectiveness of the Eurodollar market as a lubricant for European capital-market integration and would keep alive some dangers of speculation, but it would provide a measure of flexibility between these two currency blocs.

Another alternative, though perhaps not a practical one, would be to include the dollar in the irrevocable fixing of exchange rates. If the dollar could also be permanently fixed in value relative to European currencies, the scope and influence of equilibrating capital movements would be greatly increased and the problems of reserve adequacy and hot-money movements greatly diminished.

Such an Atlantic monetary pact seems politically improbable for the near future. It would require the formulation of an Atlantic monetary

policy, perhaps through an Atlantic open-market committee, as has already been suggested by Kindleberger and others. Europe and the United States may nevertheless find a strong common interest in stable exchange rates within the Atlantic community, leading them to adopt policies and forms of cooperation that will make fixed exchange rates possible. In this way, a de facto Atlantic monetary integration may emerge, even though formal agreement is not reached. The key question is whether Europe and the United States can agree on monetary policy.

The choice of an exchange-rate regime for the European Community vis-à-vis the U.S. dollar and other outside currencies involves many issues in the great debate about reform of the international monetary system—fixed vs. flexible exchange rates, reserve adequacy, etc. These issues lie beyond the scope of this essay, but, however they are settled, monetary integration implies that the European Community must act as a unit and must adopt a common policy.

While such unification of monetary and exchange-rate policies may seem to be a drastic infringement of national sovereignty, nations are in fact already limited in their scope for central-bank creation of credit, and they would be limited even under a system of flexible exchange rates if they wished to avoid repeated currency depreciations. Furthermore, member countries have accepted, in principle and increasingly in practice, a great deal of coordination, compulsory prior consultation about economic policy, "concertation" of specific actions and policies, and other measures that constrain national autonomy. Nations may possess as much real economic autonomy—ability to influence the behavior of real economic variables within their borders—under monetary integration as they did de facto under the system that existed from 1945 to 1972, especially if we assume closely integrated markets for goods, services, and capital. Monetary union may be accompanied by a transfer of fiscal authority from national governments to the Community government, but this is in large measure a matter of political choice. (Until the 1930's the fiscal weight of the federal government in the United States was small in comparison to that of the states, except in wartime.) Member nations in the European Community may, similarly, retain control over the bulk of their fiscal revenues and expenditures. Given their power to tax and spend, and given the opportunity to borrow in Community capital markets, they can exert significant economic influence through fiscal measures. In a centralized Community, these actions would be classified as regional policy, as they are in the Werner Report, but in a loose federal system much initiative and autonomy can remain with the individual member nation.

In this essay we shall be primarily concerned with the internal opera-

tion of the Community and with intra-Community mechanisms of adjustment, on the assumption that full and complete monetary union, as defined above, actually exists. Whether nations will be willing to accept such a union is a political question, but economists should at least discuss adjustment processes and economic feasibility on the assumption that they *are* willing. If economists dismiss integration on the grounds that nations will not accept it, they are making a political, not an economic, judgment. Economists may also be able to say something about the division of economic-policy functions between the Community and the several national governments, particularly the extent to which national autonomy can be preserved.

The Transition to Monetary Integration

Some of the most difficult practical problems will concern the process of transition to full monetary integration. The debate between "monetarists" and "economists" about strategy and the timing of further steps toward monetary union has dealt largely with this interim stage. "Monetarists" argue that positive steps toward monetary integration would strengthen and accelerate the process of economic integration. Such steps would force member nations to coordinate their economic and financial policies, thus reducing disparities in wage and price trends and making exchange-rate rigidity easier to achieve. "Economists" argue that policy harmonization and real economic integration must come first, and that further steps toward monetary integration should not be taken until wage and price changes have in fact converged and structural adaptations in response to intra-Community free trade been completed. Only then, they say, would monetary integration be feasible.

A related point concerns the appropriateness of existing exchange rates. When member nations remove their present barriers to capital movements and dismantle remaining obstacles to the free flow of goods and services, they may find that the existing exchange rates are not equilibrium rates. Premature attempts to fix exchange rates irrevocably might therefore impede the subsequent liberalization of trade and capital markets, because nations would find it necessary to retain controls in order to maintain the prematurely fixed exchange rates. The trend toward liberalization of capital movements has been reversed in 1971 and 1972, as European nations have restored exchange controls in an effort to control speculative capital flows and maintain their new central rates of exchange.

It is argued contrarily that, as capital transactions become freer while exchange rates remain pegged but adjustable, rumors of a parity change can lead to massive speculative capital flows that could force exchange-rate changes in the anticipated direction. Official exchange reserves can