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Organization and Administration of a Monetary Union

Polly Reynolds Allen

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I. INTRODUCTION

In 1970, the European Community announced its plans for forming an "economic and monetary union" in the coming decade. The blueprint for this plan, the Werner Report (European Communities, 1970), dealt explicitly only with the first stages of monetary union and remained deliberately vague about the final form of the Community's economic and monetary union. At the time of the Werner Report, exchange rates among the members of the Community had remained fairly stable for a number of years, and their economies appeared to be moving more closely together. Ten years did not seem to the authors of the plan to be an unreasonable time horizon.

Today the prospects for European economic and monetary union look far less hopeful. A recent Commission Study Group considers "that the efforts undertaken since 1969 add up to failure. Europe is no nearer to economic and monetary union than it was five years ago; in fact if there has been any movement it has been backward" (European Communities, 1975a). In large part, this situation is due to economic disturbances that have come from outside the Community—large speculative capital flows resulting from uncertainty about the long-overvalued dollar, the breakdown of the Bretton Woods international monetary system, and the large increase in the price of oil. These events affected the countries of the Community in different ways, making it painfully clear that the harmonious movements of their economies had depended upon stable economic conditions. Another source of problems has been the wide variety of understandings, and in many cases lack of understanding, of what is entailed in forming an economic and monetary union.

Some of these disagreements stem from differences in motivation for pursuing economic and monetary union. At one extreme are those who envision a total European union, encompassing political as well as economic and monetary integration; this is the ideal of many who work within the Commission. In that context, monetary union is but one step

The research for this study was begun on my sabbatical leave from Princeton University in 1973. It was supported by a grant from the Council on International and Regional Studies and by the International Finance Section, both of Princeton University, and by the Ford Foundation's Research Program on International Economic Order. I wish to thank my colleagues Peter Kenen, Lester Chandler, and William Branson for their helpful comments on earlier drafts.

toward much more comprehensive unification and, as such, has occasionally been viewed as a means of forcing other forms of integration. In contrast have been the motivations of the French, who pushed for the early formation of a monetary union as a means of forming a common Community position in international monetary negotiations, as a balance particularly against the strength of the American views. At the same time, the French place a high value on national autonomy in most economic and political matters; their vision of monetary union is quite different from those favoring a total European union. Other countries, such as Germany, have placed more emphasis on the nonmonetary economic aspects of union, stressing the impossibility of coordinating monetary measures in advance of cooperation on and integration of other economic policies.

Beyond the differences in motivation, however, there appears also to have been a lack of understanding in the Community of the implications of taking certain steps toward economic and monetary union. Insufficient attention was paid to the interrelationships of various aspects of economic and monetary policies, wherein advances made in one area affect, and are affected by, conditions in other areas.[1] The European Study Group, mentioned above, attributes the failure of the Community to progress toward economic and monetary union to three main factors: (1) adverse external developments, (2) lack of political will on the part of the governments, and (3) insufficient understanding of what is involved in forming such a union (European Communities, 1975a).

There are a number of reasons why the European Community may still wish to pursue an economic and monetary union despite these setbacks. The recent disruptions to the European economies, while making coordination or integration more difficult, are viewed by some as emphasizing the importance of coordinated European action. The economic and political spillovers among the European countries, and the perceived impossibility for any one country effectively to meet external challenges in the face of fragmented and conflicting national policies, are taken as evidence that European union in some form is essential. The Commission has recently reaffirmed that economic and monetary union is its primary objective (European Communities, 1975c, p. 7).

[1] Balassa (1975) discusses, for instance, the inconsistency of medium-term objectives of the European governments and the Community, when these objectives are evaluated in the context of a single macro model.

It is to increase the understanding of the relationships in an economic and monetary union, between monetary and other economic policies and between monetary policy and market integration, that this study is written. Since the initial steps toward economic and monetary union in Europe were primarily concerned with the monetary aspects of the union, and since much of the European debate has centered on the possibility of moving toward a monetary union before establishing economic union in other areas, the focus of this paper is on *monetary union.* I examine some of the problems of administering monetary policy for a monetary union of several countries and some of the necessary conditions for such a policy to be effective. I consider the implications of the formation of a monetary union for the other economic policies of governments and the likely impacts of these other policies on the effectiveness of union monetary policy. While the study is directed toward considerations of monetary union, it also asks which other economic policies must be unified in conjunction with the monetary union.

The analysis begins with the assumption that a monetary union is to be formed and then asks what characteristics, beyond the minimal requisites, will be necessary to make the monetary union work. Immediately one sees the need to define the minimal requisites of a monetary union and to agree on what is meant by saying that a monetary union "works." The failure to come to agreement on these very basic issues has been one of the problems for the proposed European economic and monetary union.

Before I give a basic definition of a monetary union, however, let me point out that a number of areas relevant to an understanding of the implications of a monetary union are not considered in this paper. First, the study bears only peripherally on the crucial question of whether a group of countries, and the European Community specifically, *should* form a monetary union; it starts with the initial assumption that a monetary union is to be formed. I do, however, draw conclusions that certain decisions concerning institutions, market integration, and unification of other economic policies are necessary for a successful monetary union, and these conclusions may in turn influence the initial assumptions about the desirability of monetary union. There is a substantial body of literature on optimum currency areas, and on the European case in particular, that is specifically concerned with the question of whether countries should form a monetary union.[2] In exam-

[2] The early contributions to the literature on optimum currency areas are in Mundell (1961) and McKinnon (1963). The considerable work since that time,

ining the conditions necessary to conduct an effective union monetary policy, this study considers the implications of market integration in facilitating adjustment to *monetary* disturbances. The adjustment process in response to nonmonetary disturbances, such as different rates of growth or inflation within the union, is not discussed here; balance-of-payments adjustment to nonmonetary disturbances has been treated extensively in the literature on optimum currency areas and existing monetary unions. Finally, the study concentrates on the requirements for an existing, although newly established, monetary union. While it is important to understand these requirements in order to know how best to move toward a monetary union, the study does not specifically examine, or make recommendations for, the transition process toward a monetary union.

Definition of Monetary Union and of Economic Policies

It is useful to draw a distinction between the characteristics that are essential for any monetary union and the additional characteristics that are necessary for the continued and successful existence of the monetary union. The minimal definition is by far the easier.

First, in any monetary union either there must be a single currency or, if there are several currencies, these currencies must be fully convertible, one into the other, at immutably fixed exchange rates, creating effectively a single currency.

Second, as the immutability of fixed exchange rates depends upon mutually consistent monetary policies within the union, there must be an arrangement whereby monetary policy for the union, including control of high-powered money and regulations affecting the commercial banks' ability to create money, is determined at the union level, leaving no national autonomy in monetary policy.

Finally, since there can be only one rate of exchange between an external currency and the union currency, there must be a single external exchange-rate policy. Toward this end, the national authorities

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either dealing directly with optimum currency areas or having important implications for the subject, is surveyed in some detail by Tower and Willett (1976). Discussions of monetary union with particular reference to the European Community are in Corden (1972), European Communities (1970), Hirsch (1972), Ingram (1973), and Magnifico (1973). Some of the transitional questions raised by moving toward a monetary union in the Community are treated in European Communities (1973a, 1973b, and 1973c), Magnifico and Williamson (1972), and Mundell (1973). "Economic" aspects of the union are the focus of Denton (1974).

must relinquish individual control over their international reserves and invest such control in a union authority.

These three requirements—effectively a single currency, a single union monetary policy, and union control of international reserves and the external exchange rate—are regarded here as minimally essential for any arrangement to qualify as a monetary union. It would probably not be difficult to find a consensus on the necessity of these conditions for a monetary union, though certainly not on their sufficiency.[3] The additional characteristics that are necessary for the success of the monetary union are more subjective and controversial, varying with the underlying political and economic conditions for a particular union and with the ultimate goals of the countries forming the union. Those additional conditions for a successful monetary union are the main subject of this study.

Since the arrangements whereby governments conduct economic policies, and the kinds of policies they pursue, vary widely from country to country, it is important also to be clear about our definitions of these policies. This study discusses three kinds of governmental economic policies—monetary, fiscal, and credit. For our purposes, they are defined as follows:

1. Monetary policy includes (a) the standard instruments of internal monetary policy—open-market operations in securities by the monetary authority, the setting of reserve requirements for commercial banks, and discount policies (i.e., the conditions under which the monetary authority will extend loans to the commercial banks)—and (b) the basic instruments of external monetary policy—control of the external exchange rate through intervention in the foreign-exchange market and the setting of any external barriers to the flow of financial capital.

2. Fiscal policy includes government purchases of goods and services, taxation and transfers to the public, and the issuance of securities to finance any resulting budget deficits.

[3] This definition is essentially in accord with the definitions of the Werner Report (European Communities, 1970) and of other economists who have analyzed European monetary union, such as Corden (1972), Ingram (1973), and an EC Study Group (European Communities, 1973a). Some definitions, such as the Werner Report's and Corden's, go further, however, and include complete lack of capital controls within the union as a prerequisite for monetary union. Here, rather than assuming the necessity of intra-union capital mobility and making it part of the definition of monetary union, in Chapter IV I examine to what extent and why capital mobility is important for the conduct of union monetary policy.

3. Credit policy includes measures, taken either by governments or the monetary authority, to channel investment toward particular sectors and to direct the flow of saving through certain financial markets. (Direct quantitative and qualitative controls over commercial banks' balance sheets are defined here as credit policy, rather than monetary policy, because of their effects on the flow of funds. Because such direct controls over commercial banks affect the banks' ability to create money, however, this aspect of credit policy must be included with the mandatory centralization of monetary powers in a monetary union.)

Goals of Economic and Monetary Union

One of the major difficulties in the Community's unification effort has been the failure to agree on its ultimate goals in forming an economic and monetary union. As a result, it has found itself with a variety of definitions of what such a union should be. That issue, of course, cannot be resolved in this study but must be worked out within the Community itself.

For our purposes, it is useful to compare some of the possible intentions in setting up an economic and monetary union and to consider how they reflect upon our suggested characteristics for a "successful" monetary union. The essential question is to what degree and in which areas the member nations wish to turn over national sovereignty to union authority. While it is expected that every nation will act in its own national interest, that interest may best be served for some purposes by exchanging a national identity for a union identity. In other situations, a nation may wish to retain its identification with its own national interests but may recognize at the same time that the national interest can best be served through cooperation and compromise to form a single union policy.

In economists' terms, the choice between these two postures is the choice between maximizing a *union* welfare function or some weighted average of separate *national* welfare functions. If the member countries are sufficiently integrated to have adopted a union welfare function for some purpose, the question of whether to centralize the relevant policy becomes largely a question of efficiency. On the other hand, if countries are maximizing their individual national welfare functions, the desirability of centralizing a policy depends, for each nation, upon the gains from cooperation compared with the costs of compromise.

Since the European Community seems far closer to the latter model, recognizing the need to cooperate but reluctant to relinquish national autonomy, this study is based on the assumption that countries have

determined to have a monetary union but are reluctant to give up any more national autonomy than is necessary. The arguments on centralizing fiscal and credit policies are couched in terms of how the relative gains and costs are influenced by the existence of monetary union. At times, I will ask whether national interests are best served through coordination of national policies for a particular function or by relinquishing national autonomy in the interests of a single union policy.

II. THE STRUCTURE OF THE UNION MONETARY AUTHORITY

A group of nations could conceivably form a monetary union by (1) agreeing to fix their exchange rates permanently and to guarantee convertibility of the currencies; (2) instructing the central bankers of the respective countries to meet and negotiate on the monetary policies to be followed by each, with the understanding that they must abide by the group decision; and (3) having a single agent for external exchange-rate policy who would control the common pool of reserves for that purpose. This minimal arrangement might function as a monetary union, but it is doubtful if it would work for long.

A workable monetary union requires that the member nations be committed to its permanence and that they perceive the net benefits of remaining in the union to exceed the potential gains from secession. Furthermore, the financial institutions, firms, and households of the union must generally believe in its permanence. If they do not have such confidence, they will continue to presume that dealings with other countries of the union involve exchange-rate risk and risk of discriminatory capital controls. This would reduce their willingness to hold the other national currencies, to incur debts or acquire assets with other countries' financial institutions, or to make long-term contracts across national borders of the union. The resulting separation of national securities markets would in all likelihood constitute a failure to achieve the union's goals and would certainly make more difficult the implementation of a union monetary policy, as will be discussed in Chapter IV. Furthermore, if the union were suspected to be temporary, there would be reluctance to grant the union monetary authority significant powers that it might need to operate effectively.

The question addressed in this chapter is then: What provisions for the organization of the union monetary authority, beyond the minimal requirements, will improve the gains and reduce the costs of the union, promote its stability, and create confidence in its endurance?

National Banks and National Currencies

The minimal requirements of a fixed exchange rate and a single monetary policy permit the countries of the monetary union to retain their national currencies and to have separate national banks within

the structure of the union monetary authority. The national banks would presumably be the remnants of the pre-union central banks, operating in the monetary union under reduced authority and independence. While national banks and national currencies are consistent with our definition of monetary union, there is some question whether the continued existence of these national institutions would contribute to a workable monetary union.

It has been noted that strong commitments to the union by the member countries are required for the success of the union, perhaps even for its continued existence. One measure of the strength of these commitments is the difficulty nations would have extricating themselves from the monetary union. By this criterion, a single central bank and a sole union currency would indicate strong national commitments to the union, for there would be formidable practical barriers to a nation's withdrawing from the monetary union if it no longer had either a national bank or a currency it could claim as its own. The desire of governments to retain these national institutions within the structure of the monetary union might stem from questionable commitments to that union. And even if governments' commitments were in fact incontrovertible, the citizens of the union might view the retention of national banks and currencies as an indication that the union would not be permanent. Such perceptions would make full participation in the union highly unlikely and could create political pressures on a national government to withdraw, particularly if monetary factors were blamed for a bad national economic situation. These kinds of doubts about the permanence of the monetary union would probably be assuaged by the creation of a single union central bank and by the replacement of the national currencies with a single union currency. Such a course of action may not, however, be the best way to ensure member nations' commitments to the union and the credibility of those commitments.

1. Arguments concerning national banks. There are potential advantages in retaining the national banks in the organization of a union monetary authority. It may be less costly to use the established bureaucracies of the national central banks than to set up a wholly new union central bank. In a large diverse economy, decentralization of ongoing monetary operations may be more efficient than a single central bank. As a practical matter, the central banks would probably be more willing to cooperate in the formation of the monetary union if they were going to lose only their independence and not their very existence. Moreover, public confidence in the monetary system may require a

continuity of institutions that could be achieved only by incorporating the national central banks into the new union monetary authority.

At the same time, there are bound to be difficulties in requiring central banks, which have always either formulated their own monetary policies or answered to their national governments, to accept the rulings of the union monetary authority in all significant decisions. This problem is aggravated when the monetary practices of the member nations have traditionally differed, as has happened in the European Community in its efforts to unify banking regulations. Monetary structures and policies in the Community differ widely—in the number and size of the banks controlled by the central bank, in the emphasis on written regulations or informal agreements to enforce monetary policy, and in the use of market pressures or quantitative and qualitative controls to effect monetary policies, to name a few. Furthermore, the jurisdiction of each national bank coincides with the jurisdiction of the national government. The possibility that a national government could claim independence for its national bank, making the national bank no longer subject to the union monetary authority, might present a temptation to a government needing another tool to manage its economy.

The relationship between the union monetary authority and the national banks can, however, be designed to minimize this pressure for national monetary independence while still retaining the national banks in the system. Basically, the role of the national banks must be limited to carrying out the instructions of the union monetary authority in all major decisions, with very little latitude for autonomous action. To the extent that national monetary interests may differ, these can be accommodated by negotiation at the central level among the national representations within the union monetary authority. But the result of such bargaining must be a *single* union monetary policy.

Moreover, whenever possible monetary policy should be implemented, as well as planned, by the central monetary authority. Open-market operations, for instance, should probably be conducted at the central level. Instead of buying and selling securities for their own account at the instructions of the union monetary authority, the national banks should deposit the relevant securities in a central open-market fund. The central authority would buy and sell securities for the open-market fund, crediting and debiting the respective accounts of the national banks in accordance with centrally determined allocations. Under such an arrangement, a national bank would not have the means to defy the open-market policy of the union monetary authority if it so desired. Similarly, the national banks should deposit