

The European Monetary Union and the European Monetary System (I)

Ali M. EL-Agraa

In the early and mid 1960s, most of the literature on economic integration was devoted to a discussion of the economic consequences of tariff removal and the establishment of common external tariff rates (CETs), i.e. the major preoccupation was with the 'customs union' elements of the European Community (EC). It is now well established that monetary integration is by far the most important aspect of economic integration. Hence the purpose of this paper is to discuss in Part I both the theoretical and practical issues in a context which enables in Part II a direct appraisal of the European Monetary System (EMS).

Although the Treaty of Rome does not specifically state that a European Monetary Union (EMU) should be established, its architects foresaw the EC evolving into a fully-fledged common market with complete monetary and economic integration of its members. The serious monetary upheavals of 1970, which culminated in the devaluation of the French franc (FF) and in speculation in favour of the Deutsche mark (DM) leading to its eventual revaluation, prompted the Ministers at The Hague to agree in principle to the establishment of an EMU. The EC later agreed to introduce a complete EMU by 1980, in stages, with the first phase to begin on 1 January 1971. Later when the Six became nine and the world monetary system was in complete disarray, it was inevitable that the 1980 date should be waived—see the Marjolin Report (1975). In 1978, the Bremen Conference affirmed its commitment to achieving the objective in the near future by adopting the EMS.

In spite of this progress, some very influential economists have expressed very great doubts as to whether there will be any gains from monetary integration and have emphasised the costs to members of such a union. The

aims of this paper is to reappraise the whole issue with the object of finding out whether or not there is a case against complete monetary integration.

WHAT IS MONETARY INTEGRATION?

Monetary integration has two essential components: an exchange rate union and capital market integration. An exchange rate union is established when member countries have what is, in effect, one currency. The actual existence of one currency is not necessary, however. One could of course argue that the adoption of a single currency would guarantee the irreversibility of undertaking membership of a monetary union, which would have vast repercussions for the discussion in terms of actual unions, a point which I shall discuss later because if member countries have *permanently* fixed exchange rates amongst themselves, the result is effectively the same even though the member currencies may vary in unison relative to non-member currencies.

Convertibility refers to the *permanent* absence of all exchange controls for both current and capital transactions, including interest and dividend payments (and the harmonisation of relevant taxes and measures affecting the capital market) within the union. It is of course absolutely necessary to have complete convertibility for trade transactions, otherwise an important requirement of customs union formation is threatened, namely the promotion of free trade between members of the union. Convertibility for capital transactions is related to free factor mobility and is therefore an important aspect of *capital market integration* which is necessary in common markets, not in customs unions or free trade areas.

Monetary integration takes place when an exchange rate union is accompanied by capital market integration. In spite of the fact that these two components are essential elements in the definition, Corden (1972) contends that both in theory and in practice a distinction can be made between them. For example, it is possible to have fixed exchange rates without private capital movements (allegedly the case in Europe) or fluctuating exchange rates with complete freedom of movement for private capital (the US-Canada relationship). Whether or not such a distinction can be made in the case of the envisaged EMU is a point that I shall discuss shortly.

In practice, this definition of monetary integration should specifically include:

- (a) an explicit harmonisation of monetary policies;
- (b) a common pool of foreign exchange reserves;
- (c) a single central bank.

There are important reasons for including these specifications. Suppose union members decide either that one of their currencies will be a reference currency, or that a new unit of account, say the *Euro*, will be established. Also assume that each member country has its own foreign exchange reserves and conducts its own monetary and fiscal policies. If a member finds itself running out of reserves, it will have to engage in a monetary and fiscal contraction sufficient to restore the reserve position. This will necessitate the fairly frequent meeting of the finance ministers or central bank governors, to consider whether or not to change the parity of the reference currency. If they do decide to change it, then all the member currencies will have to move with it. Such a situation could create several difficulties:

- (a) Each finance minister might fight for the rate of exchange that is most suitable for his own country. This might make bargaining hard; agreement might become difficult to reach and the whole system might be subject to continuous strain.
- (b) Each meeting might be accompanied by speculation about its outcome. This might result in undesirable speculative private capital movements into or out of the union.
- (c) The difficulties that might be created by (a) and (b) may result in the reference currency being permanently fixed relative to outside currencies, e.g. the US dollar.
- (d) However, the system does allow for the possibility of the reference currency floating relative to non-member currencies, or floating within a band. If the reference currency does float, it might do so in response to conditions in its own market. This will be the case, however, only if the union requires the monetary authorities in the partner countries to vary their exchange rates so as to maintain constant parities relative to the reference currency. They will then have to buy and sell the reserve currency so as to maintain or bring about the necessary exchange rate alteration. Therefore, the monetary authorities of the reference currency will, in fact, be able to determine the exchange rate for the whole union.

- (e) Such a system does not guarantee the permanence of the parities between the union currencies that is required by the definition of monetary integration. There is the possibility that the delegates will not reach agreement, that one of the partners might finally choose not to deflate to the extent necessary to maintain its rate at the required parity, in that a surplus partner might choose neither to build up its reserves, nor to inflate as required and so might allow its rate to rise above the agreed level.

These problematical possibilities make it necessary to include in the definition of monetary integration the harmonisation of monetary policies and the common pool of foreign exchange reserves under the authority of a single central bank. The bank would operate in the market so as permanently to maintain the exchange parities among the union currencies and, at the same time, it would allow the rate of the reference currency to fluctuate, or alter intermittently, relative to the outside reserve currency. For instance, if the foreign exchange reserves in the common pool were running down, the bank would allow the reference currency, and with it all the partner currencies, to depreciate. This would have the advantage of economising on the use of foreign exchange reserves, since all partners would not tend to be in deficit or surplus at the same time. Also surplus countries would automatically be helping deficit countries.

However, without explicit policy co-ordination, a monetary union would not be effective. If each country conducted its own monetary policy, and hence could engage in as much domestic credit creation as it wished, surplus countries would be financing deficit countries without any incentives for the deficit countries to restore equilibrium. If one country ran a large deficit the union exchange rate would depreciate, but this might put some partner countries into surplus. If wage rates were rising in the member countries at different rates, while productivity growth did not differ in such a way as to offset the effects on relative prices, those partners with the smaller inflation of wage rates would be permanently financing other partners.

In short,

Monetary integration, in the sense defined, requires the unification and joint management both of monetary policy and of the external exchange-rate policy of the union. This in turn entails further conse-

quences. First, in the monetary field the rate of increase of the money supply must be decided jointly. Beyond an agreed amount of credit expansion, which is allocated to each member state's central bank, a member state would have to finance any budget deficit in the union's capital market at the ruling rate of interest. A unified monetary policy would remove one of the main reasons for disparate movements in members' price levels, and thus one of the main reasons for the existence of intra-union payment imbalances prior to monetary union. Secondly, the balance of payments of the entire union with the rest of the world must be regulated at union level. For this purpose the monetary authority must dispose of a common pool of exchange reserves, and the union exchange rates with other currencies must be regulated at the union level. Under such a system it may not be possible for a member to calculate its balance of payments with its partners and the rest of the world (Robson 1984).

Therefore, monetary integration which explicitly includes the three requirements specified will do away with all these problems. Incidentally, this also suggests the advantage of having a single currency.

EUROPEAN MONETARY UNION

For the purposes of this paper it is of the utmost importance to establish the nature of the envisaged EMU in the light of the agreed definition of monetary integration.

According to the EC 1972 document on 'Economic and Monetary Union,' usually referred to as the Werner Report:

... The Community would, according to the Council resolution:

1. Constitute a zone where persons, goods, services and capital would move freely—but without distorting competition, or creating structural and regional imbalances—and where economic undertakings could develop their activities on a Community scale:
2. Form a single monetary entity within the international monetary system, characterised by the total and irreversible convertibility of currencies: the elimination of fluctuation margins of exchange rates between the [members]; the irrevocable fixing of their parity relationships. These steps would be essential for the creation of a single currency, and they would involve a Community-level organization of central banks:
3. Hold the powers and responsibilities in the economic and monetary field

that would enable its institutions to ensure the administration of the economic union. To this end, the necessary economic policy decisions would be taken at Community level and the necessary powers would be attributed to Community institutions.

The Community organisation of central banks would assist, in the framework of its own responsibilities, in achieving the objectives of stability and growth in the Community.

These three principles would apply to:

- (a) The internal monetary and credit policies of the union;
- (b) Monetary policy *vis-a-vis* the rest of the world;
- (c) Policy on a unified capital market and capital movements to and from non-member countries;
- (d) Budgetary and taxation policies, as related to the policy for stability and growth . . .
- (e) Structural and regional action needed to contribute to the balanced development of the Community.

As progress was made in moving closer to the final objectives, Community instruments would be created whenever they seemed necessary to replace or complement the action of national instruments. All actions would be interdependent: in particular, the development of monetary unification would be backed by parallel progress in the convergence, and then the unification of economic policies.

Hence, it is clear that the envisaged EMU is consistent with, and satisfies all the requirements of, the accepted definition of monetary integration.

THE GAINS AND LOSSES

It is important to ask the question: are there any gains and losses for countries from membership of a monetary union?

The gains and losses due to membership of a monetary union could be both economic and non-economic, i.e. political, sociological, etc. Some of the non-economic effects are too obvious to discuss and, in any case should be left to experts in their respective fields. In the economic field, the gains could be briefly summarised:

- (a) The common pool of foreign exchange reserves already discussed has

the incidental advantage of economising in the use of foreign exchange reserves both in terms of the fact that member nations will not go into deficit *simultaneously* and intra-EC trade transactions will no longer be financed by foreign exchange. In the context of the EC this will reduce the role of the US dollar or 'reduce Europe's dependence on the dollar' (Corden 1972).

- (b) If the EC adopted a common unit of account (the *Europa*), it would be inevitable for it to become a major world currency able to compete with the dollar on equal terms. The advantages of such a currency for the EC are too well established to discuss here. However, the use of an area's currency as a major reserve currency doubtless imposes certain burdens on the area, but in this particular case, it would create an oligopolistic international monetary situation which could either lead to collusion, resulting in a permanent sensible reform of the international monetary situation, or intensify the situation and lead to a complete collapse of the international monetary order. The latter possibility is of course extremely likely to result in the former outcome.
- (c) Another source of gain could be a reduction in the costs of financial management. Monetary integration should enable the spreading of overhead costs of financial transactions more widely. Also 'some part of the activities of foreign-exchange-dealing institutions could be dispensed with, thus generating resource use savings' (Robson 1984).
- (d) There also exist the classical advantages of having permanently fixed exchange rates (or one currency) among members of a monetary union for free trade and factor movements. Stability of rates enhances trade, encourages capital to move to where it is most productively rewarded and ensures that labour will move to where the highest rewards prevail. It seems unnecessary to emphasise that this does not mean that *all* labour and *all* capital should be mobile, but simply enough of each to generate the necessary adjustment for any situation.
- (e) The integration of the capital market has a further advantage. If a member country is in deficit (assuming that countries can be recognised within such a union), it can borrow directly on the Community

market, or raise its rate of interest to attract capital inflow and therefore ease the situation. However, the integration of economic policies within the union ensures that this help will occur automatically under the auspices of the common central bank. Since no single area is likely to be in deficit permanently, such help can be envisaged for all the members. (Hence, there is no basis for Corden's 1972 assertion: 'No region . . . can borrow indefinitely to sustain real-wages and consumption levels that are out of line with the region's productivity and the demand for its products.

(f) When a monetary union establishes a central fiscal authority with its own budget, then the larger the size of this budget, the higher the degree of fiscal harmonisation (the McDougall Report 1977). This has some advantages:

(i) Regional deviations from internal balance can be financed from the centre.

(ii) The centralisation of social security payments financed by contributions or taxes on a progressive basis 'would have some stabilising and compensating effects and so would modify . . . adverse effects of monetary integration.' (Corden 1972).

This is a point much emphasised in the McDougall Report—see Chapter 17 of El-Agraa (1985).

(g) There are negative advantages in the sense that an EMU is necessary for maintaining the EC as it exists; for example, the CAP would be undermined if exchanges were to be flexible (see Ingram's excellent 1973 exposition of this and other themes and Chapter 8 of El-Agraa (1985).

It should be clear that monetary integration does not 'necessarily yield resource allocation gains any more than a customs union does; moreover, even if there are gains, they may not be distributed acceptably among the member states. Discussion of costs . . . , however, has centred, not on these issues, but mainly on the question of whether or not the attainment of national macroeconomic objectives could be impaired if a common monetary regime were to be adopted' Robson (1984).

The losses from membership of a monetary union are emphasised by Fleming (1971) and Corden (1972). Assume that the world consists of at

least three countries and that, in order to maintain both internal and external equilibrium, one country (A) needs to devalue its currency relative to the outside world (C), while another country (B) needs to revalue *vis-a-vis* C. Assume also that countries A and B use fiscal and monetary policies for achieving internal equilibrium. If A and B were partners in an exchange-rate union, they would devalue together—which is consistent with A's policy requirements in isolation—or revalue together—which is consistent with B's requirements in isolation—but they would not be able to alter the rate of exchange in a way that was consistent for both. In such circumstances, the alteration in the exchange rate could leave A with an external deficit, hence forcing it to deflate its economy and create unemployment, or it could leave it with a surplus, hence forcing it into accumulating foreign reserves or allowing its prices and wages to rise. Hence if countries deprive themselves of rates of exchange (or trade impediments) as policy instruments, they 'impose on themselves losses that are essentially *the losses* resulting from enforced departure from internal balance' (Corden 1972; the emphasis is not in the original text).

In short, the rationale for retaining flexibility in the rates of exchange rests on the assumption that governments aim to achieve both internal and external balance, and as Tinbergen (1952) has shown, to achieve these *simultaneously* at least an equal number of instruments is needed.

It is important to follow Corden's explanation (Corden 1972) of the enforced departure from internal equilibrium. Suppose a country is initially in internal equilibrium but has a deficit in its external account. If the country were free to vary its rate of exchange, the appropriate policy for it to adopt to achieve overall balance would be a combination of devaluation and expenditure reduction. When the rate of exchange is not available as a policy instrument, it is necessary to reduce expenditure by more than is required in the optimal situation with the result of extra unemployment. The excess unemployment, which can be valued in terms of output or whatever, is the cost to that country of depriving itself of the exchange rate as a policy instrument. The extent of this loss is determined, *ceteris paribus*, by the marginal propensity to import and to consume exportables, or, more generally, by the marginal propensity to consume tradables relative to non-tradables.

The expenditure reduction which is required for eliminating the initial external account deficit will be smaller the higher the marginal propensity to import. Moreover, the higher the marginal propensity to import, the less the effect of that reduction in expenditure on demand for domestically produced commodities. For both reasons, therefore, the higher the marginal propensity to import, the less domestic unemployment will result from abandoning the devaluation of the rate of exchange as a policy instrument. If the logic of this explanation is correct, it follows that as long as the marginal propensity to consume domestic goods is greater than zero, there will be some cost due to fixing the rate of exchange. A similar argument applies to a country which cannot use the exchange rate instrument when it has a surplus in its external account and internal equilibrium: the required excess expenditure will have little effect on demand for domestically produced goods and will therefore exert little inflationary pressure if the country's marginal propensity to import is high.

This analysis is based on the assumption that there exists a trade-off between rates of change in costs and levels of unemployment—the much criticised Phillips curve—see appendix for a theoretical exposition of these aspects. Corden contends that if one assumes that money wages are not adjusted in response to changes in the cost of living (and hence in the exchange rates) to the extent of maintaining a given, or pre-existing, level of *real* wages, then (Corden 1972) it is possible to argue that at any moment in time there will exist a particular level of money wages and labour productivity in each country and, therefore, there will be a particular set of rates of exchange which, when combined with the appropriate monetary and fiscal policies in different countries, will achieve both internal and external equilibrium in these countries simultaneously. As money wages and labour productivities change over time, a new set of rates of exchange will be needed to maintain overall equilibrium. Here, as in the previous explanation, the extent of the losses from abandoning the rate of exchange as a policy instrument to rely exclusively on expenditure-changing policies will depend, *ceteris paribus*, on the marginal propensity to consume tradables.

Corden concedes that the mention of different countries within a monetary union is misleading. He maintains that in such circumstances the question of internal equilibrium should be considered in terms of regions in

a country. However, he insists that, generally speaking: 'one particular level of aggregate demand associated with the appropriate exchange rate for the country (union) as a whole can maintain full employment in one region, but it may lead to inflation in another. If inflation in most regions is to be avoided, excessive unemployment in some regions may have to be tolerated' (Corden 1972).

I have quoted freely and extensively from Corden simply because his work is recognised as classic in this context. The reader needs to digest his argument as explained by him before considering its limitations, as I see them. These are:

- (a) It is clearly stated in the definition of monetary integration that the fixity of exchange rate parities within the union (or the adoption of one currency) does not mean that the different member currencies cannot vary in unison relative to extra-union currencies, i.e. devalue/revalue the *Europa* relative to the US dollar. Hence the union is not foregoing the availability of exchange rate variations *vis-a-vis* the outside world. This limitation applies to regions only.
- (b) In a proper monetary union, an extra deficit for one region can come about only as a result of a revaluation of the union currency—the union as a whole has an external surplus *vis-a-vis* the outside world. Such an act would increase the foreign exchange earnings of the surplus region, and hence of the union as a whole, provided the conditions for a successful revaluation exist. The common central bank and the integration of monetary policies will ensure that the extra burden on the first region is alleviated: the overall extra earnings will be used to help the region with the extra deficit. Needless to say, such a situation does not lead to surplus regions financing deficit regions indefinitely because no single region is likely to be in deficit of surplus permanently and because the policy coordination will not allow one region to behave in such a manner unless there are reasons of a *different* nature.
- (c) Even if one were to accept Corden's argument at its face value, his assumptions are extremely controversial. For instance, devaluation can work effectively only when there is 'money illusion,' otherwise it would be pointless and would not work. Is it really permissible

to assume that trade unionists in the EC suffer from money illusion? Johnson, Ingram and others (in Krause and Salant 1973, pp. 184–202) have all pointed to the fallacious nature of such an assumption in the context of the EC—see Sumner and Zis (1982) for a full discussion of this issue. Corden's response has been to suggest that exchange rate alterations may work if money wages are forced up because the catching-up process is never complete. Such an argument is far from convincing simply because the catching-up process has no validity as a true adjustment; it cannot be maintained indefinitely because, sooner or later, trade unionists will allow for it when negotiating money wage increases.

- (d) One must remember that in practice there would never be a separation between the exchange rate union and capital market integration. Once one allows for the role of convertibility for capital transactions, capital will always come to the rescue. Corden has reservations about this too (Corden 1972):

... in the short run capital integration can help, but in the long run, while having its own advantages, it cannot really solve the problem ... No country or region can borrow indefinitely on a private market, however open and efficient the market is, to sustain levels of real wages, and hence real consumption levels which are too high, bearing in mind the productivity of the country or region.

Corden is switching grounds here: devaluation is nothing but a temporary adjustment device as the discussion of the monetary approach to the balance of payments has shown. Why then should devaluation be more desirable than short-term capital adjustment? Moreover, for a region that is permanently in deficit, all economists would agree that devaluation is no panacea.

- (e) The EC allows for free labour mobility and this will also help in the adjustment process. Even though Corden (1972) does concede this point, he believes that labour mobility may:

... marginally reduce problems of internal balance caused by integration, but it would take prolonged unemployment generating a

spirit of hopelessness to lead to substantial emigration out of some of the Community countries into others. Furthermore, if monetary integration gets too far ahead of psychological integration—the suppression of existing nationalisms and sense of attachment to place, in favour of a European nationalism and an American-style geographic rootedness—then it is not hard to imagine the intensity of nationalistic reaction to any country's depopulation.

This is yet another unreasonable argument which presupposes that the problem region is a *permanently* depressed area. Since no region in the union is ever likely to experience chronic maladjustments, labour mobility needs only to be marginal and nationalistic depopulation is far from the truth (see chapter 16 of El-Agraa 1985).

- (f) Finally, and more fundamentally as far as Corden's own argument is concerned, a very crucial element is missing. Corden's analysis relates to a country in internal equilibrium (the combination of unemployment and inflation that a country prefers from an internal viewpoint) and external deficit. If this country were outside a monetary union, it could devalue its currency. Assuming that the necessary conditions for effective devaluation prevailed, then devaluation would increase the national income of the country, would increase its price level, or result in some combination of the two. Hence a deflationary policy would be required to restore the internal balance.

However, if the country were to lose its freedom to alter its exchange rate, it would have to deflate in order to depress its imports and restore external balance. Corden claims that this alternative would entail unemployment in excess of that prevailing at the initial situation.

The missing element in this argument can be found by specifying how devaluation actually works. Devaluation of a country's currency results in changes in relative price levels and is price-inflationary for, at least, both exportables and importables. These relative price changes, given the necessary stability conditions, will depress imports and (maybe) increase exports. Hence, the deflationary policy which is required (to accompany devaluation) in order to

restore internal balance should eliminate the *newly injected inflation* as well as the extra national income.

By disregarding the 'inflationary' implications of devaluation, Corden reaches the unjustifiable *a priori* conclusion that membership of a monetary union would necessitate extra sacrifice of employment in order to achieve the same objective. Any serious comparison of the two situations would indicate that no such *a priori* conclusion can be reached—Corden is not comparing like with like. It is, therefore, inevitable to conclude that, at the worst, the economic advantages of monetary integration far outweigh any possible (if any) disadvantages.

THE TRANSITION TO MONETARY INTEGRATION

It was pointed out in the previous section that the most pessimistic conclusion that an economist can reach is that the gains from European monetary integration must exceed any possible losses from its formation. If that is the case, why is it that Corden's argument has been so dominant in this field?

The answer is twofold. Firstly, it is because economists have failed to point out the fallacy in Corden's argument. Secondly, it is due to his distinction between a *complete* and a *pseudo* exchange rate union and to his equating the latter with the envisaged EMU. The latter point should be discussed in some detail.

The *pseudo* union, unlike the *complete* union, does not allow for economic policy co-ordination, a pool of foreign exchange reserves and a common central bank. It therefore creates the problems discussed in the definitional section. This raises the practical question: is the envisaged EMU equivalent to a *pseudo* union?

The Werner Report (which was endorsed by the Community Council of Ministers in February 1971, but the implementation of which was later temporarily halted for reasons discussed in the Marjolin Report 1975) recommended the following (the emphasis is not in the original text):

- (a) An economic and monetary union could be attained during this decade, if the plan had the permanent political support of the member governments;

- (b) The first phase should begin on January 1, 1971, and could technically be completed within three years. This phase would be used to make the Community instruments more operational and to mark the beginnings of the Community's individuality within the international monetary system;
- (c) *The first phase should not be considered as an objective in itself; it should be associated with the complete process of economic and monetary integration. It should therefore be launched with the determination to arrive at the final goal;*
- (d) *In the first phase consultation procedures should be strengthened; the budgetary policies of the member states should accord with Community objectives; some taxes should be harmonised; monetary and credit policies should be co-ordinated; and integration of financial markets should be intensified.*

There are therefore two points to emphasise about the first stage of the envisaged EMU. Firstly, it is more than a pseudo exchange rate union—the underlined points, particularly (d), clearly indicate this. Secondly, it is only the *first stage* in a *process* leading to complete monetary integration. Even Corden admits that this first stage, even though it might take a long time to achieve, cannot be the permanent reality.

The confusion between the ultimate objective (complete monetary integration) and the first stage as a step in that direction is clearly demonstrated by the discussion relating to whether or not the EC (or some members of it) is a feasible or optimum currency area. Such a discussion, useful as it may be, has no relevance here: the fact that the members of the Community *are committed* to monetary integration has been substantiated by the declaration of the summit meeting of July 1978. (One way of exposing the fallacious nature of this argument is: if it can be conclusively proved that the US is more than a feasible currency area, should economists advise its disintegration?) There are, of course, great *difficulties* in the *transition* to complete monetary integration, but no economist is able, or should even attempt, to predict that these difficulties would be permanent ones. In the words of Ingram:

. . . 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 . . . (Ingram 1973)

(Readers interested in a critical evaluation of the approach to the theory of economic integration are advised to consult El-Agraa 1980 and 1985, or refer to El-Agraa and Jones 1981).

TACKLING THE TRANSITION PROBLEM

It is necessary for the purpose of this paper to recall the positions of the 'monetarists' and the 'economists' regarding European monetary integration. The 'monetarists,' whose leading protagonist is France, insist on the immediate implementation of *irrevocably fixed rates of exchange* within the EC, accompanied by the imposition of very strict controls over capital mobility; the coordination and harmonisation of economic policies should be introduced at a later date. The 'economists,' on the other hand, whose main leader is West Germany, propose the more or less immediate introduction of the coordination and harmonisation of economic policies, to be followed almost immediately by complete freedom of capital mobility; only then should the irrevocable fixing of exchange rates be implemented. The 'monetarists' are mainly influenced by their interest in achieving a successful CAP (Common Agricultural Policy); the adoption of permanently fixed rates of exchange would, for example, eliminate the problems which led to the MCA (Monetary Compensatory Amounts) system of border taxes and subsidies discussed in Chapter 8 of El-Agraa (1985). The 'economists' are influenced by the fact that the members of the EC are at different stages in their economic development and they are particularly worried that the permanent fixing of exchange rates would force the 'weaker' members to manage their economies by interest rate policies with the result of increasing their unemployment levels. However, the point is a general one in that the fixing of exchange rates could lead to heavy inflation in West Germany, resulting in an underpricing of her industrial commodities. For France, who needs to restructure her agricultural sector, and the UK, who needs to restructure her industrial sector, the fixing of exchange rates could result in balance of payments deficits which would force them to adopt deflationary policies with resulting high levels of unemployment.

The Werner Report is essentially a compromise between the positions

of the 'monetarists' and the 'economists.' The Report, however, has remained essentially a background document in that it has become a blueprint for European monetary integration, without ever becoming embodied in a Council Resolution (Robson 1984; Sumner and Zis 1982). It recommended the establishment of the EMU by *stages*, with the achievement of complete monetary integration by 1980. The monetary upheavals of the 1970s, the oil crisis and the entry negotiations of the new members made that target impossible; hence the Marjolin Report recommended the postponement of that date. It is therefore necessary to reflect on the nature of the transition to monetary integration.

It was pointed out earlier that the recommendations of the Werner Report are consistent with *complete* monetary integration, in that the stages *taken together* do lead to the attainment of the ultimate goal. Hence the problems associated with Corden's pseudo-exchange-rate union cannot be envisaged in the context of the Werner Report, unless one is convinced that the EC is never likely to proceed beyond the first stage, i.e. the first stage will become the permanent reality. I shall return to this point shortly, but it ought to be mentioned that the Werner Report was not the only set of recommendations available to the EC; a number of proposals were made and are still being made regarding the minimisation of the costs of transition—see Meade (1973), Johnson (1973a & b), Coffey and Presley (1971), Magnifico and Williamson (1972), Cairncross *et al.* (1974), Giersch *et al.* (1975), Tindemans (1976) and Sumner and Zis (1982). Since the literature on this subject is extensive, brief reference to it would not do it justice. I shall therefore give only a summary of the main categories of ideas. For a more detailed discussion, the reader is advised to consult Coffey and Presley (1971), Cairncross *et al.* (1974), Coffey (1977), Corden (1977) and Sumner and Zis (1982).

There are four basic groups of recommendations on ways of tackling the problems of the transition to European monetary integration.

MONETARY INTEGRATION ALL AT ONCE

This amounts to introducing *all* the necessary ingredients of complete monetary integration *together* as soon as a commitment has been made to launch the EMU. An EC central bank is created and is vested with the

powers of controlling the pool of all members' foreign exchange reserves, of conducting the Community monetary and economic policies and of producing the legal tender and therefore the money base. Such a step has to be a decisive, definitive and irrevocable one, so that all possible expectations are immediately adjusted once and for all. Hence this proposal gives all the advantages and none of the disadvantages of complete monetary integration. The essence of this proposal is to tackle the problems of transition through the simple act of eliminating the process of transition itself.

Since this is the best method, why has it not been adopted by the EC? According to Cairncross *et al.* (1974):

to abandon exchange-rate changes completely and finally without indicating how imbalances will be dealt with in future . . . would be to run serious risks in relation to both economic stability and to that political will without which economic union will not hold.

However, if these serious risks are to disappear, the EC central bank has to be responsible for tackling the regional problems that are likely to arise as a result of the EMU—those problems that worry the 'economists.' Hence, the regional problem has to become part and parcel of the management of the EC economic and monetary policies conducted by the central bank. It is therefore evident that an 'all at once' implementation of the EMU cannot be envisaged without a properly functioning EC central bank; hence the prior commitment of the member countries to a political union becomes an absolute necessity.

THE STEP-BY-STEP APPROACH

This approach is in effect that of a considerable number of the proposals and certainly forms the essence of the Werner Report. There are two sets of recommendations within this approach broadly consistent with the two sides of the 'monetarists' and 'economists' dichotomy, but they can be treated together—for a detailed description the reader should consult Cairncross *et al.* (1974).

The step-by-step approach means that exchange rate margins are narrowed over a period of time and that the narrowing of the margins is very gradual. Some collaboration between the members is envisaged, such that

those with balance of payments surpluses come to the rescue of those with deficits. At a later stage, the pooling of all foreign exchange reserves is introduced and then follows the complete and irrevocable elimination of all exchange rate margins. Finally, when the member nations declare their solemn commitment to monetary integration, an EC central bank with the necessary powers is created.

It should be emphasised that this approach is, strictly speaking, not very different from the 'all at once' approach, provided those participating make the political commitment that is necessary for the effective support of *all the stages* leading to the implementation of complete monetary integration, i.e. members must not only declare themselves to act, but must also be seen to act in the spirit of the final goal. Otherwise, the national versus Community interests discussed earlier become the order of the day and therefore reduce the whole exercise to a pseudo-exchange-rate union. Hence this approach cannot be envisaged without the political commitment of the participants *from the start*.

APPROACHING THE EMU VIA THE 'SNAKE'

In this set of proposals, members of the EC approach monetary integration via the 'snake'; they join the 'snake' when they feel ready to do so. Hence those who are either ready for or keen on achieving monetary integration go ahead, while those who are either not yet ready or not so eager join when they are. From there on the process is similar to the step-by-step approach. Hence, the most vital moment comes when those members who are in the 'snake' take a solemn vow to go the whole way to monetary integration. Such a step, as already indicated, is not feasible without the prior political commitment of the members.

This approach is similar to that advocated by the Tindemans Report (1976) and is different from the Werner Report in that the various stages do not have to be coordinated. It could be argued, however, that a lack of coordination is necessary if member countries are to be free to join if and when they are ready or feel so inclined. As Corden (1977) has pointed out, this amounts to there being a 'two-tier' EC, consisting of those moving towards monetary integration via the 'snake,' and the others. For a general background discussion, the reader should consult Cairncross *et al.* (1974),

Coffey (1977) and Sumner and Zis (1982).

PARALLEL-CURRENCY PROPOSALS

The fourth set of proposals is for achieving monetary integration through the creation of a parallel currency called the *Europa*. One version of this proposal calls for the creation of a *Europa* supported by US dollars, gold and SDRs, as well as by the domestic currencies of members of the EC. The *Europa* is held by the EC central banks alone, or by them and by members of the general public. The implication of this is that countries of the EC have the freedom of altering their own rates of exchange relative to the *Europa* and that the *Europa* itself can be devalued or revalued relative to the US dollar. The object of the exercise is for member nations to narrow the margins between their domestic currencies and the *Europa* with the eventual permanent and irrevocable fixing of their parities.

The second version of this approach was suggested by Giersch *et al.* (1976). This is different from the first in that the *Europa* has a *constant purchasing power* and is therefore 'inflation proof.' The *Europa* is held simultaneously with local currencies and it is hoped that the competition between the *Europa* and the local currencies proves favourable to the former. When the *Europa* becomes dominant, it establishes itself as the EC currency.

It is obvious that if such a parallel currency is introduced and proves to be more attractive than local currencies, a mechanism of controlling its supply must be created. This must be an EC central bank which must have the power to conduct its financial operations anywhere within the EC. Hence such an EC central bank cannot be established and cannot function properly without the necessary backing of the EC nations. There is therefore a need for the prior political commitment to support it and to guide it in the direction of the ultimate objective of monetary integration.

It is therefore evident that none of these four sets of proposals can be achieved without a firm commitment by the participating nations to a United States of the EC countries.

THE BREMEN DECLARATION

At this juncture it is appropriate to ask: how do the Bremen Declaration (6 and 7 July 1978), its Bonn affirmation (16 and 17 July 1978) and its adop-

CONCLUSION

The conclusion of this part of the paper is that the alleged macroeconomic disadvantages of monetary integration apply only to the so-called pseudo exchange rate unions. Such a union is neither consistent with the first stage of the EMU as envisaged by the Werner Report, nor with its nature as a process leading to a complete EMU. All economists would concede the difficulties associated with a transitional phase, but none of them, in their strict area of competence, should pass political judgements regarding the reality of attaining the ultimate objective. The EC is here to stay and, as the 1978 Bremen Declaration stated, monetary union is to remain a very clear objective—see the text of the Jenkins 1977 speech which was delivered in Florence. Moreover, as far as overcoming the difficulties of achieving monetary union is concerned, we have seen that a number of proposals have been made.

In his latest book, Corden (1977) finally conceded the point that there is no long-term case against the EMU. This, however, does not transform him into a firm believer in it, particularly since he still emphasises that the events of 1973–75 vindicated the short-term case against it. So presumably he will not object to being described as a mild supporter of the EMU.

REFERENCES

- Cairncross, Sir Alec, *et al.* (1974) *Economic Policy for the European Community: the Way Forward* (London: Macmillan).
- Coffey, P. and Presley, J. (1971) *European Monetary Integration* (London: Macmillan).
- Corden, W. M. (1972) 'Monetary integration,' *Essays in International Finance*, no. 93, Princeton University.
- Corden, W. M. (1977) *Inflation, Exchange Rates and the World Economy*, Oxford University Press.
- De Grauwe, P. (1975) 'Conditions for monetary integration: a geometric interpretation,' *Weltwirtschaftliches Archiv*, vol. 111.
- De Grauwe, P. and Peeters, T. (1979) 'The EMS, Europe and the Dollar,' *The Banker*, April.
- El-Agraa, A. M. (editor) (1980; 1985, second edition) *The Economics of the European Community* (Oxford: Philip Allan).
- El-Agraa, A. M. and Jones, A. J. (1981) *Theory of Customs Unions* (Oxford:

- Philip Allan).
- Fleming, J. M. (1971) 'On exchange rate unification,' *Economic Journal*, vol. 81.
- Friedman, M. (1975) *Unemployment versus Inflation?: An Evaluation of the Phillips Curve* (London: Institute of Economic Affairs).
- Giersch, H. *et al.* (1975) 'All Saints Day manifesto,' *The Economist*.
- Ingram, J. C. (1973) 'The case for European monetary integration,' *Essays in International Finance*, no. 98, Princeton University.
- Jenkins, R. (1977) 'Europe's present challenge and future opportunity,' *Bulletin of the European Communities*, vol. 10.
- Jenkins, R. (1978) 'European Monetary Union,' *Lloyds Bank Review*, January.
- Johnson, H. G. (1973) 'Problems of European Monetary Union,' in M. B. Krauss (editor) *The Economics of Integration* (London: Allen & Unwin).
- Krause, L. B. and Salant, W. S. (editors) (1973a) *European Economic Integration and the United States* (Washington, D.C.: The Brookings Institution).
- Krause, L. B. and Salant, W. S. (editors) (1973b) *European Monetary Unification and its Meaning for the United States* (Washington D.C.: The Brookings Institution).
- Magnifico, G. and Williamson, J. (1972) *European Monetary Integration* (London: Federal Trust).
- Marjolin Report (1975) *Report of the Study Group 'Economic and Monetary Union 1980'* (Brussels: Commission of the European Communities).
- Masera, R. (1981) 'The first twosyears of the EMS: the exchange rate experience,' *Banca Nazionale del Lavoro Review*, September.
- Meade, J. E. (1973) 'The balance-of-payments problems of a European free-trade area,' in M. B. Krauss (editor) *The Economics of Integration* (London: Allen & Unwin).
- Phelps, E. S. (1968) 'Money-wage dynamics and labour market equilibrium,' *Journal of Political Economy*, vol. 76.
- Phillips, A. W. (1958) 'The relation between unemployment and the rate of change of money wages in the United Kingdom 1862-1957,' *Economica*, vol. 25.
- Robson, P. (1984, second edition) *The Economics of International Integration* (London: Allen & Unwin).
- Sumner, M. T. and Zis, G. (editors) (1982) *European Monetary Union: Progress and Prospects* (London: Macmillan).
- Tinbergen, J. (1952) *On the Theory of Economic Policy* (Amsterdam: North-Holland).
- Tindemans, L. (1976) 'European Union,' *Bulletin of the European Communities*, Supplement, vol. 9.

Ungerer, H., Evans, O. and Nyberg, P. (1983) 'The European Monetary System: the experience, 1979-82,' *International Monetary Fund Occasional Papers*, no. 19, May.

Werner Report (1970) 'Report to the Council and the Commission on the realisation by stages of economic and monetary union in the Community,' *Bulletin of the European Communities*, Supplement, no. 11.

APPENDIX

As indicated in the main text, the economic rationale for exchange rate flexibility depends on Tinbergen's (1952) criterion of at least an equal number of policy *instruments* and policy *objectives*. Orthodoxy has it that there are two macroeconomic policy targets (internal and external equilibrium) and two policy instruments (financial, which have their greatest impact on the level of aggregate demand, hence on the internal equilibrium, and exchange rate, which operates mainly on the external equilibrium). Of course, financial instruments can be activated via both monetary and fiscal policies and

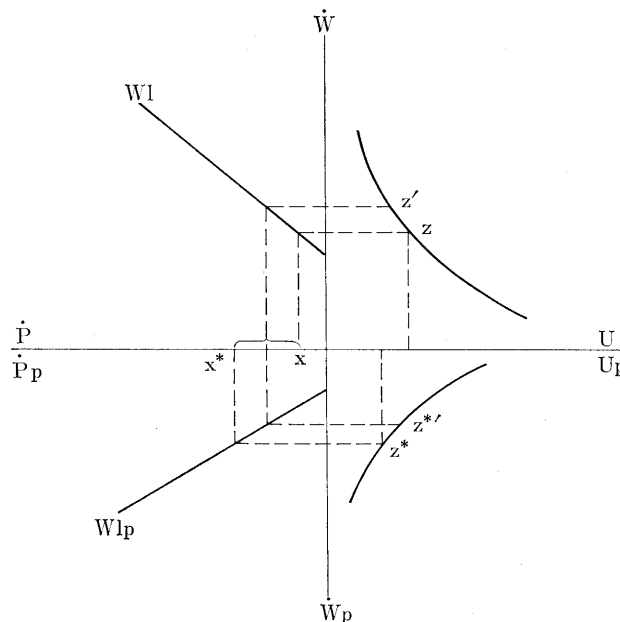


Figure 1. The Fleming/Corden Analysis

may have a varied impact on both the internal and external equilibria. Given this understanding, the case for maintaining flexibility in exchange rates depends entirely on the presumption that the loss of one of the two policy instruments will conflict with the achievement of both internal and external equilibria.

Assuming that there is a Phillips (1958) curve relationship (a negative response of rates of change in money wages— \dot{W} —and the level of unemployment— U), Fleming (1971) and Corden (1972) can explain their argument by using a simple diagram which was first devised by De Grauwe (1975). Hence, in Figure 1, the top half depicts the position of the home country A while the lower half depicts that of the potential monetary integration partner, country P. The top right and the lower left corners represent the two countries' Phillips curves while the remaining quadrants show their inflation rates— \dot{P} . WI and WI_P are, of course, determined by the share of labour— L —in total GNP, the rate of change in the productivity of L and the degree of competition in both the factor and commodity markets, with perfect competition resulting in the WIs being straight lines. Note that the intersection of the WIs with the vertical axes will be determined by the rates of change of L 's share in GNP and its rate of productivity change. The diagram has been drawn on the presumption that the L productivity changes are positive.

The diagram is drawn in such a way that countries A and P differ in all respects: the positions of their Phillips curves; their preferred trade-offs between \dot{W} and \dot{P} ; and their rates of productivity growth. A has a lower rate of inflation, x , than P, x^* , (equilibria being at z and z^*), hence, without monetary integration, P's currency should depreciate relative to A's; note that it is only a chance in a million that the two countries' inflation rates would coincide. Altering the exchange rates would then enable each country to maintain its preferred internal equilibrium; z and z^* for respectively countries A and P.

When A and P enter into an exchange rate union, i.e. have irrevocable fixed exchange rates *via-s-vis* each other, their inflation rates cannot differ from each other, given a model without non-traded goods. Hence, each country will have to settle for a combination of U and \dot{P} which is different from that it would have liked. Therefore, the Fleming/Corden conclusion is vindicated.

Well, it does not require much imagination to see that if this crude version of the Phillips curve is replaced by an expectations adjusted one along the lines suggested by Phelps (1968) and Friedman (1975), i.e. the Phillips curves become vertical in the long run, the Fleming/Corden conclusion need no longer apply. Moreover, once non-traded goods are incorporated into the model and/or capital and L mobility are allowed for, it follows that the losses due to deviating from internal equilibrium vanish into oblivion—see the main text. Finally, this model does not allow for the fact that monetary integration involves at least three countries; the outside world has to be explicitly incorporated into the model—the implications of this are discussed fully in the main text.