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Two Monetary Unions

On July 1, 1990, European Monetary Union (EMU) will formally enter its first stage, starting a process which shall, over several years, eventually lead to a single European currency managed by a European Federal Reserve System (EuroFed). That same day, German Monetary Union (GEMU) will be established, less than five months since it was first put forward as a policy objective and only three months after negotiations actually began. This coincidence raises a number of important issues.

To begin with, is the vigour with which GEMU is being pursued an indication that official German support for the "coronation theory" of monetary integration is eroding in favour of the "corner-stone theory" or, to put it differently, that finally the "monetarist" approach is prevailing over the "economist" approach – with all the implications that has for EMU? That conclusion would certainly be too far-reaching. It should be noted that the two integration processes differ profoundly.

In the case of EMU the problem is to merge twelve national monetary and financial systems with distinct traditions, institutions and instruments into one joint European system. This merger should take place without discarding the "acquis communautaire" in terms of price-level stability and policy credibility, now based upon the D-Mark as the monetary anchor of the EMS. The difficulties encountered, e.g. in agreeing upon a common set of policy instruments – not to speak of the thorny political issue of the EuroFed's institutional autonomy – should suffice to demonstrate that this is indeed a formidable task. In the case of GEMU it was clear from the beginning that the obsolete monetary and financial system – and indeed practically the entire economic constitution – of the GDR had to give way to the Federal Republic's, which had clearly demonstrated its superiority, and that the Bundesbank would be entrusted with acting as the area's sole and fully responsible central bank. Indeed, making the GDR part of the D-Mark area proper was, and is, at the very heart of the strategy of economic reconstruction.

Putting the corner-stone theory into practice in the case of GEMU goes hand in hand with a hegemonic approach to currency unification and an economic shock treatment. The example is therefore not easily transferable to EMU. Yet it appears that a full-fledged European monetary union need not wait for the economic and political conditions to be satisfied from first to last, as the coronation theory holds. And intermediate stages to EMU may well be perceived of as catalysts to convergence, provided that agreement can be reached in the process about certain fundamental elements of a European monetary constitution: an unequivocal mandate for the EuroFed to safeguard price-level stability; institutional autonomy of the EuroFed and the participating national central banks, and personal independence of the members of the decision-making bodies; full disposal of the EuroFed over the necessary monetary policy instruments; and strict and narrow legal limits to the provision of central bank credits to governments.

Performance of the EMS since its creation in 1979 as well as the move to the first stage of EMU give evidence that long-established policy attitudes may well be changed for the better

under the impact of new institutional challenges. Among the more recent examples are the abolition of exchange controls in France and Italy and of the two-tier exchange market in Belgium as well as the shift to (economic and) monetary policies in France, Italy and Spain, which lend credibility to the countries' exchange-rate commitments, different as they are. At the same time, however, past experience points to the need to allow flexibility in the process to EMU. The "variable geometry" of the EMS with its "layers" of obligations, allowing EC member countries to participate – or stay aside – on the basis of their own assessment of the costs and benefits, has in the end been crucial to the system's survival and success.

Flexibility with respect to the timing of the EMU process and to initial membership of the EuroFed should, however, not be confused with flexibility as regards the material elements of EMU referred to above. The recent "softening" of the European Parliament's and the EC Commission's position regarding the status of the EuroFed must therefore be criticized strongly. In this connection the politics of GEMU formation has provoked some malicious comments abroad on the practical relevance of the Bundesbank's autonomy, and the case of an autonomous EuroFed has certainly not been strengthened by the Federal Government's benign neglect of the Bank in the process.

Yet the dissonance in GEMU decision-making is a poor example to demonstrate a lack, or an erosion, of Bundesbank autonomy: in fundamental political decisions of that sort the Bank is not – and never has been – autonomous. Formation of GEMU, including the terms on which this is to happen, is clearly a decision to be taken by parliament. Only in exercising the powers and competences set out in the Bundesbank Act and referring to current monetary policy is the Bank independent of instructions from the government. That is precisely the concept advocated by the Delors Committee for the EuroFed. The GEMU case should therefore not be used as a pretext to water down that concept.

On the other hand, GEMU should induce EMU policy-makers to give second thoughts to an approach which rests on the progressive narrowing of margins for exchange-rate fluctuations and a permanent fixing of exchange rates. In the GEMU case this approach was ruled out, not least because of the lack of credibility and the high risks involved for intervention policy (and in the last instance for monetary policy proper). This consideration holds for EMU, too. In fact it is difficult to see how credibility of monetary policy could be maintained in the process of European monetary integration if central banks had to stabilize exchange rates of national currencies within narrow or zero margins. Transition to EMU will in the end have to proceed in a quantum leap directly from the present EMS to a single European currency managed by a strong and highly centralized EuroFed, the elements of which are to be developed in the first stage. In monetary policy there is little room for the "subsidiarity principle".

What economic influence on the EMU process will the creation of GEMU have? It appears that for some time to come German economic policy will follow the "Reagan" pattern: rising budget deficits (including the debt financing of the DM 115 bn Fund for German Unity), coupled with a restrictive monetary policy directed towards containing inflationary pressure. High growth of demand and output in Germany and a reduction of the German current account surplus (if not its disappearance) will provide growth opportunities for EC and EMS economies while the high real rates of interest may be felt as a burden by some. It should be noted, though, that France, Italy and Spain have recently experienced a narrowing of their interest differential vis-à-vis Germany to the point where such narrowing is felt to render difficult the anti-inflationary policy stance in these countries.

The short and medium term consequences for the exchange rate of the D-Mark vis-à-vis the dollar and in the EMS remain to be seen. The EMS may well be facing turbulences which could put European economic and monetary cooperation to a severe test. Success of a cooperative policy approach in the Governors' Committee in maintaining low-inflation growth will be crucial to the success of the first stage and in the last instance to the very credibility of the EMU venture itself.

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