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A Second Attempt at Economic and Monetary Union

On 14 December 1990, the Intergovernmental Conferences on European Economic and Monetary Union (EMU) and on European Political Union (EPU) will formally begin with their negotiations. Two years from now, on 31 December 1992, when the Single European Market is scheduled to take effect, ratification of the amendments to the EEC Treaty shall be completed and the Community be ready to proceed towards new goals.

Since the presentation of the Delors Report in the spring of 1989 the Community has moved quite a bit in the direction recommended by the Report. Exchange restrictions on capital movements have been abolished as planned, Spain and recently Britain have joined the exchange-rate mechanism of the European Monetary System (EMS), Italy has finally accepted the narrow band margin, central rates have been virtually unchanged for four years now, and the Committee of Central Bank Governors has reorganised and deepened its monetary policy cooperation. What is perhaps even more important: the notion of an independent European Central Bank System legally committed to the objective of price-level stability is now finding acceptance throughout most of the EC member countries. At the European Council meeting in Rome on 27/28 October 1990 this model was formally endorsed. The Governors' Committee has finalised the Draft Statutes of the ECBS which translate the general principles into legal language.

Therefore, much groundwork has been laid already. Yet, the major decisions still need to be taken. To begin with, the Conference will have to engage in defining the institutional "finality" of EMU. Preoccupation with a second stage without a clear definition of the final stage would be counterproductive. The second stage alone does not warrant an amendment of the EEC Treaty: neither the setting up of an empty shell called European Central Bank, with the sole purpose of furthering monetary cooperation and without a clear institutional perspective, nor the creation of a European Reserve Fund to manage a thirteenth currency, the Hard ECU, are in any way conducive to the goal of monetary stability in Europe.

Defining the "finality" implies that the principal elements of the ECBS – its commitment to price-level stability, its institutional, functional and personal independence and its full control over the necessary instruments – are established in concrete terms, in line with the Governors' Draft Statutes. Moreover, there must be no ambiguity about the fact that EMU means nothing less than the full transfer of national competences in monetary policy to a supra-national European institution. In fact, monetary policy is the wrong area to plead for "subsidiarity": in EMU there is no room for differential discount rates, minimum reserve requirements, or open-market operations.

It appears that until now this truth has not really been understood (or accepted) by all policy-makers: definition of the final stage as a status with "irrevocably fixed exchange rates" among national currencies – as recently repeated at the Rome Summit – obscures the fact that there will be no more room for national currencies, nor for national central banks in any politically meaningful sense. De facto, though initially not de jure, national central banks will be reduced to branches of the European central bank.

This of course raises the question not only of the political readiness but of the economic ability of various member countries to engage, in the course of the next few years, in such an ambitious

venture. Participation in a system of stable but adjustable exchange rates is one thing, membership in a single-currency area quite another. In fact, the latter decision implies not only that a major instrument of adjustment – the exchange rate – is dispensed with once and for all; an instrument which countries with persistently high rates of inflation may wish to retain for the time being in order to be able to safeguard the international competitiveness of their exposed sector.

More than that: as recent experience with German monetary union has demonstrated, giving up one's own money in favour of a common currency may lead to a collapse of money and incomes illusions in the less prosperous country or countries and give rise to wage claims based on equity grounds rather than on economic performance. Increases in regional unemployment and/or social unrest are likely to be the consequences. Huge intra-Community fiscal transfers may therefore be necessary, not in order to improve the long-term economic basis of less developed regions, but to compensate for the economic and social costs of monetary union.

For the Community at large with its high inflation differentials and regional productivity and incomes disparities these risks are real enough to outweigh the potential gains of monetary union. This does not imply that the Community should renounce the goal of EMU altogether. It rather suggests that participation in the ECBS should be made optional rather than obligatory (even with some flexibility in timing). Coherence of the Community does not require that all – or most – of the member countries take part early.

On the contrary, chances for a successful take-off of the ECBS are improved if the venture is started by a group of core countries which have demonstrated a high degree of economic convergence. The EC Commission in a recent study names Germany, France, the Benelux countries, Denmark, and Ireland as the obvious candidates on that count. Others could join if and when they feel fit to do so – and when the ECBS has (hopefully) demonstrated its attractiveness. This is not to plead for a two-tier Community of “strong” versus “weak” countries but rather for a Community based on economic self-interest rather than on political coercion. The EMS is a convincing demonstration of the merits of such an approach.

For the core group it would indeed make sense to proceed rather quickly to full economic and monetary union (provided the institutional conditions can be met). With membership in the exchange-rate mechanism of the EMS growing, and more countries with a poor record of monetary stability taking part, the system is approaching its limits. The Bundesbank's ability to serve as the anchor of monetary stability is increasingly undermined by the “exchange-rate trap” of the system: regardless of the Bank's good record of price-level stabilisation the D-Mark is consistently weak in the band whereas countries with high rates of inflation – and high nominal interest rates – enjoy a strong position.

It is to be hoped that the Intergovernmental Conference will agree on an amendment of the EEC Treaty that provides for a strong and independent European Central Bank System as laid down in the Governors' Draft Statutes. Even if EMU is a highly political venture, as it indeed is, political considerations must not be allowed to win over economic exigencies. Flexibility should be applied as to (initial) membership in the system. On the other hand, the road to the end must be straightforward rather than built upon political compromises: a change in the ECU's definition – from a basket to a “hard” unit – would certainly be in line with the final objective; establishment of a European Monetary Fund would mean a deviation. In fact, it would distract attention from the more important issues: according institutional and personal autonomy to national central banks, giving all of them full and exclusive control over the instruments of monetary policy, and cutting linkages between money creation and the financing of public-sector deficits.

Twenty years ago the first attempt at economic and monetary union failed, not because of the oil crisis (as is usually suggested by politicians) but because of poor preparation. This time the conditions are better. Good luck to the Intergovernmental Conferences!

Hans-Eckart Scharrer