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Siegfried Utzig*

The Path to European Monetary Union

An Institutional Economics Approach

The planned broadening of the common internal market into an economic and monetary union as proposed in the Delors Plan means a significant qualitative leap in the process of European integration, which should ultimately lead to political union in Europe. Is this objective realistic? In what ways could it be achieved?

The task the twelve present member states of the European Community have set themselves with the move towards economic and monetary union is nothing less than the creation of a single economic constitution, followed later by a political constitution. In the sense expressed by J.M. Buchanan, the EC states are therefore at the constitutional stage of a contract. The problem to be resolved at this stage concerns "decisions over alternative rules or processes which define constraints within which subsequent choices over outcomes may be made".¹ As the debate about the Delors Plan shows, the task facing them is anything but trivial. The Community embarked upon the path towards monetary union at the start of the first stage, the liberalisation of capital movements. The direction the path will now take remains unclear, however, since the content of the second stage has not yet been decided.

The realisation of the preliminary stage to monetary union – the common internal market – shows just how difficult it is to introduce a new constitution if no central power exists. The quality of its free-market economic order will be a significant factor in the success of economic and monetary union, and also political union. The willingness of the twelve EC countries to accept a liberal, open economic order committed to the principle of competition can be seen as the litmus test of a successful process of European unification.

The prospects in this regard are not very encouraging. At present the picture is determined by the postponement of Community solutions until well into the nineties, as in the question of indirect taxes, and attempts to extend national industrial protection zones to the entire EC, as in the discussion of the Community's external relations. There still appears to be very little common ground with regard to fundamental economic principles. This has serious implications, as the path to economic and

monetary union entails laying down common criteria for monetary and fiscal policy and surrendering a considerable degree of national sovereignty even before the introduction of a common currency.

It is therefore of paramount importance to define the content of the common monetary order. The objective this involves, namely the introduction of a common currency in the EC, provides an opportunity not only to show that a decision in this regard entails a dilemma but also to assess the various proposed paths to a single monetary order in terms of their ability to resolve that dilemma.

The creation of a monetary union means irrevocably locking the exchange rates between participating currencies (with the possibility of replacing them by a single currency at a later stage) in a context of completely and permanently guaranteed freedom of movement of capital. As a consequence, countries must also forgo their independent national monetary and exchange rate policies and surrender responsibility in this regard to the Community.² The constitutional decision to be taken in connection with the establishment of a monetary union is therefore: in what way and in what form should responsibility for monetary and exchange rate functions be exercised within the monetary union?

As it is currently perceived, the objective of national monetary policy is to maintain the value of the currency. If there were agreement among the twelve member countries as to the meaning of this concept and if the consequences of a monetary policy geared towards this objective were accepted by economic and fiscal policymakers and wage negotiators in all member

¹ J.M. Buchanan: Sources of Opposition to Constitutional Reform, in: J. M. Buchanan (ed.): Liberty, Market and State Political Economy in the 1980s, Brighton 1986, p. 56.

² Deutsche Bundesbank: Stellungnahme zur Errichtung einer Wirtschafts- und Währungsunion in Europa, 1990.

³ Deutsche Bundesbank, op. cit.

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countries, it would be a trivial matter to establish a monetary union. The present economic situation in Europe shows, however, that this is patently not the case. Inflation rates range from 2.4 to 22%; measured as a percentage of gross national product, budget balances range from a surplus of 1.1% to a deficit of 15% and current account balances from a surplus of 4% to a deficit of more than 3%. In most cases it is not cyclical factors that are responsible for these divergences so much as marked differences in fundamental economic ideology and the behaviour of wage negotiators.³ There are clearly still sharply differing policy approaches to monetary stability in Europe.

Danger of Artful Dealing

If further steps along the path to monetary union were taken without this problem of divergence being resolved, the Community would unavoidably find itself in a dilemma. There is then the danger of countries behaving opportunistically, at both the constitutional and post-constitutional stages.⁴ Opportunism at the constitutional stage entails artful dealing during the preparation and negotiation of the contract; at the post-constitutional stage it means strategic behaviour in fulfilling the contract. In concrete terms, opportunistic behaviour at the constitutional stage would mean deceiving the other parties as to what one meant by "monetary stability". There is cause for concern in this respect on account of the present monetary and fiscal policies in some member countries, which clearly lead to large inflation differentials, but also in account of the continuing debate about the independence of a European central bank. For example, a position paper from the EC Commission on European monetary union states that "the new Community monetary system also needs to enjoy a high degree of independence vis-à-vis national governments and other Community bodies".⁵ It remains unclear what precisely is to be understood by "a high degree of independence".

The controversial nature of such a statement quickly becomes apparent if one bears in mind that most of the central banks of the EC countries are bound in varying degrees to do the bidding of their governments. The only independent central bank is the Deutsche Bundesbank, and the currency it issues has been the stability anchor of the European Monetary System for years. Defining central-bank independence in terms that are open to

interpretation simply means that there are loopholes in the contract on the monetary order. The monetary order would be flawed, and further measures to regulate countries' behaviour would have to be introduced at the post-constitutional stage.⁶ Loopholes in the contract would therefore mean that the dilemma had not been fully resolved.

Irrespective of this, there is naturally always the possibility that individual countries will try to win one-sided advantages at the post-constitutional stage by means of strategic behaviour. For example, it is conceivable that fiscal and incomes policy conducted at national level would be inconsistent with monetary policy. The consequences would be unemployment and a fall in output in these countries, which would trigger financial transfers from the other countries.

If some parties act opportunistically during negotiation of the contract and if the others either do not discover it or actually tolerate it, the contract will be concluded, but the result will not be a Community based on stability but one based on inflation. If the other parties discover the opportunistic behaviour and act likewise themselves, the negotiations will lead to nothing. The status quo, which is essentially undesired, will remain unchanged.

This raises the question of how to prevent opportunistic behaviour at the constitutional stage; only if this can be done will the objective of a single stable currency be attainable.

Co-ordination Efficiency

To achieve the desired Community of stability, it is necessary to find a formula whereby all participants will voluntarily adopt a co-operative approach rather than an opportunistic one. A framework conducive to co-ordination efficiency could in principle be achieved by declaring certain forms of behaviour to be unpermissible and penalising countries that adopt them. The strategy chosen in the context of the new parameters will then lead to the desired Community of stability. It is important to note that co-ordination efficiency can be achieved through decentralised decisions alone without direction from a central government, provided that the contracting parties impose sanctions on the "right" forms of behaviour at the constitutional stage. Furthermore, it should not be forgotten that the sanctions will lead to the desired result only if there is an institution to apply them.

For the contract to be accepted by all parties, an arrangement must also be reached on the method of agreement. The Single European Act lays down that a decision to establish an economic and monetary union requires unanimity. This rule corresponds to Buchanan's proposal for the creation of a "protective state".

⁴ Cf. O. E. Williamson: *The Economic Institutions of Capitalism: Firms, Markets, Relational Contracting*, New York 1985, p. 48.

⁵ Commission of the European Communities: *Economic and Monetary Union*, Brussels 1990, p. 13.

⁶ Cf. H. J. Schmidt-Trenz: *Außenhandel und Territorialität des Rechts*, Baden-Baden 1990, pp. 157 ff.

The Community does not have to start from scratch in creating a European monetary union. Experience with the way in which monetary institutions must be organised so that they do not impede the objective of monetary stability is already available. It is also known what rules monetary, fiscal and incomes policy must follow if this goal is to be achieved. The necessary and sufficient criteria for an economic and monetary union committed to price stability are therefore known. They were reiterated by the Bundesbank in its position paper on the establishment of economic and monetary union.⁷ They are:

- an economic union with a common economic area without internal frontiers that is also as open as possible to the rest of the world;
- a fiscal policy geared towards price stability;
- the establishment of a European System of Central Banks (ESCB) with
 - price stability as its objective,
 - permanently guaranteed independence,
 - national central banks as components of the ESCB,
 - inadmissibility of administrative monetary controls,
 - sole responsibility for exchange market intervention, and
 - no obligation to finance public authorities.

The only question that remains is therefore which path to follow in order actually to achieve the Community based on stability.

The simplest solution would be to declare that the institutional arrangements that have proved their worth in individual Community countries shall henceforth be applicable to the entire Community. In practice, this would mean the Deutsche Bundesbank becoming the European central bank and the D-Mark the European currency. Such a solution cannot be entertained, for several reasons, the most important being probably that it evokes images of German hegemony.

The second possibility would be a "one-shot decision". As with the monetary union between the two Germanies, a European System of Central Banks and a single currency would be introduced at a stroke. Here too, it is quickly apparent that the desired stability would not be achieved. The pronounced economic disparities that exist between the EC states would lead to serious problems of unemployment or inflation or both. These would be difficult to eliminate, as the countries' fundamental notions of economic policy are still wide apart. The prospects for co-operation in monetary and fiscal policy would be extremely poor.

⁷ Cf. Deutsche Bundesbank, op. cit.

The attempt to get round this dilemma simply by postponing the implementation date does not have a high chance of success either. As before, there is no incentive to get used to behaving in a co-operative way before that date is reached. In other words, it cannot be expected that national economic policies will have converged sufficiently by then for there to be reasonable certainty that opportunistic behaviour will not occur. The EC countries clearly believe they would be unable to enforce the necessary sanctions, which would have to threaten the withholding of financial aid if the rules were broken, for the Delors Plan chooses another, iterative approach.

Iterative Approach

This provides for the single European currency to be achieved in three stages, with entry to each new stage requiring consensus. This evolutive approach may prove to be an appropriate way of finally achieving the objective, for after each stage all the participants have sufficient time to examine the behaviour of their fellows. It does require, however, that the necessary regulations are made sufficiently precise at each stage. If some countries nonetheless behave opportunistically, either no consensus will be reached on the next stage or the offenders will be excluded from the future contracts. In this way the uncertainty about strategic behaviour could be sufficiently reduced before the final stage is reached, the stage involving the introduction of a common currency. The pressure for individual countries to be co-operative will be maintained by the knowledge that there will be another round of negotiations that can end in consensus only if all co-operate.

This should form the basis for an adequate system of sanctions. The disadvantage, however, is that it may take a very long time before consensus on progress to the next stage is reached, particularly if the number of participants is large and their willingness and ability to co-operate differ, for it must not be forgotten that economic policy differences also arise at national level.

An attempt to speed up the process by setting deadlines for individual stages would not be a great benefit, however, as the effect of deadlines is less to put pressure on contracting parties that are unwilling or unable to co-operate than to force concessions from the co-operative parties in the search for consensus, thus ultimately jeopardising the final objective.

The timetable set out in the Delors Plan appears to be a fundamentally practical way of proceeding. However, it stands or falls on the rules that are set. During the first stage all member countries have the chance to gain experience with the use of monetary and fiscal policy instruments in the context of liberalised capital

movements. It will become obvious to all that they have already lost part of their supposed autonomy in monetary policy. The period up to the start of the second stage will give sufficient opportunity to see whether all participants demonstrate their acceptance of this loss of sovereignty by behaving in a co-operative manner.

The debate about the second stage, in which closer harmonisation of monetary policy is to be achieved, has not yet thrown any light on the institutional arrangements for this stage. The dispute hinges essentially on the role of a European central bank during this stage. The extreme positions are represented on the one hand by the proposal to skip the second stage and move immediately to the creation of a European System of Central Banks with full powers over monetary policy, and on the other by the view that it would be enough to enhance the powers of the Committee of Governors.

The resolution of this dispute depends on the economic policy consensus reached in Europe. Since a decision on the second stage is now due and economic policy consensus still limited, in the interests of ensuring co-operative behaviour the second stage should not be omitted. It should be used to give all the participating countries time to practise reaching national consensus in the context of an independent central bank. This entails, in particular, a fiscal policy designed to strengthen the public finances and wage settlements in line with productivity growth. For that purpose, responsibility for monetary policy must remain at national level for the time being. Only after this running-in period has ended will there be a sufficient guarantee that a Community-wide monetary policy will not be undermined by national strategic behaviour. Progressing too rapidly towards a European currency increases the dangers that can spring from such behaviour.

As a variant of the iterative method, agreement to move to the next stage might be reached initially by only a few countries, but with the door being left open for other members to join later as and when they achieved progress in reaching national consensus. This procedure too would largely ensure that the new members were co-operative after their accession to the next stage, for the experience of co-operative behaviour at national level would be a precondition for joining the consensus that already existed.

The British Proposal

As well as the Delors Plan, there is the alternative British proposal for a "hard ECU", whereby the objective of monetary union would be achieved by introducing a thirteenth currency alongside the twelve Community currencies. The spread of this thirteenth currency, the

"hard ECU", would be controlled by a European Monetary Fund. The usual disadvantages of parallel currencies would be avoided by having an asymmetrical intervention mechanism. It is envisaged that the hard ECU could not depreciate against any of the other currencies. The monetary policy of a European Monetary Fund would have to be geared towards the most stable currency in the Community; the other countries would have to set their monetary policy accordingly or devalue. In the current debate there is no dispute about the effectiveness of the proposed intervention mechanism; the point in contention is the establishment of a European Monetary Fund. There are also doubts whether the concept would ultimately lead to a single European currency in any case.

From the institutional point of view, the British proposal differs only slightly from the proposal to introduce a single currency immediately. The crucial point is that the hard ECU concept is workable only if a single European monetary policy is pursued from the outset. Hence, here too agreement would have to be reached on the institutional arrangements for a European central bank. The British proposal remains extremely vague on this point, but a formal transfer of national monetary autonomy to the European level is clearly not envisaged. This accords with the maxims of current British exchange rate policy, but would set the stage for conflict from the outset.

A fundamental prerequisite for a European monetary policy geared towards stability continues to be co-operative behaviour by participants in economic policy at national level. If such consensus is lacking, the hard ECU concept will lead not to the desired solution of the problem but to devaluations and thence to familiar ills, such as loss of competitiveness, rising unemployment and the need for financial transfers. If the hard ECU did in fact displace the national currency in the course of this, the conflicts would become even more intense, destabilising the economy.

The question therefore immediately arises whether a European Monetary Fund could function at all in these circumstances. Fund directors from countries subject to strong pressure to adjust would have to agree to a monetary policy requiring adjustment that they knew might exceed their country's capacity in the short term. The hard ECU proposal therefore has implications that go far beyond those of the stage-by-stage approach of the Delors Plan. One must therefore question the purpose of a proposal in which the true extent of the surrender of monetary autonomy is clearly underplayed. This question becomes all the more insistent when one knows that the proposal comes from the corner of the Community that has hitherto vehemently rejected the surrender of sovereignty. Could it be that the hard ECU proposal is nothing more than a strategic negotiating ploy?