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Helmut Schlesinger*

The Road to European Economic and Monetary Union

The debate on the concrete shape of the second stage of European economic and monetary union is in full swing. What are the benefits that may be expected from EMU? What risks have to be avoided?

The European Community has made enormous progress on the road to European economic and monetary union during the past few years. This is not a matter of course. One recalls the Community's efforts in the so-called Werner plan at the end of the sixties. These began optimistically but soon foundered in the turmoil arising from the collapse of the Bretton Woods system. A second attempt in 1988 (the meeting of the heads of state and government in Hanover) took quite a different course. Two years later, on July 1, 1990, stage one of the European economic and monetary union began and in October 1990 the heads of state and government commissioned two intergovernmental conferences to draft the necessary changes to the Treaty of Rome for establishing an economic and monetary union so that they could be ratified by the respective parliaments by the end of 1992. This is expected to lead gradually to a political union.

What is sometimes not sufficiently realised is the fact that we are not dealing simply with a monetary union but also with an economic union; in other words, we are contemplating a single market in which governmental barriers (be they, say, of an administrative or fiscal nature), which could impede the free movement of labour, goods, services and capital, no longer exist and the same rules, especially those governing market access, apply to all regions. It is planned to achieve the most important elements of this single European market by 1993.

To support economic union there must be an economic policy which—even if it is not fashioned by a single hand—is still pursued in line with common principles. Formulating

these principles simply as objectives is not enough; they have to correspond to economic reality. Roughly 60% of the relevant measures have already been adopted in the EC, and the Commission has requested once again that they now have to be incorporated into the national legislation of the individual countries.¹

These two aspects are reflected in the decisions taken in Rome in October 1990, which I have already mentioned. Firstly, economic union is intended to achieve price stability, growth, increased employment and environmental protection in a market-economy system; secondly, stable fiscal and budget conditions and a certain social cohesion are also required. As I see it, there would be little point in underestimating the value of these objectives of economic union and pursuing monetary union alone simply because it is politically and administratively easier to create a monetary union. For example, a monetary union would already exist if the exchange rates of the national currencies were irrevocably fixed and responsibility for monetary policy transferred to a common institution. But the desire for a single currency is also associated politically with a common institution.

Reasons for Economic and Monetary Union

I am often asked why we Germans want a single European currency and what advantage it would have for Germany. A lot of words and figures have extolled the economic benefits of monetary union. In what is known as the Cecchini report the benefits of monetary union were

* President of the Deutsche Bundesbank.

¹ European Economy, Social Europe, special edition 1990, published by the EC Commission, p. VII.

quantified by rather exaggerated assumptions that the EC, as a result, would see a 4.5% increase in GNP, a 6% reduction in prices and a 1.5% improvement in the level of employment. A later study by the EC Commission² speaks more soberly of “sure advantages”. In microeconomic terms these would be in the form of greater efficiency through the disappearance of exchange rate uncertainties and the transaction costs for foreign exchange in intra-Community trade; in macroeconomic terms the main advantages to be expected would result from greater price stability.

I cannot say exactly how far these studies overestimate the advantages of monetary union and underestimate the risks, but a number of factors support this assumption: for example, the questionable advantages at the microeconomic level. Fixing exchange rates and introducing common monetary and economic policies remove the necessity of expenditure on hedging activities in intra-Community trade and capital transactions and to that extent provide a more reliable basis for calculation. In view of the high degree of exchange rate stability which has now been achieved within the EMS, however, the effects will probably not be all that great.

The Commission also assumes that the “general uncertainty” arising from national currencies and nationally motivated economic policies will decrease under a centralised monetary policy. This should reduce the “risk premium” on fixed assets and therefore capital costs and thus encourage growth. Provided the Community policy is of a higher quality than the sum of the national policies, especially if the quality of the Community’s stability policy is better, that may be the case. However, the EC area is not a closed economy but an open one and competes with the economies of the rest of the world where it has to hold its own – despite fluctuating exchange rates; it is a moot point whether that will be more easily achieved with a giant ship (340 million inhabitants) than with somewhat smaller vessels which have proved their seaworthiness.

The effect of monetary union is easily overestimated in the case of transaction costs as well. It is true that, in the event of a single currency, exchange rate charges between EC currencies would disappear and that payments within the EC would become somewhat simpler and therefore cheaper. However, regional and structural differences do not disappear automatically. Charges for financial transactions from Ireland to Greece or from Germany to Greece, etc., will certainly be higher even with fixed

exchange rates than they are in each of the “old domestic markets” themselves. Figures on potential savings seem highly exaggerated.

And what about the macroeconomic advantages of economic and monetary union? There will certainly be positive effects on growth, as one would expect from any intensification of the international division of labour. The Commission is probably right when it says, as it did recently, that the expectations in this regard have played a positive role since 1985 (i.e. since the time of the Cecchini report). Yet the single European market will not be comparable with that of the United States or Japan, even in ten years’ time. Enormous national differences in, say, education, taxation and the social systems remain. Even the agreed dismantling of tax barriers for merchandise trade will not be achieved in the foreseeable future. In the case of turnover and excise taxes the borders – and the relevant controls – are being shifted to the offices of enterprises, according to the decisions taken so far, as agreement could not be reached on the introduction of the country of origin principle.

Advantages and Risks

The EC Commission expects the greatest overall economic effects on prosperity to come from the anticipated progress on stability in the Community. The positive effects of more stable prices on the overall economy in the form of greater cyclical stability, higher growth, higher employment and improved external equilibrium are obvious, and with the right monetary and fiscal policies there could be more price stability in a single economic and currency area.

Of course, these advantages are accompanied by the risks associated with abandoning the exchange rate as an adjustment instrument between greatly disparate economic regions. If in an economic area with fixed exchange rates or a single currency internal and external disturbances of an “asymmetrical” nature arise, e.g. the productivity in one country can be raised only slightly or not at all, wage and price adjustments and factor movements or compensatory fiscal policy measures must function smoothly so that other deflationary or inflationary problems do not arise in individual countries. However, if such preconditions are not met, income and price differentials will cause disruptions of the economic process, of production and employment which will be no less significant than the calculation risks associated with exchange rate adjustments but which might be greater and more deep-seated. And the compulsion to transfer financial resources from the richer or simply better managed countries to the others will increase.

² One market, one money, in: *European Economy*, No. 44, October 1990, published by the EC Commission, op. cit., pp. 9 and 31.

This sounds a bit theoretical. In the past colleagues of mine, and I myself, tried to illustrate by means of a concrete example what can happen when two countries form a monetary union and one of them takes over the currency of the other whose economic structure is very different from that of its own. With the necessary qualifications, for example, with reference to the different economic systems prior to union, we chose the example of the monetary union between the two German states; once, as a result of an abridgement, however, this pedagogical exercise was unsuccessful.

The Political Reality

However, the problem involved can also be illustrated in a different and less concrete way: the exchange rate can be a great help to a country if that country does not succeed in developing its economy at the same pace as other countries. If depreciations of national currencies cease to exist as an economic tool, undesirable trends are possibly reflected in higher unemployment and a growing need for government transfers. If the cost of the factors of production, especially wages, were sufficiently flexible, that could possibly be avoided.

But can one rely on that? One cannot count on lower wages even in a national context. In the case of German unification the very opposite happened, namely, wages rose sharply in the new *Länder* at a time when productivity was actually falling. The research institutes were right when they commented recently: "Enterprises were quickly confronted with a wage policy which was geared simply to wage levels in western Germany and not to the productivity of the east German economy." Elsewhere they state: "It appears as though those involved are unaware of the fact that harmonising wages in so short a space of time is far exceeding the means of almost all existing enterprises in eastern Germany."

What will it be like in an economic and monetary union? One is probably aware of the problems. But what is the political reality, particularly in some of the larger countries? To what extent will a few, especially southern countries, rely, for example, on the system of minimum wages, index-linking of wages and a combination of the two? Do the economic weight of these countries and the powerful influence of their trade unions not pose the danger that minimum wages will be prescribed for the whole of the EC and that index-linking will continue to be allowed and will generally be applied?

Then there are the problems of fiscal policy. For the time being responsibility for this will remain in the hands of national governments and parliaments. If fiscal policy is not largely convergent, we will run the risk in the event of

economic and monetary union of countries with weak currencies being able, not unjustifiably, to hope for stability policy progress at home while countries with hard currencies will at least have to face the possibility that the Community currency is actually weaker than their respective former national currencies were.

Advantages for Germany?

I repeat the question which I asked earlier: what advantage does economic and monetary union have for Germany? As far as growth and higher living standards are concerned, the answer in my opinion, i.e. from a purely economic point of view, is a positive one. Account must also be taken, however, of growing financial burdens on the taxpayer and a possible deterioration in the value of money.

The Commission recently published an extensive study in which the competitiveness of the individual EC countries is examined at the microeconomic level, by economic sector, so to speak. The "old" Federal Republic, which was the part of Germany included in the analysis, did exceedingly well, particularly in those branches of industry which are important for the future of a highly industrialised country.³ If that is true of the whole of Germany as well, there is much to be said for the first, and positive, justification; however, that does not mean that the second aspect is invalid.

From the German point of view, it is actually mainly political reasons which have prompted the government not only to support the decisions to establish an economic and monetary union but actually actively to promote it. In this respect economic and monetary union is an important contributory factor to political union. I can fully understand this. Yet there would be no point in denying the economic problems or in deliberately suppressing them. Economically speaking, we Germans cannot afford a "precipitate delivery" a second time.

Actual Currency Area

Let us leave the plans for the future for the moment and turn our attention to the present. The move towards creating an actual currency area is already further advanced than some people realise. With the instruments already at our disposal we have, at any rate, come closer to the aim of the EMS of creating an area of internal and external monetary stability:

□ Changes to the central rates within the EMS have become increasingly less frequent and have actually not

³ European Economy, Social Europe, op. cit., p. VII.

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been made at all for four years now. Added to that, Italy has narrowed the fluctuation band for the lira (to a nominal $\pm 2.25\%$), and the United Kingdom and Spain have joined the intervention system. Only Greece and Portugal are still outside this system.

□ The spread of inflation rates in the member countries and the average rate of inflation within the EC have been reduced. A small nucleus of countries – mostly EC founder members – have already achieved a high degree of “convergence” in this sphere, too. French politicians are already looking forward to the day when their inflation rate will be lower than ours, and that is still possible this year; if it does occur, we shall certainly be the first to congratulate them.

□ Interest rate development reflects these findings. Long-term and to some extent short-term interest rates have fallen significantly. As a result, interest rate differentials between the currencies of the countries participating in the system have levelled off considerably. The difference in interest rates between Germany and France, for example, is now about 1 percentage point compared with $7\frac{1}{2}$ percentage points in the second half of 1982. The full extent of the convergence just mentioned might be illustrated, among other things, by the fact that interest rate differentials in the credit markets of the EC countries have largely disappeared.

There is no doubt that the EMS has helped to implement stability-oriented fiscal and monetary policies. However, the stability of the system has also been encouraged by the global economic environment, by the longest post-war economic upswing and by a disinflationary process which continued until a short time ago. German monetary policy, which maintained its anti-inflationary course and consequently contributed greatly to the credibility of the entire system, played an essential part in this.

It looked for a time as if the EMS had become a victim of its own success because the sustained stability of exchange rates and the reduction in interest rate differentials contrasted with the divergent price movements of the member countries – even though these recognisable and cumulative differences were declining. In practice, a certain distortion of trade flows in Germany's favour did persist until the surge in demand from the new *Länder* more or less compensated for this for the time being.

It is also somewhat surprising that Italy could get itself into an extremely difficult fiscal policy situation without a deterioration in the exchange rate of its currency (the lira is still not in a weak position within the EMS today). The EMS did not sanction the undesirable behaviour but instead

rewarded it in a way as the markets reduced their risk premium – as a result of their confidence, so to speak, in the internal control exercised by the Community's anti-inflationary EMS. The sanctions mechanism which a few experts, including the Economic Advisory Council, had expected – namely, that less favourable conditions would apply to highly indebted member countries in the EMU and would therefore enforce adjustments – will probably function even less satisfactorily in a future EMU.

Conversely, some EC countries think that the exchange rate stabilisation within the EMS is demanding higher interest rates from them than would be reasonable from the domestic point of view during a cyclical downturn; however, they are perhaps underestimating the interest rate advantage from membership of the EMS; in other words, without the exchange rate mechanism of the EMS and the temporary exchange rate guarantee some countries would have higher interest rates.

The First Stage of EMU

Parallel to these developments the first stage of the European economic and monetary union came into force in the middle of last year. It is the aim of this stage to achieve “increasingly compatible policies with precise and appropriate commitments by the member states” in a kind of learning process in the economic and monetary policy field.⁴ The goal of economic policy cooperation is to attain a high degree of convergence in economic performance as a precondition for progress on the road to economic and monetary union.

In the forefront is budgetary policy, the – albeit non-committal – review of which should take place possibly ahead of national budgetary planning. In addition, closer cooperation between the central bank governors, especially the coordination of monetary policy aimed at price stability, has been agreed; in practice, this amounts to a continuation of the tasks which the Committee of EC Central Bank Governors has been performing for a long time. As far as Germany is concerned, it is essential that this cooperation does not lead to a relaxation in anti-inflationary policy. In this stage the coordinating bodies cannot release the national central banks, including the Bundesbank, from their legal obligation to safeguard the currency.

If this principle is retained, and experience so far has not suggested the contrary, this first stage of economic and monetary union can provide an important input for the success of the final stage. Reducing existing divergences

⁴ Council decision of March 12, 1990 on the attainment of progressive convergence of economic policies and performance during stage one of economic and monetary union.

requires a period of adjustment until the final stage of monetary union comes into force. It is not yet time to lay down how long this period should be.

Divergences in costs and prices, in government deficits and in external imbalances cannot be fully eliminated in the somewhat longer term either, as can be seen from the regional differences within a given national economy. The divergences at the European level are still too large, however. The same is true of the considerable differences in institutional structures, the basic economic stance, the behaviour patterns of management and labour and the general framework within which they negotiate (e.g. index-linking).

In its statement to the Federal Government (which in Germany is the only negotiating partner) the Bundesbank referred to these points in detail; we may safely say that there are no differences of opinion here.

The Final Stage

During the first stage the amendment to the EC Treaty necessary for the implementation of the second and third stages of EMU is to be decided. Discussions on this are now fully under way and the preliminary work for the final stage has been completed for some time. The architects have so far dealt with the interim stage, or stage two, between the present foundations and the eventual roof, in a preliminary draft:

It has been agreed that by the *start of the final stage*, at the latest, which I shall deal with first, a European central bank system must exist which is ready to go into operation and which consists of a central institution and the national

central banks; according to the preliminary work already done, the functions and management structure of the system will be modelled largely on those of the Bundesbank or rather on those of the Bank deutscher Länder with its pronounced federal character.

In the draft statute submitted by the central bank governors, which has been largely accepted so far, agreement has been reached on the following points:

- priority commitment to monetary stability,
- independence of the institution, its functions and its staff,
- a bar on lending to governments and
- termination of the independent policies of the national central banks, which are to continue as regional components of the system.

There has so far been no agreement on two important issues, which have characterised different attitudes for a long time.

- Firstly: some of our partners think it is necessary for the council of heads of state and government or the council of finance ministers to be able to give general policy orientations to the central bank system. In our opinion that would not be consistent with the independence of the central bank. The Bundesbank Act (section 12) states that the central bank is required to support the general economic policy of the Federal Government without prejudice to its priority function.
- Secondly: some partner countries, somewhat more than in the case above, want responsibility for exchange

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rate policy, e.g. formulating binding exchange rate targets, to remain exclusively in the hands of the council. However, exchange rate targets commit monetary policy and can undermine the commitment to monetary stability, as we know from the time of the Bretton Woods system.

Economic union involves an adequate degree of permanent commitment on the part of all member states to gear their fiscal policies to stability. As the fiscal policy decisions in the EMU remain largely in the hands of the member states, contractual precautions, including binding rules and sanctions, must be taken at the Community level to achieve effective budgetary discipline in all member states. The views of member countries on these ideas are still comparatively far apart as conditions and sanctions naturally interfere with the sovereignty of individual countries, and the sovereignty of a country is particularly highlighted in this field.

On the other hand, if a country breaks ranks on budgetary discipline, the common monetary policy is considerably impaired; in addition, there are probably direct consequences for the budgets of other countries and the Community budget.

Describing the third stage and defining it in a statute is one thing; enforcing it is another. In their decisions taken in Rome the governments envisaged the second stage coming into force on January 1, 1994. However, at the same time and mainly as a result of German pressure the conditions which would have to be fulfilled were spelled out. Implementation of the third stage would have to be subject to even more stringent conditions. The decision on when EMU can be brought into force is to be taken on the basis of a progress report three years after implementation of stage two; this decision is not to be made before 1997. I would not like to rule out the possibility that these dates will be subject to change.

The Interim Stage

That brings me to what is currently the most difficult topic for discussion, the interim stage (or second stage, as it is known). What is it all about? In short, it concerns the question as to how one is to reconcile the retention of national central banks' responsibility for the continued existence of their respective currencies with the aim of giving up this responsibility after the transitional period and transferring it to the European central bank.

I have still not quite grasped why this second stage is necessary when it is already known during the first stage that one wants to move to the quite different circumstances of stage three. Can it be that stage two is an engagement period with the undeclared proviso that one can still turn

back before the altar? Or are we encountering the motto of the eternally engaged couple: yes, but not now. The "engagement" was envisaged in Rome in terms of "creating" the "new institution". The latter is supposed to be established before the final stage comes into force. What that means is clear in one respect, and that is that the potential couple has still to clear this matter up.

□ The British proposal provides initially for a thirteenth independent currency, the "hard ECU", after stage one. In contrast to the present ECU, which, for example, has depreciated by 18% against the Deutsche Mark since its creation, this artificial currency is not to be depreciated against the hardest of the EC currencies. Secondly and most importantly, the hard ECU is to be issued by the "new institution" as a parallel currency and is to compete with the existing national currencies. A governing body consisting of the central bank governors of the participating countries and a kind of directorate is to take over the management of the fund; that is to say, there is to be a kind of thirteenth central bank or currency board for a thirteenth currency. This currency is then supposed to compete with the others and substitute for them.

□ France, Italy and one or two other countries understand from the term "institution" an ECBS which will be created as early as the beginning of 1994, although monetary policy will remain a national responsibility during the transitional stage. One objective is that during the transitional stage a common policy on intervention vis-à-vis third currencies can be pursued. Perhaps ECU (the basket ECU) are also to be issued, thereby "putting an even tighter rein" on the national currencies.

□ Supported by one or other member country, the German government interprets the "new institution" as a "council of central bank governors" which is supposed to emerge from the Committee of EC Central Bank Governors. During the transitional stage the governors' council could deal with the coordination of central banks' instruments and structures while responsibility for monetary policy, as generally agreed, remains with the national central banks. It should not – in our view – be cut back by important policy areas such as exchange rate policy either. A superordinate authority with its own apparatus, a "half-baked" central bank to use Sir Alan Walters' description for it, would in any case not make sense.

The German proposal does not mean that there is nothing more to be done during this second stage. The independence of the national central banks should be guaranteed in those countries where it has been withheld so far. Coordination of monetary policies should be further improved by laying down clear objectives based on, say,

agreed monetary targets and ensuring that they are observed. In other words, as far as national monetary policy is concerned, one should achieve in practical terms as much as possible of what will be required in stage three later on. Stage three cannot produce miracles simply by creating an institution.

Monetary policy can only be successful in the sense of maintaining monetary stability when this objective is firmly embedded in the minds of the population. If that is not the case, even independent central banks will have difficulty in warding off the pressures of governments which often have only short-term objectives in mind. It is only when the public and public opinion are alert and express their own long-term interests in a stable currency and speak out against possible smokescreening through inflationary policies that a central bank can completely fulfil its mandate. I think that in some EC countries matters still need a certain time to mature.

Which of the proposed concepts will prevail and what kind of compromises will be negotiated is important and not just for a short transitional period because both the British solution and those of other partner countries involve the risk that the Bundesbank's room for manoeuvre is already curtailed at a point when the preconditions for monetary union do not yet exist. There is no need to be quite as sceptical as *The Economist*, which recently commented: "Politicians would try to use the stage-two Euro-bank as a back door towards influence over Bundesbank policy and might be tempted to postpone indefinitely the hard economic choices involved in a transition to stage three, preferring instead to transfer national monetary competence bit by bit to the Euro-bank in the name of integration."⁵ *The Economist's* fears are based not least on the possible consequence of a political compromise in which Germany's insistence on a comprehensive political union would be accepted and the Germans in turn would agree to the creation of "the institution" for monetary policy; I hope *The Economist* turns out to be wrong.

Conclusions

However, the second intergovernmental conference, which is to lay down the contractual preconditions for political union, is not concerned with a federation in the classical sense but with changes in the areas of responsibility and powers of supervision of the Community bodies, especially the European Parliament, and with the transfer of strictly defined national responsibilities to the Community. This limitation is probably useful at this stage.

However, in the transitional period and until after the final stage comes into force rules must be devised for

sharing the adjustment costs; these are more likely to be kept within limits if the harmonisation of living standards in the various countries is largely left to market economy mechanisms instead of attempting from the outset to provide for a mechanism for transfer payments. What was necessary for the ad hoc unification of the two German states and what can be demanded economically from a nation involuntarily divided as a result of historical events should not be taken as a model for a multinational community. The sense of solidarity within a nation must not be overestimated either.

A final word on the negotiations themselves: I think I am right in saying that public interest in Germany in the subject of European monetary union is not particularly great. However, much is at stake for us in the discussions currently being held at the intergovernmental conferences. "... a monetary union is ... an irrevocably sworn confraternity ... which, if it is to prove durable, requires, judging from past experience, even closer links in the form of a comprehensive political union."⁶

However difficult the intra-German problems may be, Germany will overcome them over the longer term. Wrong decisions taken in the interim, no matter how bad they are, can be corrected or compensated for later on. The decisions which are now to be taken on European monetary union cannot be changed once they have been taken and ratified by the national parliaments.

Naturally, the interests of our partner countries are not necessarily the same as ours. Some countries may be hoping for a way out of enormous domestic problems – for example, concerning national budgets and inflation – not least as a result of political pressure from Community bodies even though this form of rescue from abroad is not reliable either.

As far as the influence of Community decisions is concerned, we can hardly expect a similar effect. The D-Mark is to remain the anchor as long as there is not an equally satisfactory or an even better currency. In the interests of Europe we must also continue to try to maintain the economic achievements of the old Federal Republic, and that is a double task given the unification process between the two German states and the unification process within the EC. I hardly need to emphasize that to achieve this the cooperation of all economically and politically important groups in our country – in view of the limited intellectual and physical energy available – is necessary now more than ever.

⁵ *The Economist*, May 4, 1991, p. 83.

⁶ Statement by the Deutsche Bundesbank of September 1990 on the establishment of an economic and monetary union in Europe.