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□ Ambitious legal and institutional as well as economic standards (i.e. sustained convergence with the performance of the country with the most stable prices) must be set as a condition for participation in the final phase of monetary union.

□ Voluntary participation in the system: any member state which fulfils the preconditions must make its own decision as to whether it wishes to enter. In view of the importance of such a step the decision ought to be subject to a parliamentary vote.

□ A low minimum number of participants (say, six) during the start-up period. Further member states should be admitted upon application, provided that they have fulfilled the legal, institutional and economic conditions.

□ The ESCB and the European Central Bank itself should not be established until the final phase has begun, and only those countries should participate in them which have surrendered their monetary sovereignty to the ESCB.

□ Even after the foundation of the ESCB, the council of central bank governors should continue to operate as an institutional link between the ESCB countries and the remaining member states. ESCB participant countries should be represented in that council by the President of the European Central Bank.

The Dutch proposal does greater justice to this position than the preceding draft treaty, and is therefore deserving of support. However, the proposed "trial period" for establishing convergence is rather short at just two years. If some countries feel the convergence criteria are too tough, they will have to face up to the question of whether they are really concerned with stability-policy objectives in wishing to participate in EMU, or whether they are not primarily seeking to soften the deutschmark-based stability standard which is already established. As far as Germany is concerned, at any rate, there can be no question of participating in an EMU which is built on weak foundations.

The European Community is now at the threshold of a new phase in its development. This phase will not only consist of the "deepening" which is about to be embarked upon but also of further widening. To say that the Community and the Economic and Monetary Union should be one and the same thing would appear extraordinarily problematic in view of the possibility that Community membership could double in the years to come. The admission criteria for participation in the monetary union should be demanding ones if EMU is to act to (further) cement members together, and not to blast them apart. Establishing the proper framework for monetary policy is not therefore a field which permits any political compromises.

Alfred Pfaller*

Economic Policy within a European Monetary Union

A European Monetary Union (EMU) and the complete transfer of the responsibility for monetary policy to a European central bank are no longer utopian ideas, but a politically highly relevant possibility. The question how economic policy goals can be achieved within such a monetary union is therefore gaining in importance.

Two questions are still at the forefront of the debate about European Monetary Union (EMU):

1. How far must member countries have achieved convergence in inflation rates and the policies responsible in this regard before binding commitment to a monetary union makes sense? Must far-reaching convergence be

achieved first, or is monetary union itself a means of accelerating convergence?

2. How can price stability be safeguarded within the monetary union? Put another way: how can the previous areas of stability (Germany, the Netherlands) protect themselves against imported inflation from other EMU countries if they are shackled to them by irrevocably fixed exchange rates?

These two questions epitomise the doubts that continue to stand in the way of the rapid implementation of

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European monetary union. On the other hand, the political will to create a single European monetary area sooner rather than later has now become so strong that this is no longer a purely utopian plan. Questions about economic policy *within* the monetary union are therefore gaining in importance. How these questions are resolved will also determine how the viability and desirability of EMU itself is assessed.

There are two main issues in this regard:

1. Can price stability be maintained solely by an independent European central bank (a "Eurofed") vested with adequate powers? Are not fiscal or incomes policy arrangements needed as well? If so, national sovereignty would have to be curtailed in these fields of economic policy too.

2. If monetary conditions are set for Europe as a whole by an "apolitical" body committed solely to price stability, will it still be possible for countries to pursue an independent national policy geared towards economic growth and employment? Is there a danger that these objectives will be neglected if they are not addressed at European level in the coalition of EMU member countries? Such a coalition is inherent in the idea of a European economic union that the Delors Report of 1989 envisaged in parallel with the establishment of a monetary union.

Different conceptions as to how economic policy operates within a monetary union are clearly at the root of both problems. As regards price stability, it is assumed that autonomous national fiscal policies may run counter to the stability policy of the European central bank and blunt its impact. Budgetary discipline is therefore regarded as a necessary condition for price stability. By contrast, the fear in connection with the second problem is that the monetary parameters will limit the scope for fiscal policy too severely. Which of these two problems is the more serious therefore depends on whether fiscal policy prevails over monetary policy or vice versa.

Fiscal Discipline

A political consensus is emerging that a European monetary authority committed to monetary stability may not provide credit to finance the budgets of member states or of the EC. States that want to run up large deficits, for whatever reason, must therefore borrow from the private sector. In this way they withdraw demand from the private sector and limit its ability to spend. Total demand for the available supply of goods and services does not increase. Monetary stability is not endangered. This is the crux of an approach based firmly on the notion that the central bank can keep control over the money supply in the economy,

and hence over demand. It is then only a question of actually committing the central bank to this objective and vesting it with the necessary powers.

Other problems arise, however. If monetary policy is strongly geared towards stability, increased loan demand tends to raise the cost of credit, in other words interest rates. Higher interest rates can induce individuals to save more, and thus to demand even fewer goods and services. However, they will also cause the private sector to demand less credit and to refrain from productive investment. Government securities and private sector physical investment compete for the available savings, especially corporate savings. A reduction in productive investment means slower growth in production capacity and possibly also a slowdown in the modernisation of plant, causing firms to fall behind their competitors.

In an economic area with integrated financial markets these effects are not confined to the country whose budgetary policy is driving up interest rates, but spill over across the entire economic area. Attempts by national monetary authorities to hold interest rates down can easily trigger a capital outflow and a depreciation of the national currency, which in turn increases the danger of inflation. In a monetary union with an integrated capital market and a single monetary policy, countries can counteract an increase in interest rates induced by the policy of another member state only by reducing their own budget deficit or even achieving a budget surplus. Even by this means, however, relatively small countries can accomplish little on their own. Moreover, such a policy means sacrificing their own political objectives in order to enable other governments and populations to have a higher level of spending. But without such accommodation, productive investment will be crowded out generally throughout the monetary union and all member states will have greater difficulty borrowing because of generally higher interest rates. The competition for scarce savings will intensify. Hence every member country has an interest in ensuring that another member country does not pursue an uncontrolled "high interest rate" policy. Efforts to limit government borrowing in the EMU – by means of fixed limits expressed as a percentage of gross national product or indirectly through the pressure of political consultations – appear sensible, even if such action is not necessary to safeguard monetary stability.

Uniformity in budgetary positions cannot be the objective, however. Rather, it would be a question of balancing the deficits and legitimate financing requirements of some countries (to overcome backwardness in development, for example) with the excess saving of other countries. Complementarity is

more effective in this regard than convergence. To that extent, differing budgetary situations can co-exist quite happily within the monetary union. However, even co-ordinated state borrowing reaches its limits at the point where financial manoeuvrability is constrained by rising debt servicing obligations. Even if the Community can wash its hands of responsibility for the official affairs of a member state that has run into difficulties – indeed must reject responsibility categorically from the outset – it would be affected by the fact that this country would no longer be able to co-ordinate its fiscal policy with that of other countries and would be condemned to run a deficit, with the potential to push up interest rates.

The interest rate problem that can be caused by uncontrolled budget deficits arises precisely because *no* monetary policy concessions are made to high-spending countries and because monetary policy can, in fact, keep the demand for money under adequate control. In the eighties the USA demonstrated how this may work in practice. However, doubts are also being expressed whether one can rely upon these two conditions. On the one hand, it is feared that the future Eurofed would be unable to resist the political pressure to which it would be subjected in the event of a rigorous policy of high interest rates. On the other hand, there are indications that there are technical limits to a central bank's ability to control the money supply, that it is simply unable to neutralise all credit and money-creation processes in the economy. In this connection it is significant that increased credit demand, coupled with higher interest rates, leads to an inflow of capital from outside the monetary union. It is doubted whether the central bank can fully sterilise the domestic liquidity coming into circulation as a result of foreign investors' purchases in the foreign exchange market as a counterpart to such inflows.

The empirical evidence in this regard is ambiguous. Where expansionary fiscal policies have had inflationary effects, there has always been a question whether monetary policy was not too lax for political considerations. Indeed, it appears risky to place the *entire* political responsibility for monetary stability on the "apolitical" central bank. For this reason alone, it would be wise not to test the resilience of monetary policy by pursuing irresponsible national budgetary policies, and instead to make arrangements for collective fiscal discipline at EMU level.

Latent Contest

While some people fear that a lack of discipline in state spending could jeopardise price stability within the EMU despite a monetary policy geared towards that objective,

others consider the danger lies in an excessive narrowing of the scope for fiscal policies oriented towards growth and full employment. Several considerations may lead to this conclusion.

The monetary union rules out the possibility of devaluing the national currency. For that reason one would assume that no country can afford to lag continually behind its EMU partners as far as price stability is concerned. If there is even a small possibility of buying more growth and employment at the cost of slightly higher inflation, price stability must be given priority; otherwise, the country falls behind in terms of competitiveness. As long as responsibility for monetary policy rests with national central banks, sooner or later they will have to adopt a restrictive monetary policy to defend the exchange rate. According to this view, the whole design of the monetary union is such that it engenders a kind of contest in terms of stability at the expense of growth and employment. To overcome this would require member countries to agree on a common fiscal policy line that allowed enough stimulus to growth.

This view is based on two assumptions: first, that it is in fact possible to achieve growth by making certain concessions on the inflation front, and secondly that state deficit spending can inject additional demand into the economy irrespective of the monetary environment, which will be determined by the future Eurofed. As to the first assumption, one can only note here the widespread scepticism with which it is currently regarded by economists. But for all the justified criticism of earlier nonchalance based on the Phillips curve, one should probably nevertheless take care not to throw the baby out with the bathwater. The second assumption is the same as that underlying the demand for fiscal discipline in the interest of monetary stability, as discussed above. The spotlight here, however, is not on the problem of excess demand but on that of underutilised production capacity and hence insufficient investment incentives.

If monetary policy really were able to control the nominal volume of demand, budgetary policy would be a rather blunt instrument as far as stimulating demand was concerned. Its significance would lie "only" in the correction of private spending preferences and the safeguarding of social interests that are considered important. Even EMU-wide co-ordination would not widen the overall scope for cyclical policy. In order to safeguard demand, monetary policy itself would have to be adjusted. In other words, the monetary policy of a European central bank may not be *too* restrictive; it must pay full regard to the existing scope for economic expansion. That is almost axiomatic, however. The question is whether the structure

of monetary policy responsibilities in the envisaged EMU pays adequate heed to this principle. At present, fears are rather that it will result in too lax a policy.

If on the other hand one concedes the possibility for fiscal policy to influence the volume of demand in a given monetary configuration (because monetary policy cannot control all money creation and because it does not turn restrictive immediately when fiscal policy is expansionary), there appears to be a case for a co-ordinated expansion of EMU budgets. However, the complications that have already been mentioned in discussing the problem of discipline then come into play.

International Complications

Whatever form money creation may take in the course of a general expansion of economic activity and however monetary policy may cope with it, higher budget deficits initially entail higher borrowing from the private sector, as direct financing by the central bank is ruled out. This means that private individuals rearrange the disposition of their income, especially the investment of their current savings. The funds lent to the expanding Exchequer must be withdrawn from other uses. This adjustment is not confined to the country itself or to the EMU area; as a rule, the state's increased demand for credit also attracts savings that were previously invested abroad. In this way demand, and hence growth stimulus, is diverted to the country from abroad. Fiscal policy can thus induce growth without assistance from monetary policy, the only condition being that the central bank does not immediately respond with a tight money policy.

In parallel with the increased inflow of savings into the EMU, the interlocked European currencies (or the ECU, as the case may be) appreciate against the dollar, yen, etc. This in turn tends to reduce the prospects for European products in both domestic and foreign markets. The increased public sector demand is offset by a decline in world demand for European products. Depending on the worldwide supply of savings and demand for capital, interest rates rise, again tending to curb growth. It is impossible to say even approximately how much growth remains; this depends in part on the price elasticity of world demand for European goods (both exports and import substitutes). In any case, there will be a shift towards goods and services that are not traded internationally and are therefore not open to international competition, the so-called "non-tradables".

How one should assess such growth financed on credit depends essentially on the situation prevailing when it was initiated and the scale of foreign trade imbalance it causes. If it was initiated to overcome a situation of excessive

saving and the accompanying current account surplus, as in the Federal Republic of Germany during the eighties, one can speak of a welcome normalisation. The transitional problems can nevertheless be considerable. We shall come back to that point in a moment. On the other hand, if the starting point is a situation of sizable deficits, as was the case of the USA in the eighties, the question of sustainability will become increasingly insistent. The correction that must be made sooner or later is accompanied by an increased risk of both recession and inflation. Moreover, while the currency is overvalued the country is losing competitive potential that must be painstakingly regained at a later stage. It is therefore very questionable whether concerted government borrowing can be the golden path to steady "adequate" growth in a European monetary union. This would be appropriate only in the exceptional event that a kind of stability competition caused European fiscal policies to be over-restrictive by comparison with those in the rest of the world and if the situation of Germany prevailed in the EMU as a whole, namely generally weak growth partly offset by a trade surplus. At present there are no signs that this is the case.

Contrary to the notion of impending stability competition, it appears to be easier for *individual* member states of the EMU than for the entire currency area to counter low capacity utilisation by means of expansionary fiscal policy, as the increased inflow of capital from abroad or reduced outflow do not cause their currencies to appreciate against those of other EMU countries, their most important trading partners, or lead to a deterioration in their competitive position within Europe. Most of the benefit of the increased state demand would accrue to national economic growth and only a small part would be neutralised through loss of market share for goods exposed to competition ("tradables"). As shown above, however, it would be growth mainly at the expense of the other EMU countries, which would face higher interest rates and an outflow of demand. Moreover, the capital inflow from outside the EMU into the country with the expansionary policy would cause the ECU as a whole to appreciate against the dollar, yen, and so forth. As a result, even countries that themselves recorded no capital inflow would also suffer a loss in competitiveness.

If the country pursuing an expansionary fiscal policy approached full capacity utilisation, prices would admittedly rise and national competitiveness would decrease even within the EMU, albeit with a lag. The result would be a kind of regional inflation within the currency area. In principle this would have the same effect as an exchange rate adjustment. In fact, only the prices of non-tradable goods and services could rise; tradable products would gradually lose out to cheaper foreign articles. The

EMU partners would now share in the growth in the expansionary country. Once adjustment was complete, in other words after the switch to increased production of non-tradables and the creation of the necessary current account deficit in the expansionary country, the inflationary surge would have to peter out.

Seen in this light, a *national* policy of economic stimulation via increased budget deficits need not fail owing to a lack of monetary accommodation on the part of the European central bank. Such a policy would give all the less cause for concern from the point of view of stability the greater the spending restraint shown by the other EMU countries (and households and enterprises in those countries). On the other hand, if several member countries tried to follow this path simultaneously, there would be heightened competition for the available savings and hence the very opposite of stability competition: a kind of growth competition.

Adjustment Problems

The deciding novelty for countercyclical policy in the European monetary union will be the fact that any expansion or reduction in demand in *one* member state will require mirror-image changes in the rest of the union because of the centralised monetary policy. The system is therefore preprogrammed not only for rivalry in terms of economic policy but also for adjustment problems whenever a member state drastically alters its budgetary policy or a nation its saving and investment behaviour. The EMU countries' remaining powers over economic policy make such macro-economic "disturbances" more likely than would be the case in regions within a state. Such changes lead directly to a redistribution of demand across national borders within the EMU. However, they also divert demand to other market segments, for almost everywhere the bulk of purchasing power continues to be spent on domestic goods and services. Untenable imbalances therefore quickly develop when the economy is operating at full capacity. In one country supply cannot keep pace with the expansion in demand, while in others there is excess supply.

This imbalance must be corrected by current account adjustment. In the country or countries with a higher propensity to spend, the propensity to import must be increased and export prospects (i.e. price competitiveness) reduced. In countries with a reduced propensity to spend (and hence an increased propensity to save) the opposite must happen. Import propensities and export prospects are largely a function of the comparison between prices at home and those abroad. However, the simplest way to adjust relative prices in the required

direction, namely by adjusting exchange rates, is now ruled out in a monetary union. It would be rather unrealistic to look for a reduction in absolute prices (and wages) in the countries with a low propensity to spend. The only remedy remaining is therefore regional inflation – which is tantamount to a covert real revaluation of the currency – in the country with an increased propensity to spend. If this is opposed by the monetary authorities, however, the necessary adjustment can no longer take place via relative prices, and must be achieved via volumes.

This would lead directly to recession, however, as a non-inflationary situation could be created in the country with a high propensity to spend only if the overall level of demand in the EMS area were reduced sufficiently, at *given* import propensities and competitiveness, to cause the exports of the expansionary country to contract until they were in line with its supply capability. Similarly, a country making good a previous savings shortfall – by drastically reducing its budget deficit, for example – will move into recession if improved competitiveness does not simultaneously stimulate increased foreign demand for its goods.

A further difficulty arises if changes in external circumstances affect some EMU countries more severely than others. A sustained decline in the dollar and the Third World currencies tied to it could create such a situation, as it would adversely affect primarily the cost-sensitive competitiveness of peripheral EMU countries. Here it would initially be the task of the Community to mitigate the unavoidable losses of income by making additional transfer payments and hence simultaneously enabling the countries affected to run higher current account deficits. For donor countries, this implies either a reduction in expenditure on consumption or investment or a contraction in capital exports to other countries. In certain circumstances, however, the latter could lead to devaluation in the countries concerned, and hence increase the competitive pressure on the periphery of the EMU. Over the long term, transfers are no solution in any case. There is no way round the need to restore competitiveness. This means adjusting the level of costs (in other words, wage restraint) and the structure of production. The alternative would be permanent unemployment and/or an accentuation of the dualism in the labour market.

The Example of German Unification

The unification of the two Germanies offers an example of the adjustment problems that are to be expected. The flows of goods and capital that had gradually developed over the last ten years were abruptly changed. German savings surpluses that had provided the rest of the world

with capital were largely diverted to domestic uses for the economic development of the eastern Länder. This had an impact on both goods and financial markets.

As far as goods markets were concerned, it caused increased domestic demand for German products (and imports), without export demand being able to contract immediately to the same extent. The pressure of demand on German production capacity therefore increased, and soon began to affect price stability as well. On the financial front, it is now a question whether German monetary policy will succeed in stifling the growing inflationary tendencies and hence strengthening confidence in the D-Mark. If that occurs, the German currency can be expected to come under upward pressure, since fewer D-Mark will be offered on the foreign exchange market. However, from the foreign trade point of view, more rapid inflation in Germany would also be a sign of the efforts of the markets to bring about a real revaluation of the D-Mark and divert demand from German products to cheaper goods from elsewhere.

In the present situation, the Bundesbank must counter not only rising inflation at home but also upward pressure on the D-Mark vis-à-vis the other EMS currencies. This means that the more effective is its stability policy, the more D-Mark it must offer on the foreign exchange markets, particularly as rising interest rates in Germany are reinforcing international demand for the currency. The only way out of this dilemma is concerted European action, whereby other countries reduce their demand not only for DM investments but also for German goods. Interest rates in the other EMS countries would have to rise in parallel with DM interest rates and overall demand would have to be curtailed, because a unilateral rise in the prices of German products is not an option, given the priority Germany accords to price stability. A restrictive monetary and fiscal policy throughout the EC would therefore be required. EMS currencies would have to be revalued collectively against third currencies, which would again be particularly damaging to the competitiveness of the European periphery.

An easier course of action would be to remove the constraint of fixed exchange rates and to *revalue* the D-Mark within the European Monetary System. This would divert demand generally to other European countries and ease the pressure on German production capacity. The reduction in current account imbalances within the EMS (German surplus, deficits elsewhere) that would necessarily accompany the elimination of Germany's savings surplus would be achieved in a manner consistent with stability via a shift in relative prices. Price stability would not have to be safeguarded by inducing a general contraction in demand.

This is, of course, a theoretical model to which a number of objections can be raised. First, it is doubtful whether demand for German products is sufficiently elastic in its response to price increases. If it is not, something might be done to anticipate or intensify the signals coming from the market by adjusting the structure of industry. It remains an open question how far this would be feasible, however. Nothing could be done in this direction in the short term in any case. A further objection is that an exchange rate realignment would be a setback on the path to European monetary union. Such a step might also jeopardise the progress that other EC countries have already made in combating inflation. Moreover, several countries have pegged their currencies to the D-Mark and emulate every parity change against third currencies. A revaluation of the D-Mark within the EMS would therefore be effective only in relation to a limited selection of trading partners.

However the new equilibrium is achieved, the problem arises that a smaller volume of German savings will be available to meet foreign credit demand. Assuming monetary policy in the major countries is oriented towards price stability, this pushes up interest rates until sufficient borrowers have fallen by the wayside. Private investment, which is more sensitive to interest rates (such as the construction sector), would be squeezed out of the credit market. If this is not to happen, new state borrowing in the deficit countries would have to be reduced (reduction in expenditure, increase in taxes) or private saving would have to be increased. This problem is at its most acute in the USA as far as the impact on the world economy is concerned. However, it also applies to the deficit countries of the European Monetary System.

Co-ordinated Incomes Policy

In order to avoid recession, it is important not only that monetary policy acknowledges any available scope for growth, but also that other economic policies exploit the scope monetary policy offers them. One central requirement is that there are no "unnecessary" price increases that tie the available supply of money to an undersized real volume of goods. Such price increases stem not from excessive demand for goods and services fuelled by an inflated money supply but from the exercise of monopoly and cartel power. As far as possible, policy would have to prevent battles for a greater share of national income from occurring via the market. This includes, in particular, wage increases, which would be passed on in higher prices. A policy that produces consensus between the two sides of industry on non-inflationary wage behaviour would safeguard real demand in the context of a given monetary policy. The more effective and reliable this policy is, the closer monetary policy can risk going towards

the point at which excess demand develops, and hence inflation accelerates. The more unbridled wage and price behaviour is, the more the monetary authorities feel obliged to haul on the reins.

To demand a European incomes policy would be to ignore the institutional realities, but the causal relationship between wage restraint and the scope for monetary expansion might nevertheless become the conceptual focus of macro-economic co-ordination at EMU level. If the premises set out above are correct, this would be more fruitful than a fiscal approach.

But what would be the effect of a combination of a stability-oriented monetary policy at EMU level and inflationary wage developments in a few countries? It is conceivable that the other countries would simply follow in their wake, in a kind of wage domino effect. If this did not happen initially, the inflating countries would lose competitiveness and demand would be diverted abroad. In fact, the monetary union favours countries whose institutions and political traditions foster effective wage discipline. However, if plant were generally working at full capacity, these countries would also feel the upward pressure on prices emanating from their less disciplined partners. The European System of Central Banks would then have to take countermeasures and reduce overall demand. The primary victims would be producers in the original inflationary countries who had become uncompetitive, but the other countries would also be affected by a general policy of tighter money. As well as a joint interest in price stability, there is therefore an additional Community interest in joint wage discipline. The danger of becoming uncompetitive and losing markets without the possibility of compensatory exchange rate adjustments might foster such discipline.

Full Employment

Whatever the scope for expansionary economic policies in the future EMU, the employment objective must not be seriously affected. It has been proved that full employment or low unemployment rates are possible even during long periods of weak growth. Sweden provides the most striking example. The central policy aim, although not the only one, is to manipulate the achievable demand in such a way that all those willing to work find employment. The most direct way of doing this is to syphon off private demand by means of taxation and to spend the resulting government revenue on the production of labour-intensive services and goods. An indirect way is to make labour relatively cheap and capital (and energy, etc.) relatively expensive by means of discriminatory taxes and subsidies. Another basic way of making production more

labour-intensive is to extend the operating times of the installed capital (machinery, offices, etc.) so that it is combined with a larger number of working hours. If at the same time individual working hours are reduced, the existing capital stock offers even more scope for employing additional labour. The provision of jobs must obviously go hand in hand with appropriate training.

In principle, all of these labour market policies can be applied at national or even sub-national level. The question of exchange rate adjustment does not arise initially, but there are costs involved that must be considered with a view to their compatibility with national competitiveness. Adjustment via the exchange rate would no longer be an option in the EMU. The costs in question, depending on the type of labour market policy, are:

- ☐ taxes to finance state consumption,
- ☐ higher tax burden on capital-intensive production,
- ☐ lower wages than are otherwise possible if working hours are cut.

Care would have to be taken to ensure that as far as possible taxes did not translate into higher production costs or lower capital yields. In other words, the burden would have to fall primarily on households rather than enterprises, although it would still be admissible to tax away "excess" profits. Otherwise, there is a danger that over the long term capital will migrate elsewhere. Labour is more firmly rooted to the national location, but labour mobility is also tending to increase, particularly among highly qualified workers, not least as a result of greater freedom of movement within the EC, so that here too there may be limits to the burden that can be imposed. To the extent that these limits are reached, there will be a need for European co-ordination in this field of policy too.

Income Distribution Objectives

The common market forbids the protection of domestic producers against competition from other Community countries. Locking into a monetary union also removes the possibility of offsetting excessively high wages, ancillary labour costs and corporate taxes via the exchange rate. These two constraints together force individual countries to align their production costs directly with those set by competitors with the lowest overall unit costs. It becomes very difficult to achieve a market income that does not correspond to the actual scarcity value of the production factor involved. Those offering factor services that are in excess supply, such as unskilled workers, may have to be satisfied with very low wages and fringe benefits. The removal of the barriers to migration within the Community may also contribute to eliminating national labour

shortages and undermining the resulting income privileges.

The income distribution determined by the market can then only be corrected through the direct and indirect taxation of households. Here too, however, competition limits the discretion of individual countries. Consumers can circumvent value added taxes and specific consumption taxes that are too high in relation to those in other parts of the Community. Workers with scarce qualifications can increasingly settle in countries with low income taxes. Moreover, the dismantling of the previous protective mechanisms gives some countries an opportunity to undercut their neighbours in terms of tax rates in order to gain market advantages. The other countries then have to follow suit, whether they like it or not.

What has been said with regard to income distribution also applies to environmental protection and other political objectives that entail costs for economic agents and in a broader sense call for an adjustment of personal preferences as expressed in the market. The EMU would therefore be a means of largely removing the entire question of income distribution from the political arena and delivering it up to market forces, with their scarcity and power relationships. If this is politically undesirable, the process of determining income distribution must be recreated at EMU level and new limits imposed on competition waged in terms of tax rates, duties and regulations.

Regional Redistribution

The disadvantage at which peripheral regions find themselves when it comes to the distribution of economic opportunities and growth is not peculiar to a monetary union. It stems first and foremost from the periphery status itself and from the market's inherent tendency to concentrate capital in the growth pole of an integrated economic area. However, in one decisive respect the monetary union restricts the scope for the European periphery to find a market niche that suits its productive potential. It makes it impossible for the countries concerned to devalue their currency more sharply against external competitors (such as the newly industrialising countries) than is deemed appropriate by the highly developed core countries of the EMU, which are largely immune to competition from the NICs. Hence, if countries such as Ireland, Portugal and Greece join the EMU they will be virtually forced to come as close as possible to the productivity levels of their EMU partners.

In the past the possibility of devaluation also played a role, in that wage discipline was more lax in the periphery than in the central growth regions of Europe. Ireland and the Southern European countries are using integration in a

European currency arrangement mainly as a means of combating inflation. Hence the level of costs, which will be virtually frozen in these countries by the abstinence from future devaluations, will tend to be too high. This initial sacrifice in terms of competitiveness was consciously accepted as the price of the monetary stabilisation they want to achieve.

Against the background of fixed exchange rates within Europe, it is now a question of establishing a favourable relationship between wages, other costs and productivity. This is *first and foremost* the responsibility of the countries concerned. Monetary union should make their task easier in one respect, since the removal of the exchange rate risk should allow interest rates to fall, thus reducing a marked cost disadvantage in relation to the industrial core countries of the Community. However, competitive wages, interest rates, land prices, and so forth are not enough. Notwithstanding all of these, it comes down to attracting investment into the peripheral regions, so to speak against the tide of market forces. In *this* respect it is also a task for the Community.

It is not a task for which there is a simple recipe, however. Financial transfers from rich to poor regions are not the solution, as numerous examples of unsuccessful regional development policy have shown. If regional development potential is lacking, financial transfers ultimately only subsidise public consumption in the poorer regions. Transport and communications infrastructures are included in this. Generous credit facilities to permit budget and current account deficits may run up against sensible debt limits, which in many cases have already been reached. The fact that regional policy nevertheless operates primarily through financial transfers (distributed mainly by the structural funds) coincides with the general interest of governments to see a direct expansion of their perennially too narrow scope for spending.

More important than transfers are incentives for productive investment, the promotion of indigenous entrepreneurship and focused measures to eliminate innumerable bottlenecks (with regard to human resources, for example), which together constitute the locational disadvantages of the periphery. These aspects do not lend themselves to the bureaucratic implementation of promotional programmes into which Community aid all too easily degenerates once it has been given political blessing. On the other hand, the less successfully the peripheral countries perform the genuine development tasks, the more important consumption-oriented subsidy programmes become. However, they are undoubtedly as much a political sop as a manifestation of genuine solidarity.

The creation of an integrated economic and monetary area in Europe must not be allowed to obscure the unsolved problems that have arisen since the early seventies in relations among the major economic powers. Changes in saving and investment behaviour in the USA and Japan, and in other country groups as well, have repercussions on the EMU bloc, repercussions that are necessarily reflected in current account balances and possibly also in the level of economic activity. Unless the major economic blocs settle their differences, there is a danger that adjustment will lead directly to recession. Depending how far the monetary authorities in Europe and elsewhere yield to political pressure, it may also fan inflation, which sooner or later would provoke a recessionary correction. This is no abstract possibility; in view of the massive balance-of-payments imbalances that accumulated in the eighties (the twin deficit of the USA), it is a concrete and imminent danger that even opens up the prospect of an escalation of political conflict.

If the USA seriously begins to reduce its current account deficit and hence to bring the constant borrowing by the state and the private sector into line with its national savings, Japan and Europe will have to co-operate on two fronts:

- ☐ they must allow the dollar to decline to a level at which the US economy is competitive enough to have a more balanced current account. This may entail the loss of significant market opportunities, particularly for the structurally weaker countries and regions of Europe;
- ☐ Japan and Europe, for their part, must increase their level of expenditure in order to prevent a decline in world demand as a result of the American adjustment. The most obvious means would be an increase in government borrowing co-ordinated with the USA. Viewed in this light, the massive additional borrowing by the German state in the wake of German unification is very much in the interest of a reduction in tension in the world economy.

Collective co-ordination with non-EC countries – primarily the USA today, perhaps the Third World tomorrow – overlays the equally important intra-European co-ordination of national budgetary policy and savings and investment behaviour. Since an increase in Europe's propensity to spend in advance of the adjustment in competitive positions brought about by exchange rate changes will lead initially to a growth in demand for European products, the necessary international co-ordination may clash with strict adherence to the objective of monetary stability. As there is unanimous agreement that responsibility for exchange rate policy will not be transferred to a future European central bank, one can

foresee delicate problems of co-ordination between this "apolitical" institution and the ministerial committees (or whatever) that will have to decide the target external value of the ECU.

Need for Co-ordination

The co-ordination of national policies within an alliance of sovereign states is necessary or desirable insofar as

- ☐ the spontaneous behaviour of individual states tends to jeopardise or ignore the alliance's common objectives;
- ☐ membership of the community limits the ability of individual countries to achieve their own objectives.

A monetary union is itself a piece of economic policy co-ordination designed to give member states more favourable conditions for creating prosperity. It is an answer to existing interdependence, an attempt to gain control over instabilities that are detrimental to all. On the other hand, however, monetary union increases interdependence and hence creates new vulnerabilities. Member states lose some of the freedom to shape economic policies to attain objectives that are not addressed by monetary co-operation as such.

These may be objectives shared by all member states, or they may be regarded as important by some member states but not by others. As far as common objectives are concerned, there is a danger in a monetary union that "undisciplined" fiscal behaviour by individual member states will push up interest rates for everyone. Depending on the effectiveness of monetary policy, price stability could also be jeopardised. In this area it would therefore be desirable to make the behaviour of individual member countries subject to binding discipline.

To some extent, the monetary union achieves this by its very existence, for it automatically punishes a lack of discipline: the over-indebted state is penalised by high interest rates, and the wage negotiators who ignore the level of costs by a loss of competitiveness. It is precisely because of these automatic sanctions that there is a need for some degree of economic policy convergence before the final move to monetary union becomes even politically acceptable. That was true of progress towards unification in the past and is certainly also true of the transitional period that still has to run before final monetary union (phase III of the Delors plan). Sovereign states, particularly ones that depend on internal consensus, can be *forced* to exercise discipline only up to a certain degree. Convergence to the point where discipline becomes feasible is itself a case for co-ordination. In other words, an explicit common understanding must be reached on the convergence objective.

It is not just a question of discipline, however. If exchange rates cannot be adjusted, situations will repeatedly arise that call not for identical but complementary behaviour. A country can then take the correct action only if it co-ordinates with others. In such instances "blind" co-ordination via the market could entail horrendous costs in the form of lost production. The Community aim of avoiding recessions could virtually go out of the window, as in the absence of explicit co-ordination no-one would be responsible for it. It should be noted that we are talking not about a *general* lack of economic management, but about adjustment problems stemming from a shift in absorption levels.

Income redistribution between the member states of a community is always a case for co-ordination. Here too it is at least partly a question of coming to grips with interdependence, for redistribution is justified (a) by the general notion that countries are dependent on one another and that there should be a degree of equality in order to ensure the necessary cohesion, and (b) by the particular difficulty that membership of the integrated common economic area creates for an independent development policy. Monetary union accentuates this difficulty by removing the possibility of improving national competitiveness against third countries by means of devaluation. It also creates a more urgent temporary need for redistribution if the short-term adjustment capacity of individual member states, particularly those on the periphery, is overtaxed. And it gives rise to an increased need for development aid in order to immunise the peripheral economies against low-wage competition from outside.

The victims of interdependence, with its reduced freedom for individual states to formulate policy, may be the target groups for income redistribution within states themselves. If that is the case, only co-ordination at Community level can restore the scope for redistributive policies.

Binding Rules versus Flexible Co-ordination

How economic policy co-ordination is conducted at EMU level depends heavily on the objective of the exercise. Income redistribution requires a different procedure to that appropriate for macro-economic management, which poses a more difficult problem. In 1989 the Delors Report on the establishment of a European economic and monetary union proposed binding limits for individual countries' budget deficits. However, this proposal is so radical that many find it hard to accept. They object first and foremost to the irrevocable surrender of national, democratically accountable policy

formulation, and secondly to the doubtful economic wisdom of such a move. However, even the opponents of rigid deficit limits are in favour of having some ground rules for fiscal policy to help protect the union from the effects of unbridled national borrowing. This includes, as an important condition of a stability-oriented monetary policy, the prohibition of central bank lending to states. Another important provision would be that over-indebted states received no automatic support from the Community. This would diminish the temptation to pursue an irresponsible fiscal policy. The principle that current government expenditure should be financed fully out of current revenue can serve more as a guideline than as a binding rule.

Two alternatives to fixed, quantitative limits can be envisaged. One is a Community government with sufficient fiscal muscle. At present this is not on the agenda, particularly as the EMU may not initially encompass the entire European Community. The other is flexible co-ordination among member states. One argument in favour of this is the fact that in certain situations it is not fiscal convergence that is needed but complementarity.

From the political point of view, there is obviously much to be said for flexible co-ordination in view of the greater influence individual "sovereign states" continue to have over policy formulation. However, it also contains the danger that member states will fail to agree and hence fail to co-ordinate their policies, something that could have serious economic consequences. To prevent this, the procedural rules for co-ordination would need to exert the maximum pressure to achieve a result. However, this pressure must itself be sufficiently flexible to be politically acceptable. One of the ideas to emerge in the debate on this point was that of multi-annual economic policy guidelines, on which governments would agree and compliance with which would be subject to joint surveillance.

Policy co-ordination is obviously not the only means available to deal with serious policy divergences. One of the other mechanisms is the disciplining effect of the market, the full force of which initially falls on countries accumulating excessive debt. It was, after all, the pressure of market forces that persuaded several member states to submit themselves to the discipline of the European Monetary System, in some cases reluctantly. The other mechanism is the political pressure that the stronger states can exert to make states that are more dependent on co-operation and less able to face conflict to "see reason". The high degree of interdependence in many fields within the European Community should offer ample opportunities to apply leverage in this way.