Europe without Currency Barriers

Samuel Brittan

Does a Single European Community Market, whether achieved by 1992 or slightly earlier or later, need some kind of monetary unification as well, if it is to work?

The strict answer to this crucial question is quite simple: the Community does not *need* monetary unification, but the benefit of having it would be quite substantial. It is perfectly possible to have a genuinely free trading area - in the sense of the abolition not only of customs duties but of non-tariff and regulatory barriers - with floating exchange rates. Exchange rate shifts would then offset not only inflation differentials and real economic changes but also all the countless other factors affecting the demand for specific national currencies.

The experience of the East Asian Newly Industrialising Countries provides evidence that it is possible to have a very high level of trade and pursue fairly liberal trading policies without being part of a larger currency area.

But although possible, a free trading area without a monetary component would be pretty third best and would be far from fulfilling its potential. Indeed it would not justify the term Single Market. We have to face the fact that floating exchange rates have not lived up to the hopes that I, among others, placed in them. The problem is not short term fluctuations, but major swings and misalignments going far beyond the inflation differentials and similar factors to which businessmen in principle could adjust.

So long as these swings continue, business is not going to be indifferent to the geographical sources of its products or the distribution of its markets among different currency areas. Some international companies follow a policy of serving each national European market as far as possible from national sources. Europe will not be a single market - or a series of markets cutting across state frontiers in the sense that the USA is - while present currency uncertainties persist.

Nor should one forget the transactions costs borne by ordinary citizens. The burden they represent is well demonstrated by the story of the keen European who left Paris with 10,000 French francs to visit each Community country, changing his money at every frontier but not actually spending anything. According to the optimistic version of the story he returned to Paris with 5,000 francs. According to more realistic versions, he had almost nothing - just enough to buy a coffee and a croissant and have a wash.

The wider appeal

But the discussion should not stop at these mundane matters. There are two European Community developments capable of appealing to popular imagination. One is the removal of customs posts, so that the physical barriers between European states can be seen to come down.

The second is dispensing with the services of the money changer, so that the same currency can be used on a journey from London to Rome or Munich, as from London to Manchester. This cannot happen by 1992, but can at least be an aim.

It would be wrong to think of two polar opposites of completely independent currencies versus a single European currency. At one extreme there can be fully floating exchange rates and monetary policy geared to purely domestic targets. Then there is a degree of informal management designed to overcome the worst forms of "overshooting" (such as the Plaza and Louvre accords among the Seven Summit countries). Beyond that there are systems designed to make exchange rate changes smaller, smoother and less frequent, as in the existing European Monetary System. Further on is the goal of permanently fixed exchange rates. Finally there is the possibility of having interchangeable currencies leading to a full scale European money. The further one goes along this road the lower will be the costs of currency transactions to both business and individual citizens, although it is only in the final stages that they will be eliminated.

The enthusiasts for European integration have done a disservice to their own cause by their excessive emphasis on a common currency and a common central bank. These institutions will come as a crowning achievement. By talking about them so much now, the Community protagonists have merely caused a reaction on the part of national governments (not just the British) and also on the part of earthbound central bankers.

The place to begin is with the undeniable success scored by the European Monetary System in recent years. Exchange rate fluctuations among the continental European countries have been getting smaller since the EMS came into operation in 1979. In the decade that has elapsed since then, there have been seven "realignments" in central parities involving the German mark or the French franc. But over the period they have grown less frequent and smaller.

Changes in EMS Central Rates

Dates of realignments

	24/9 1979	30/11 1979	22/3 1981	5/10 1981	22/2 1982	14/6 1982	18/5 1983	21/3 1983	21/7 1985	7/4 1986	4/8 1986
Belgian franc	0.0	0.0	0.0	0.0	-8.5	0.0	+1.5	0.0	+2.0	+1.0	0.0
Danish kroner	-2.9	-4.8	0.0	0.0	-3.0	0.0	+2.5	0.0	+2.0	+10.	0.0
German mark	+2.0	0.0	0.0	+5.5	0.0	+4.25	+5.5	0.0	+2.0	+3.0	0.0
French franc	0.0	0.0	0.0	-3.0	0.0	-5.75	-2.5	0.0	+2.0	-3.0	0.0
Irish punt	0.0	0.0	0.0	0.0	0.0	0.0	-3.5	0.0	+2.0	0.0	-8.0
Italian lira	0.0	0.0	-6.0	-3.0	0.0	-2.75	-2.5	-7.8	-6.0	0.0	0.0
Dutch guilder	0.0	0.0	0.0	+5.5	0.0	+4.25	+50	0.0	+2.0	+3.0	0.0

From its inception up to and including the May 1983 realignment, the average annual appreciation of the mark's central parity against the French franc was over 7 per cent. Since 1983 it has been about 2 per cent.

Inflation rates have declined and inflation gaps have become narrower as other EMS members have reduced their inflation rates towards the German one, sometimes by sensational amounts. Although disinflation was initially slower in the EMS than in non-participating countries, it has proved more sustained. Who would have thought that in the late 1980s the French rate of inflation could fall to 2 or 3 per cent, half that of the underlying rate in Britain?

The volatility of exchange rates within the EMS has declined and this has probably outweighed any increases in volatility against non-member currencies. Perhaps more surprisingly, interest rate volatility has also fallen since 1979, probably because of the greater credibility of the exchange rate assurances of governments and central banks.[1]

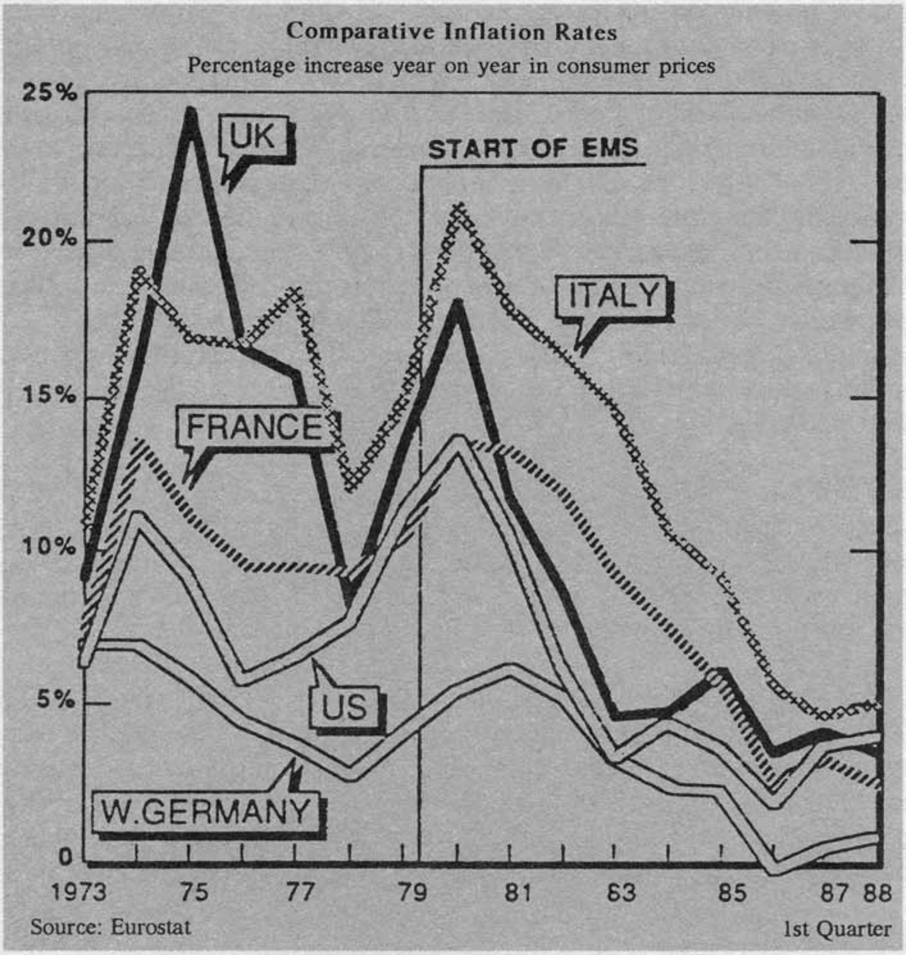
Like the gold standard and Bretton Woods in the past, the EMS has operated under the leadership of one country - Germany. And Germany (or the Bundesbank) has been the anchor of the system and has set monetary policy mainly with regard to domestic inflation objectives. Other countries have had to follow suit to minimise realignments and capital outflows.

Credit and intervention

In the early period of the EMS a great deal of attention was focused on mutual credits and intervention. More recently the pendulum has swung to the other extreme and in many accounts they are hardly mentioned at all.

At the outset member countries "transferred" some 20 per cent of their gold and foreign exchange reserves to the European Monetary Co-Operation Fund (EMCF) in exchange for official European Currency Units (ECUs). "Transferred" has been put into quotation marks because there is no higher central banking institution into which the national central banks can transfer their reserves, which remain on the books of the national central banks and are made available to the EMCF by three-monthly renewable swap agreements. All members of the EMS have taken part in this pooling arrangement, including countries such as the UK which do not belong to the Exchange Rate Mechanism (ERM).

These pooled reserves have not played the key role that the more integrationist supporters of the EMS had hoped. The official ECU is not allowed to circulate in private hands and therefore cannot be used for official intervention either within the EMS or against outside currencies.



A range of credit facilities is available to help member countries under pressure. A conditional Medium Term Financial Assistance (MTFA) facility and Community Loan Mechanism, both set up before the EMS, were merged in 1988. The only occasions when either was used after the establishment of the EMS in 1979 was a loan of ECU 4bn to France in support of the 1983 adjustment programme and a loan of nearly ECU 1.8bn to Greece in 1985.[4] There is also a quasi-automatic facility for Short Term Monetary Support (STMS), which has not so far been used in the EMS period. The loan ceilings for both the MTFA and the STMS are quite modest - ECU 13bn and ECU 8.9bn respectively for the aggregate of all members. So they could not today be of decisive importance to a leading country facing currency problems. (One ECU is approximately equal to two Deutsche Marks).

A more important kind of credit arises from the EMS rules which establish a parity grid linking every single member currency bilaterally with every other. Under the Exchange Rate Arrangement intervention becomes obligatory when a currency reaches either the downward or the upward limit of its permitted bilateral band fixed against every other currency. To help it maintain the agreed ranges the central banks of the currencies under pressure can call in aid unlimited intervention from their partners under the Very Short Term Financing Facility (VSTFF). There is also optional intramarginal intervention under this facility, which has been boosted in importance by the Basle-Nyborg Accord of 1987.

The VSTFF has proved by far the most widely usded EMS facility. Very short term concerted central bank intervention has occasionally been heavy - for instance when the Deutsche Mark came under *downward* pressure in 1986. Although no details are published, such central bank credits have been repaid quickly and no significant overhang has been allowed to develop.

The main adjustment mechanisms under the EMS have thus turned out to be domestic monetary policy and occasional realignments. Occasional heavy intervention has been helpful so long as central banks have been supporting perceived underlying trends and policies. Knowledge of the automatic nature on the obligations has added credibility to the parity grid and to central bank efforts to gain the upper hand during periods of temporary speculative pressure.

The inconsistent quartet

The EMS has worked better than expected partly because, for most of its life, a general consensus on the priority of reducing inflation has reduced policy conflicts. In addition, during the periods when the dollar has been unexpectedly strong, the mark has been unexpectedly weak in world markets and this has reduced the pressures on the other EMS countries.

The freeing of capital movement and the abolition of exchange controls due not by 1992, but by 1990, will be a fresh test for the system. The nature of this test has been described by a high official of the Bank of Italy, Tommaso Padoa-Schioppa (now a secretary of the Delors Committee on Monetary Union), as the problem of the inconsistent quartet. The members of this quartet are (a) free trade, (b) full capital mobility, (c) fixed exchange rates and (d) autonomy of monetary policy.[2]

There are many ways of posing this problem. For the sake of simplicity, let us consider a hypothetical example. If the French franc is expected to depreciate against the German mark within the next few weeks, then huge interest rate differentials will be required to prevent enormous floods of hot money rushing out of France and into Germany, thereby threatening the whole system. On the other hand, when no realignment is expected, interest rates will have to be

The Thaler, the dollar's ancestor.

nearly identical to prevent a flood of money the other way. This may not make much sense if France has a higher underlying inflation rate than Germany.

From this dilemma two opposite conclusions are drawn. The first, the Thatcher/Walters view, is that the EMS will collapse - or at least be rendered ridiculous - and that this will let Britain off the hook on EMS membership. The alternative conclusion is that there is an urgent need to move from the present EMS to full monetary union. It is not the first time that people at opposite extremes have started from a common analysis.

Before going any further, one should point out that exchange rate controls are far too leaky to stop hot money floods. Moreover, France has already gone 90 per cent of the way to removing controls over cross frontier movements of funds.[3] So if the inconsistent quartet was so unmanageable, it would already have destroyed the EMS without waiting for 1990 or 1992.

Using the margins

Why has the threat from capital liberalisation not materialised? There are two reasons. First, the EMS does provide a 2.25 per cent currency margin for each country (and 6 per cent for Italy). This means a total permissible bilateral swing of 4.5 per cent between any two currencies if each end is at the opposite end of the permissible range.

Secondly, there is uncertainty about the timing and extent of parity changes. There is usually a moderate chance of a modest franc-mark realignment in the coming year - which is enough to allow a sizable interest rate differential to persist.

The technical rule to stop speculators from having a one-way option in a regime of managed existing rates is well known. It is that the maximum change in the central parity must be less than the permitted band of fluctuation. With this rule in force, it would be possible for the market exchange rate for the franc to be higher after the weekend of a realignment than it was the week before.

Although a slightly wider margin might have been desirable, the Europeans will have to live with the 4.5 per cent band. But something nearer to the Italian band may be a necessary transitional step if entry is ever to be sought by a country like Britain with a major international currency and an internal need for relatively high interest rates.

The 1987 Basle-Nyborg Agreements provided not only for more "intra-marginal" intervention by central banks before the limits of the bands are reached, but also suggested greater movement of market rates within the bands. To avoid destabilising jumps it will also be necessary for realignments to be moderate. (The realignments of 1985 and 1987 did conform to the technical rule, but not that of 1986.)

The conditions for stability are thrown into relief by the arguments about the current desirability of a franc-mark realignment. The Bundesbank has appeared to favour one, while the Bonn Finance Ministry has joined the French Government in opposition. The main reasons are that the Bundesbank believes a mark appreciation would be counterinflationary, while the Finance Ministry wants to maintain the competitiveness of German industry. But as a subsidiary reason the Bundesbank favours a small realignment now within the parity band rather than have disruptive large realignments later. An outsider to this three-cornered debate can only observe that the first best policy would be no realignment if the two countries can run their domestic policies to sustain the current parity; the second best would be a small realignment of under 4.5 per cent, while third and worst of all would be a large, or larger realignment later.

If the Community can surmount the hurdle of capital liberalisation, it becomes then possible to think of making exchange rate changes smaller and fewer until eventually it is possible to narrow or even abolish the margins of fluctuation and think of permanently fixed exchange rates. *But to reduce the margins prematurely would be the greatest single mistake that could possibly be made.*

Schools of thought

Before moving on to further developments a most important word of warning is required. Managed exchange rates and eventual monetary union attract both hard and soft money protagonists. The former favour the EMS and further developments towards monetary union as an anti-inflationary mechanism for their countries - in return for which strong currency countries like Germany secure the benefits of a wider zone of monetary stability. From this point of view it is important that the weaker countries concentrate on their nominal exchange rates and minimise depreciations.

The Aureus, the ECU's ancestor.

There is, however, an opposite school that wants to use the European institutions to secure "competitive exchange rates"; its members observe that movements in market determined exchange rates do not always follow comparative international cost movements; and they are looking for a political mechanism which will do so instead. Its British adherents would, for instance, use the EMS to lower the sterling exchange rate. As their price for the eventual reduction or elimination of parity changes they would like more emphasis put on expansionary policies - fiscal as well as monetary - by the stronger countries, a policy they call "symmetry".

But how desirable is monetary union? Some economists and many politicians believe that there will be economic loss as well as gain if countries abandon control over their monetary destiny.

The underlying issue is as follows. If you believe that the right to allow your currency to appreciate or depreciate is a fundamental instrument of economic adjustment, you will ask a high price for monetary union. You might even play with the opposite alternative and ask whether existing currency areas are too large and whether there should not be a Scottish pound, or a Schleswig-Holstein mark.

The case for exchange rate variation depended on the idea that there was a trade-off between growth or employment on the one hand and low inflation on the other. This was known in the economics trade as the Phillips curve, which showed unemployment on one axis and inflation on the other. If unemployment was low, inflation was high and vice versa. Translated into policy terms it suggested that each country should choose its own place on its Phillips curve; and that countries that gave greater priority to low unemployment could offset the inflationary consequences by allowing their currencies to depreciate.

To cut a long story short: both the history of the 1960s and 1970s, and developments in ideas have undermined the notion of any stable long term trade-off. Of course, there can still be a heavy transitional unemployment cost in reducing the rate of inflation (as Mrs. Thatcher discovered in 1980-81); and a once-for-all currency adjustment may be advisable for a country joining a monetary union or even the existing EMS. But in the long run a country with one or two per cent inflation is unlikely to be worse off in terms of growth or employment than one with 10 per cent inflation. Indeed the opposite is likely to be true. For the 10 per cent inflation rate will be volatile and variations around it difficult to predict.

If this reasoning is provisionally accepted, why not settle for the advantages of low or zero inflation? And why not in addition avoid the costs and inconveniences of fluctuating exchange rates by giving up the right to depreciate?

It is not only the Phillips curve that has been discredited, but simple monetarism too. Many countries have found the greatest difficulty in selecting either monetary aggregates or target ranges for them which will provide for a non-inflationary growth of nominal demand.

But this very failure reinforces the case for stable exchange rates, for one way round the problem of the monetary indicators is to tackle it indirectly. If a country pegs its currency to the currency of another non-inflationary country, it is likely to experience broad price stability. Within the EEC, the Federal Republic has managed to secure rough price stability; and the Bundesbank has earned credibility by a pragmatic approach with a long history of success. Other countries, with very different records, and reputations, are more likely to conquer inflation by tying themselves to the mark than by a search for a domestic monetary grail. This is a route which France has taken: and Britain has not. It is no coincidence that the French inflation rate is well below the British.

But even if France has imported low inflation via the EMS, has not the price been excessive? Has it not led to a loss of French competitiveness, a French current payments deficit, and thus slow growth and rising unemployment?

Now maybe this is how unreconstructed French devaluationists on the left and nationalist opponents on the right would have liked things to have happened. But the picture is largely mythical. French competitiveness has actually improved over the last three years on most international indices and is now better than whén the EMS was formed in 1979. There was indeed a loss of competitiveness in the early stages of the EMS. But this has since been more than offset, first by the early Mitterand devaluations and more recently by an actual fall in French unit labour costs. Whatever else French unemployment is due to, it is not that of low international competitiveness on any obvious cost yardstick.

As for the French payments deficit: it is trivial, well under 1 per cent of GDP. This is a small fraction of that of the US or UK and well within the margin of error of the figures. A rundown of French overseas assets has been matched by a build-up of the French domestic capital stock; and the relaxation of exchange controls ensures that the rate of return on these domestic assets keeps up with those prevailing internationally.

Traded and other goods

Maximum clarity is required on the issue of what kind of price stability an arrangement such as the EMS can and cannot provide. It is primarily stability in the prices of traded goods and services - traded in the sense of moving across the frontiers of the country or region concerned. Manufactured goods are especially prominent here, but there are plenty of traded services - from tourism to investment banking.

Let us suppose, hypothetically, that Germany has complete price stability, including price stability for traded products. Then market forces will ensure that the price of UK traded products will not in the long run rise either, if the pound is tied to the mark.

But suppose also that UK productivity in *non-traded* services - housing, the retail trade, transport and so on - perform less satisfactorily. To be specific: suppose that productivity in the British non-traded sector has been rising by

4 per cent less than in the German one. Then prices in that sector can also rise by 4 per cent. The overall UK inflation rate will depend on the comparative size of the traded and non-traded sectors. It would in fact be likely to settle at just under 3 per cent. (It should, however, be kept in mind that it is an over-simplification to call all the forces that determine prices, other than pay, productivity. Where scarce factors, such as land, are involved, the inflationary forces can come from the demand side, almost irrespective of productivity.)

Rough stability in the prices of internationally traded products is the best approximation to zero inflation that countries like France and Britain can expect - certainly better than these countries have achieved since World War II. If that were achieved, overall price inflation would almost certainly settle down well inside the 0 to 5 per cent bracket, even as conventionally measured.

An obvious question to pose at this stage is that of why Britain's recent experiment in shadowing the Deutsche Mark did not have the expected theoretical effect in curbing British inflation. The short answer is that it would have done so if the British Government had stuck with it long enough.

Medieval mint.

There is, however, a longer answer to this question. The pegging of sterling to the mark lasted only a year - from spring 1987 to spring 1988. It was introduced almost by subterfuge by Britain's Chancellor of the Exchequer Nigel Lawson, without any formal undertakings or commitments. This is in contrast to France, where the practice of using the EMS to maintain the link with the mark is a principle of policy and has been adhered to by both left and right-wing governments - although the probability of a franc-mark realignment has always been higher than zero. In Britain by contrast, business has had no reason to abandon the view that the long term trend of sterling is likely to be downwards. Thus the British experiment did not lead to a breakthrough in the expectation of wage bargainers.

There was, however, a further factor. The domestic inflationary forces in Britain were concentrated in the credit, and particularly the mortgage, markets. These markets experienced both a bonfire of controls and an outbreak of ferocious competition among lenders not seen in Germany (or any other continental country).

One moral is that an exchange rate link with a hard currency country is a more effective constraint on inflation if there is a wider unification in financial markets as well. In principle, this is provided by the plans for a Single Market in 1992. But one should not take the year too literally.

Towards a monetary union

The Delors Committee has been set up to suggest steps from the managed exchange rates of the EMS towards monetary union. The report has to be ready in time for the Community Summit in Madrid this June.

The simplest way to define monetary union is: *an area of permanently fixed exchange rates, with no exchange controls or other institutional barriers to the free movements of capital or circulation of currencies.*

Defined in this way, monetary union falls short of a common currency and no more requires a United States of Europe than the gold standard or Bretton Woods required a United States of the Western World. So long as there are separate currencies, however strongly linked, it is always open to countries to leave the arrangement; and any subordination of national financial policy to common requirements is on a voluntary basis.

One very early step likely to be recommended by the Delors Committee is the strengthening of the authority of the existing European Community Committee of Central Bank Governors. The idea is that they should try to formulate jointly goals of domestic monetary policy which would be consistent with exchange rate stability at a low rate of inflation.

If the Delors Group is wise it will concentrate on the substance of what this strengthened Central Bank Committee might do. To insist at this stage on calling it a Federal Reserve type of institution or arguing about whether the Committee should have powers over member central banks would be to ask for unnecessary trouble. So too, is talk of amending the Treaty of Rome yet again.

The existing exchange rate arrangement of the EMS was established by a 1979 agreement between central banks to link financial facilities. It is thus not part of the Community institutions, which no doubt rankles with the Commission and is one reason why there is so much talk at so early a stage of amending the Treaty of Rome. Such talk is not only unnecessarily provocative, as there is a long way to go in strengthening the existing EMS; it is also a distraction from the task of discussing actual policy whereby exchange rate stability could be combined with low inflation and open frontiers.

The case for the Deutsche Mark

Indeed there has been far too much discussion of institutions and not nearly enough of the policies that any monetary body should follow to secure the maximum of exchange rate stability with the minimum of inflation.

**Samuel Brittan is Assistant Editor
and Principal Economic Commentator
of the Financial Times.
His latest publication is
A Restatement of Economic Liberalism,
London, MacMillan, 1988.**

If a great deal of what has occurred in European history before the foundation of the Federal Republic of Germany could be wiped out, both experience and simple theory suggest that Community countries should next concentrate on a credible fixed exchange link against the Deutsche Mark and on making a reality of "1992".

Europe's ideal common currency would be the Deutsche Mark and the ideal European central bank would then be the Bundesbank. This truth, however, affronts both nationalists and federalists. It affronts European nationalists for obvious reasons: even Germans are embarrassed to hear it spelt out. It affronts federalists and Eurocrats because it cuts out much complex institutional building, and employment opportunities for armies of experts, commentators and Euro-politicians.

The genuine political obstacles are memories in most European countries which prevent an easy acceptance of German hegemony, however confined that hegemony is to the monetary sphere. Without the disguise of the EMS, it is doubtful if any French Government would have been able to get away with a hard, mark-linked domestic monetary policy.

If the Community is to move to more stable, durable currency links, the system would at least have to *look* international, with a symmetry of obligations.

On what principles might such a system evolve? To answer this question one can usefully borrow (and adapt) some ideas of Professor Ronald McKinnon of Stanford. McKinnon himself takes the Western industrial world, including Japan, as an optimum currency area. He would establish that area by an agreement between the three main principals, the US, Japan and Germany, to which other countries could adhere.

But if it is too ambitious to expect a worldwide currency area, these same ideas and principles can still be adapted to the European Community. In particular, one could think of transforming the EMS into a genuine currency area, preferably with the British as members, but not making the fatal mistake of holding up progress until the British agree. What then does McKinnon suggest?

His *Principle Number One* is to establish exchange rate bands. He himself would establish the central rates on the basis of purchasing power parities. But other economists are legitimately much less confident of the actual possibility of estimating these parities or that official central rates should be based upon them. It seems indeed wiser to say that the project can get going once exchange rates are roughly in the right region. From then on, normal monetary policies can be used to prevent them from straying.

Principle Number Two provides that countries whose currencies are weak - that is, tending towards the lower edge of their band - would tighten monetary policy, in practice raising interest rates. Strong currency countries, whose currencies are threatening to burst out of the top of their ranges, would loosen policy.

Principle Number Three holds that intervention should also be used if there is strong pressure on currencies, but it should be unsterilised. In other words, the money supply in the weak countries would automatically contract, and in the strong countries automatically expand, as a result of the intervention. Thus, far from being a cop-out, intervention would be reinforcement of the required domestic changes.

As for *Principle Number Four*: the previous three principles should secure common movement of the prices of traded goods in the whole area. But it is even more important to see that this common movement is not inflationary - nor deflationary either. McKinnon would, therefore, monitor produce price indices in the major countries. If their common tendency were to rise, members would collectively agree to tighten their monetary policies. If producer prices were weak, they would agree to a loosening

The detail is endlessly debatable. But the principle of collective action to ensure overall price stability - and not merely currency stability - is crucial.

The distraction of the ECU

So far little has been said about the ECU which has been over-emphasised by both friend and foe of monetary union.

The ECU, whether in its official or its private variant, is not a genuine currency. It is rather a basket of existing currencies. The private ECU comes into existence through bankers bundling together the component currencies in the required proportions to produce ECU-denominated deposits and loans. In the last analysis the creation of ECUs is regulated by the average monetary policies of Community central bankers. (ECU bond issues were running in 1988 at nearly $ 20 billion or some 5 to 6 per cent of total international bond issues.)

The official ECUs are created when Community central banks receive them from the European Monetary Co-Operation Fund in exchange for gold and dollar reserves. Indeed as Gavyn Davies has pointed out,[5] the official ECU is simply another name for these reserves; and the official ECU cannot circulate in the private market.

There are numerous plans for increasing the use of the ECU and allowing the official ECU to circulate, thus removing the distinction between the private and the official variety. The further these plans go, the greater the freedom of the commercial banks to create ECUs and the greater the need for a unified central bank policy to prevent their excess creation. The Bundesbank is particularly worried about the spread of ECUs, which have a 35 per cent mark component, outside Germany beyond its effective control.

It is certainly possible to spell out steps whereby ECUs eventually become a genuine European currency. But if the ten component currencies are to be brought together and realignments minimised, what is the point of an eleventh parallel currency made up of the existing ten?

The Delors Committee is certain to celebrate the symbolic importance of the ECU and recommend some modest steps - such as further ECU issues by national governments along the lines of the recent British Treasury Bill issue, and allowing official ECUs to be used for foreign exchange intervention.

But too much emphasis on the ECU now can be a diversion from the main task of promoting internal monetary policies in member countries which would make for exchange rate stability at a low inflation rate and without which there can be no monetary union, let alone common currency as Mr. Anthony Loehnis, until very recently a Bank of England director, has warned.[6] In any case the German authorities would veto the development of the ECU as a major parallel currency, and in the face of British hostility, Germany is quite indispensable to monetary union proper.

Professor McKinnon believes that currency stability can be achieved by agreement between sovereign national authorities and does not see the need either for common central banks or a single currency: "Almost all the benefits

The ECU-Composition, Central Rates and Weights

	Amount of National Currency in basket	Central Exchange Rate Against ECU Since 12 Jan 1987	Weight of Currency in ECU*
DM	0.179	2.05853	34.93
Ffr	1.31	6.90403	18.97
Dfl	0.256	2.31943	11.04
Bfr	3.71	42.4582	9.07
Lfr	0.14	—	—
Lit	140	1483.58	9.44
Dkr	0.219	7.85212	2.79
£IR	0.00871	0.768411	1.13
£ST	0.0878	0.739615	11.8
Dra	1.15	150.792	0.76

* Based on existing central rates as of 12 January 1987.

of a common monetary standard - where people expect exchange rates to remain essentially the same twenty years from now - can be secured with national monies remaining in circulation. As under the late nineteenth century gold standard, each government could regulate its own banking system somewhat differently. Indeed, introducing a common currency and supernational central bank might needlessly confuse lines of responsibility for assisting failing domestic financial institutions."

On the other side it can be said that the full benefits of a single capital market and credibility on the inflation front will only be realised if there are no longer national currencies which governments can, as a last resort, take out of the system. McKinnon may underrate both the expense and inconvenience to private citizens and to small businesses of currency transactions.

The British Government has made it clear that it will not give up its own pound sterling at any price. Nevertheless, the Delors Committee may be able to obtain some measure of agreement by stating the steps required for full monetary integration, leaving it to governments to decide whether such steps are desirable or not.

The best hope does indeed lie in the evolutionary route. Once it is accepted that parity changes have become a thing of the past, currencies will become increasingly accepted across frontiers as they already are in border areas.

Eventually the difference between one European currency and another could approximate the difference between English and Scottish pound notes, or Belgium and Luxembourg francs. The different national names can be changed when public opinion is ready.

Towards a Euro-*Bundesbank* ?

When currency equivalence has got that far, it will be essential to have a European central banking institution to ensure that the newly evolved currency is neither over- nor under-issued. Even in the earlier stages when separate currencies are commonly used across frontiers, individual central banks will lose much of their power over monetary policy, which will have to be determined on a Community basis.

The Bundesbank has enunciated three key principles for any European central banking institution: it should be constituted on federal principles; it should be constitutionally committed to price stability as its first priority; and it should have the same independence from national governments (and the Brussels Commission) that the Bundesbank already enjoys.

There is no need to debate whether the Bundesbank would really like a European central bank in its own image or is simply putting forward tough conditions to stall the whole exercise. "Seek not to look into the hearts of men." No doubt some members of the Bundesbank have one motivation, some another and many mixed. It would be better if the British authorities lined up with the Bundesbank position, which is at least an improvement on the present negative and carping UK attitude.

A central banking institution along the lines advocated by the Bundesbank is undoubtedly a diminution of national sovereignty. It has been ruled out on these grounds alone by the British Chancellor Nigel Lawson in a keynote speech at Chatham House, which did not contain a single economic argument against the project. National sovereignty is less impressive when in practice it merely means the right to inflate at a faster rate than Community partners.

But one needs to go slowly before taking refuge in irreducible value judgements. For national sovereignty is in any case a matter of degree. A government can in the last resort leave a monetary union even when there is a common currency. The most recent example is Ireland, which until 1979 had a currency which was virtually identical with the UK pound and which was universally accepted without premium or discount. Yet when Ireland joined the EMS in 1979, the exchange rate link was severed and the Irish pound emerged for the first time as an independent currency.

No need for a common budget

There is another misconception which surfaced in the Chancellor's speech. This is that a single monetary policy requires a common fiscal policy and in particular central control over budget deficits. Here Mr. Lawson is reflecting the British Treasury's attitude to local authorities in his own country. In existing federal states there is no central control over regional budget deficits, certainly not in the US and not in the Federal Republic either.

Moreover, no such control is necessary or desirable as a matter of principle, especially for someone who claims to have disowned the use of fiscal policy for demand management as Mr. Lawson has. All that is required is that the European central bank should not monetise budget deficits. The capital markets will then exercise their own discipline over excess borrowing.

Another frequent assertion is that monetary union requires large fiscal transfers which can only be envisaged with a far larger Community budget, which would itself require some form of federal control. The claim, which appeals both to extreme Community enthusiasts and opponents of monetary union, is based on the mainly automatic transfers which now take place in existing federal states such as Canada or the Federal Republic of Germany.

Let us assume that such fiscal transfers really do cushion economic shocks in particular regions, which would otherwise be expressed as balance of payments problems. If such transfers are not available on the same scale on a Community basis, this may be sad for the victims.

But the absence of monetary union does not help. All that a country gains from staying out of a monetary union is that it retains the right to devalue (or revalue). It does not gain a single penny of extra resources.

The right to devalue should only appeal to those who still believe that there is enough of what Keynes called "money illusion" to engineer a cut in real wages by the devaluation backdoor.

The Tempo, the yen's ancestor.

The fiscal argument is important because it is used by left and right alike to oppose not merely a common currency, but monetary union in the simpler form of permanently fixed exchange rates. It is the argument which stands behind the claim both of Mrs. Thatcher and her more extreme opponents that European monetary union pressupposes a United States of Europe.

The existing EEC is less than a United States of Europe, and much more than an alliance of national states. Why not let it develop rather than become bogged down in semantic arguments about what it really is - a conclusion which applies as much to monetary affairs as anything else?

Conclusion - two speed Europe?

It is sad that the move towards monetary stability in Europe could be threatened by a holy war between those who believe in integration for its own sake and those who think of national sovereignty in absolute terms.

The most prudent advice one could possibly give to the British Government on the monetary union issue would be to stick close to the Bundesbank which shares its distrust of integration for its own sake and its prior commitment to economic liberalisation and low inflation. But if in the end, the British Government will not commit itself even as far as the Federal Republic, then the possibility of a two-speed Europe may have to be faced.

It is regrettable that the UK is dragging its feet on both the abolition of customs frontiers and monetary union. But that is hardly a new experience in European development. The lesson since the Treaty of Rome is that it is better if necessary to go ahead without Britain, which will later come knocking on the door.

If that means a two-speed Europe, so be it. There may even be some advantages, in the context of the re-entry of Eastern Europe, of having an inner and outer grouping, with the latter having fewer obligations but also fewer rights. Each country must decide to which group it wishes to belong.

References

[1] M. J. Artis and M. P. Taylor, *Policy Co-Ordination and Exchange Rate Substitution*, Evidence to House of Commons Treasury Committee, London, 1988.

[2] Chapter in *The European Monetary System*, Giaviazzi (ed.) *et al.*, Cambridge University Press (for the Centre of Economic Policy Research), London, 1988.

[3] Italy has further to go as it has used capital controls for the separate purpose of inducing domestic savers to finance the high budget deficit.

[4] A series of papers by McKinnon is available from the Department of Economies at Stanford. University

[5] Gavyn Davies, *A Plan for European Monetary Union*..

[6] Bank of England Bulletin, November 1988.