ASSOCIATION FOR THE MONETARY UNION OF EUROPE

A SINGLE CURRENCY FOR EUROPE
ECONOMIC POLICY AND FINANCIAL CHOICES

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1. After more than ten years of experience with the European Monetary System, a positive judgement can be passed on the effects of a brave and farsighted initiative that has overcome technical scepticism and national particularism and created an area of exchange rate stability in Europe. As a consequence, within this area we have largely avoided the monetary upheavals and the swings in real exchange rates from which the other leading currencies have suffered.

Exchange rate stability has contributed considerably to the expansion of trade and the integration of markets; further benefits will stem from the creation of the single European market, which will extend the process of integration to services and financial intermediation. The EMS has also had a beneficial effect on the conduct of economic policy: high-inflation countries have used the exchange rate constraint as an anchor for their disinflation programmes, while those with low rates of inflation have benefited from a stimulus to their exports, and hence to their growth. The EMS has also fostered cooperation, especially in the field of monetary policy coordination.

2. The results achieved have created the conditions for the removal of the restrictions on capital movements, a process that will be ended by June 1990. In turn, this will make it possible to accelerate the economic integration foreseen in the Single European Act and allow Europe to participate fully in the globalization of financial markets.

There is nonetheless the risk that the liberalization of capital movements will be completed in conditions of insufficient convergence of the economic performances and policies of the EMS countries. The narrowing of the inflation differential has come to a halt and actually shows signs of reversing; trade imbalances are growing; fiscal policies continue to remain outside the mainstream of coordination; and serious budget deficits persist in some countries. A new drive to coordinate policies with the aim of overcoming these difficulties and setting convergence in motion again is essential if exchange rate stability is to be preserved and full monetary union achieved.

In particular, complete freedom of capital movements is not compatible with the present level of monetary coordination in Europe. Failure to make progress in this field could eventually undermine exchange rate cohesion. At this point, we are faced with a paradox: the less binding the exchange rate constraint, the greater the possibility of destabilizing portfolio flows and "jumps" in the domestic demand for money. In other words, to reduce the risk of instability inherent in the integration of financial markets, we must move towards increasingly fixed exchange rates. This, however, will imply increasingly binding constraints on national monetary policies.

Progress towards closer monetary coordination was made with the Basle-Nyborg agreement of September 1987. In addition to making very-short-term finance available for intramarginal intervention, thereby increasing the flexibility of the system, the agreement recognized the need for greater symmetry in interest rate movements at times of exchange rate pressures.

The conservation in tomorrow's conditions of capital mobility of what has already been achieved will require new initiatives to strengthen the discipline imposed by the exchange rate. A key step could be to publicly announce that the fluctuation band about the central rates will be gradually narrowed and eliminated altogether after a certain number of years. This would give explicit force to the commitment to arrive at a fixed exchange rate system and the positive effect on expectations would be reinforced by the discipline all the member states would accept on their domestic costs and prices.

The undertaking to "tighten the screws" of the exchange rate mechanism would only be credible, however, if it were accompanied by the setting of coordinated objectives for monetary growth and agreement on the size of budget deficits and the manner of financing them.

In other words, monetary coordination will have to go beyond day-to-day management and include the joint determination of monetary objectives to ensure their compatibility. Until now, in practice, we have had an asymmetrical pattern of coordination, with the Deutsche Bundesbank establishing the monetary policy of all the EMS countries through the exchange rate constraint. This formula was especially useful during the phase of convergence on lower rates of inflation, but it is no longer justified today on economic grounds, and even less politically.

3. The success of the EMS, the liberalization of capital movements and the impetus given to the integration of markets by the Single European Act have rightly brought the question of European monetary unification to the centre of the stage.

Monetary union is, of course, a potentially important complement of the single market and economic integration. It will require a central monetary institution and, in the end, a single currency. The establishment of a European central bank is not a priority need, but there are nonetheless decisions pending on monetary and foreign exchange matters that will have important implications for the future. This explains why it would be desirable to agree at this stage on a European monetary design that would serve as a reference framework for decisions on individual issues and ensure consistency with the overall construction. Great importance attaches, in this respect, to the work of the Delors Committee, which was set up at the initiative of the European Council and is to report before the end of June with proposals on the stages of a gradual advance towards economic and monetary union.

A European central bank will have to be independent of national governments, the European Council and the Commission, though not indifferent to the policies that these bodies adopt. This will protect the power to create the common currency from abuse, impose market discipline on governments and ensure priority is given to the defence of monetary stability.

This, of course, is easier said than done. Independence conflicts with the institutional arrangements in place in some countries, in which the central bank's sphere of autonomy is restricted and sometimes subordinated to the will of the government.

The problem of the central bank's independence is closely linked to that of the extent and timing of the transfer of other economic policy functions to the Community. The decision to centralize monetary policy at the European level before acting on fiscal policy already implies a choice in favour of an independent central bank. In principle, of course, there is no need for sovereignty in these two fields to be transferred simultaneously. History offers numerous examples of monetary unions (federal states) with highly decentralized fiscal powers. This formula naturally implies that the "regional" governments can no longer influence the creation of money or benefit directly from seignorage.

Agreement on the underlying principles of a European monetary constitution is necessary, not only to know in what direction we are heading but also because they will have to be embodied in the Treaty of Rome before taking other action. Naturally, this does not mean that the creation of a European central bank has to be seen as a goal to be achieved in one shot when the time is ripe. It appears reasonable to envisage an evolutionary process, with monetary functions being gradually centralized against a background of increasingly stable exchange rates and substitutable currencies.

4. A European central bank will be justified only if there is a common European currency to manage. The nucleus of such a currency already exists: the ECU. This embodies a solution to the problem of ensuring that the fundamental political principle of the EEC as a community of equals is respected within the monetary union. It will, of course, be necessary at a later stage for the ECU to be made into a real currency, independent of its present components. But before

this stage is reached, there is scope for strengthening the ECU in its present form and expanding its use in the Community in public and private sector transactions.

To date, the growth of the private ECU has been fueled spontaneously by market forces. Initially it was very rapid, especially in the financial field. There are, however, good grounds for believing that the private ECU market has now reached a critical threshold, which it cannot cross by its own efforts. The ECU's share of international financial intermediation has stabilized at a low, though not insignificant, level and the ECU is only used for about 1 per cent of the Community's commercial transactions, despite the market having recognized it as the currency of the European Community and considering it the natural candidate for the role of common currency.

If the ECU is to become a true reserve currency, it will be necessary to develop a sufficiently broad and liquid financial market. This could be fostered through greater use of the ECU by European governments and public enterprises. For instance, stepping up issues of government securities denominated in ECUs would create a very large market in prime instruments. Analogously, more extensive use of the ECU to denominate major international contracts involving both public and private firms would promote the bank and interbank markets for ECU assets.

Steps can be taken to enhance the monetary and reserve currency features of official ECUs by putting their creation in the EMCF on a permanent footing and permitting their use by central banks for money and exchange market intervention. Within this framework, another aspect of the growth of the ECU concerns the arrangements for linking the private and official markets and the exchange of the two instruments.

These initiatives on their own would greatly encourage more extensive use of the ECU in commercial transactions, a prerequisite for it to become firmly established.

5. In short, progress towards monetary union requires greater convergence in macroeconomic aggregates and fiscal policies. Excessively large budget deficits and balance-of-payments disequilibria would effectively block the path leading to monetary union.

The basic features of European monetary union can and should be defined clearly at this stage. At the same time, we must not only strengthen monetary policy coordination and extend it to the management of third-currency exchange rates but also promote the ECU, so that it gradually becomes the single currency of the European monetary union. The Association for the Monetary Union of Europe can make an important contribution to this process. Business clearly can play a major role in extending the use of the ECU and helping to create the conditions that, coupled with the initiatives of the authorities, will permit the emergence of the ECU as the currency of Europe.