July 5th, 1989

EMBARGO UNTIL 5/7 19.00 HOURS
CHECK AGAINST DELIVERY

HAVE WE COME CLOSER TO ECONOMIC AND MONETARY UNION?

Niels Thygesen*

Talk at the Royal Institute of International Affairs, Chatham House, July 5th, 1989

*Professor of Economics, University of Copenhagen; Member of the Committee for the Study of Economic and Monetary Union (the "Delors Committee").

Have we come closer to economic and monetary union? This is the question which the organizers have asked me to discuss in the light of the Report of the Committee for the Study of Economic and Monetary Union, the so-called Delors Committee, which was discussed at the European Council Meeting in Madrid in late June, 1989. I take up this challenge with pleasure, particularly because the debate on the Delors Report and its implication for the kind of European Community we want to have has been more profound and critical in Britain than in any other EC member state. Since many British observers - and not only those who are critical of European integration - have labelled the approach of the Delors Report as "flawed", or even "badly flawed", it may be appropriate to devote the first half of my talk to a survey of what the Report actually contains and in what sense it is controversial.

The European Council, which met in Hannover at the end of June, 1988, adopted as part of its conclusions the following paragraphs:

"The European Council recalls that, in adopting the Single Act, the member states confirmed the objective of progressive realization of economic and monetary union.

They have therefore decided to examine at the European Council Meeting in Madrid in June, 1989 the means of achieving this union.

To this end they decided to entrust to a committee the task of studying and proposing concrete stages leading towards this union."

It is interesting to note that whereas the heading of this section is "monetary union", the text speaks of both economic and monetary union. This enlargement of the agenda was adopted at the insistence of the British Prime Minister, and it should cause no surprise therefore in this country that the Delors Report does, indeed, deal with more than monetary union.

In fulfilling its mandate the Delors Committee, consisting of twelve central bank governors, two members of the European Commission and three independent experts, of

which I had the honour to be one, essentially did two things: (1) it outlined what the ultimate stage of economic and monetary union would look like, and (2) it sketched three stages through which EC member states could approach this union. I skip in my presentation reference to the first chapter of the Report, which is largely historical and brings little new analysis.

An important aspect of the Report is that it does not pretend to give a proper cost benefit analysis of economic and monetary union. The Report chose the logical, but arguably cowardly, route to take this objective as given by the terms of its own mandate. The discussion in the Report is therefore an effort to clarify how such a union may function and what its monetary, economic and institutional prerequisites and implications are. The Report is similarly cautious in not taking an explicit stance on whether a union is necessary to assure the completion of the single market.

As regards the monetary dimensions of a union the Report follows closely on the lines of its predecessor, the so-called Werner Report of 1970. According to this report the monetary union is basically characterized by two elements: (1) completely free capital movements and a high degree of financial integration, and (2) elimination of margins of fluctuations and irrevocable fixity of exchange rates.

The Delors report is able to note that with respect to the first of these two points steps have already been taken to assure a high degree of fulfillment. The Council of Ministers has adopted, in June 1988, a decision containing a precise timetable for the removal of remaining controls of capital movement in those countries that still practise them. According to this timetable France and Italy will lift restrictions on short-term flows on July 1st, 1990, while Spain, Ireland, Greece and Portugal will do so by the end of 1992. Belgium will by the same date cease to operate a two-tier exchange market which is based on capital controls. While Portugal and Greece may request and obtain a further delay in the 1992 deadline set for them, there is no reason to continue to raise doubts that France and Italy

will proceed as planned by the mniddle of next year.

The United Kingdom was with some justification critical of the early EMS experience, which was clearly sustained with the help of significant capital controls in several member states. However, the fact that the UK was well ahead of several continental countries in adopting a liberal attitude to capital flows already in 1979, there is no reason to overdramatize the steps that remain to be taken. France and Italy have already very substantially liberalized portfolio movements and trade credits have been free of restrictions for several years. The generally positive experience with gradual liberalizations in the past few years has made it a virtual certainty both that the final steps will be taken and that they will not in themselves lead to any major tensions.

The irrevocable fixing of exchange rates is clearly some way off, particularly among all the twelve currencies of the EC. Even for the present eight currencies, which have participated in the EMS for a decade, the absence of realignments since January, 1987 has not led to any assumptions that no realignments will be required for an indefinite future. Assuring that parities can be irrevocably fixed is, therefore, the remaining challenge to them as well.

In the Werner and Delors definitions of monetary union it is not assumed that there will necessarily be a common currency. The Report only says that such a step would be a natural and desirable extension of the monetary union, since it would demonstrate that the locking of parities is, indeed, irreversible. A single currency has advantages additional to those that follow from the locking of parities: lower transaction costs, as the need to exchange money disappears, and very close substitutability between financial assets within the area. There would also be an external gain as the union would become less vulnerable to shocks from the rest of the world and more credible as an actor in the international monetary system. It is, indeed, difficult to believe that the monetary union could acquire a true common identity in the eyes of the outside world without a single currency. In this light the Report says

that national currencies should be replaced by a common currency as soon as possible after the locking of parities.

Whether this final step is taken or not, the locking of parities and full freedom of capital movements does imply that only one monetary policy is feasible. The definition adopted is, therefore, sufficient to justify the high degree of centralization of monetary authority in a European institution, which is subsequently proposed.

As regards the economic dimension of the union the Report outlines four basic components:

(1) a single market within which persons, goods, services and capital can move freely;

(2) competition policy and other measures aimed at strengthening market mechanisms;

(3) common policies aimed at strutural change in regional development; and

(4) macroeconomic policy coordination including binding rules for budgetary policies.

The first three of these components are already well on their way to realization. Although there are significant delays in the timetable, a large number of decisions have been taken to implement the single market under the 1992 programme. Already in February, 1988 a doubling of the EC structural funds up to 1993 was adopted; under this programme transfers to the weak peripheral economies (Greece, Ireland and Portugal) will reach the size of 4-5 per cent of their respective annual gross national products. The Report is careful not to say that this level of transfers will be insufficient to sustain also economic and monetary union, but that obviously is a question which has to be watched. Finally, competition policy has been strengthened considerably in recent years, and Community bodies have asserted some degree of authority over state aid to industry.

The main remaining challenge to realize the economic dimension of a union relative to what already exists or has been decided is closer coordination of macroeconomic policy. The Delors Report has caused considerable controversy by its emphasis on the demands for coordination of

budgetary policies. Neither in the theoretical literature on economic and monetary integration nor in past practical discussions in the Community has this element played quite the role that it is given in the Delors Report. There are three reasons for this emphasis:

The first and most obvious is that the European Community as far ahead as one can see will be fundamentally different from large federal states. The EC budget is presently a little more than 1 per cent of the collective GNP of member states, and there is no prospect that this share will rise significantly in the next one or two decades. The EC does have a somewhat larger influence on budgetary policies in member states than this figure suggests: some expenditures over the EC budget require matching grants in the receiving countries, and several sources of government revenue are increasingly subject to pressures for harmonization. The latter feature may, however, in the shorter term cause wider divergence between the macroeconomic effects of fiscal policies, as reductions in indirect or direct taxes cause budget deficits to rise in countries that have been at the top of the list in terms of tax pressure. The inescapable conclusion is therefore that in order to have significant macroeconomic effects one has to go through the national budgets. Only by giving community bodies some possibility of checking the aggregate of budget deficits can the Community assert its ability to influence the total policy mix of monetary and fiscal policy. European spokesmen have been critical for a long time of the failure of the United States to achieve a proper policy mix. It would not be logical to deny that by emphasizing solely monetary integration there would be a risk of even more important imbalances in the policy mix in the future European Community.

A second argument is that large budget deficits and/or debt to income ratios in some countries may constitute a threat for fixed exchange rates within the area. It could become both economically and politically unacceptable that individual member states use up a large and growing share of total savings within the Community. That could raise the average level of interst rates, crowding out private in-

vestment and/or having undesirable effects on the union´s exchange rate vis-à-vis other major currency areas. This is obviously an argument for some collective authority over individual countries´ deficits.

The <u>third</u> argument is that, as a complement to a common monetary policy direct, borrowing in the central bank to cover public sector deficits should be excluded, and that financing of such deficits through capital imports from the rest of the world should be limited. This argument is primarily a monetary rule in disguise, since norms for the total growth of money and credit in the area should, in principle, be sufficient to take care of the monetary implications of budgetary policy.

There was extensive disucssions in the Delors Committee whether it was necessary to go as far as stated in budgetary coordination. A counterargument to this line was that a common monetary policy supplemented by the disciplining effect on deficit countries of facing rising interest. costs on the Europeran capital markets as they went into debt would be sufficient through exert discipline within the union. The experience from large federal states and from sovereign debt in the international capital market do not indicate that this form of market discipline is efficient to influence the borrowing by regions or single countries. Rising deficits lead only slowly to a rising risk premium in the capital market as for example the small differentials between borrowing costs for individual American or Canadian states show. When financial markets finally react to large deficits or indebtedness it may on the other hand happen with a brutality that for some time cuts borrowers off completely from the market. Financial market discipline may, therefore, be either too slow or, suddenly, too brutal.

Could the disciplining effect of the markets be reinforced if the EC authorities stated clearly from the outset of the union, that they were not going to bail out, or provide an umbrella for, individual member states? There is really no way of knowing, but those who argue against any explicit rules for budgetary coordination should recall that there is much more of it in the existing federal

states than meets the eye. There is also the risk, evident in statements by many policy makers in deficit countries, that one important purpose they have in seeking a monetary union is to assure more automatic mechanisms of financing external deficits. While such financing may be made through private borrowing, it seems to me unlikely that a monetary union would be fully sustainable without a minimum of fiscal rules for the Community as a whole.

As regards the institutional framework for economic and monetary union the Delors Report proposes the gradual construction of a federal European System of Central Banks (ESCB) composed of a central institution and the participating central banks. In the final stage that system - the ESCB - will be solely responsible for the design and execution of monetary policy and for the management of exchange-rate policy vis-à-vis third currencies. The Report is at its most precise in describing the mandate, instruments, structure and status of the ESCB, though the Committee did not go as far as a originally suggested by the German foreign minister, viz. to prepare draft statutes for the ESCB. This task is clearly so political that it has to be postponed to an intergovernmental conference. I note in passing that the European Parliament through a Committee report, submitted by Herr Otmar Franz in March, 1989, has taken up this challenge in preparing precise statutes and that the Spinelli Foundation has recently published an elaborate set of proposals for Treaty changes and statutes for the ESCB.

Most noteworthy in the provisions for the ESCB is the emphasis on price stability as an objective. The formulation chosen:

> "-The System would be committed to the objective price stability;
>
> -subject to the foregoing the system should support the general economic policy set at the Community level by the competent bodies",

is close to that in the Bundesbank Act. It marks a return

to the classical central banking function to improve the predictability and stability of the future level of prices. Though it is also said subsequently that the ESCB is charged with the maintenance of a properly functioning payments system and with the coordination of banking supervision policies - tasks which may occasionally bring it into conflict with its prime objective of assuring a stable trend in prices - does not remove the impression that the Report has given remarkable emphasis to price stability. The reason for this is obviously that in order to assure a maximum of continuity with the more successful features of the present EMS it was found necessary to give this mandate a bias in favour of stability.

A federal system is proposed, because that corresponds best to the diversity in European Communities. The governing bodies will be the Council, composed of the governors of participating central banks and some members nominated by the European Council. There is no hint as to how voting will take place, and how the votes of national and European nominated members of the Council will be weighted. The latter category will constitute the Board, which is charged wit following monetary developments and executing the decisions of the Council in close cooperation with the national central banks, through which a number of interventions and open market operations will continue to be made.

The ESCB Council is to be independent of instructions from national governments or Ccommunity bodies and its members to be nominated for relatively long periods of service. (In the Community at present periods of service are normally from five to eight years with the exception of Italy and Denmark, where governors are nominated for indefinite mandates). To achieve a proper balance between the autonomy and the accountability of the ESCB vis-à-vis political authorities, the ESCB is charged with reporting annually to the European Council and to the European Parliament. The chairman of the board is also invited to discuss on a more regular basis with the select committee in the Parliament and with the ECOFIN Council current matters of monetary policy.

The model of a central banking system here outlined is in a number of respects inspired by the provisions in central bank legislation in the United States and the Federal Republic of Germany. Both countries aimed initially, i.e. in 1913 and 1948 respectively, to build up rather decentralized central banking systems, though gradually the need for a common monetary policy has been manifested in a high degree of centralization in the Direktorium in Frankfurt and in the Federal Reserve Board in Washington.

While the Report in a number of respects emphasizes the need for parallellism in progress towards monetary and economic union, this parallellism is not refound in the description of institutions. There is no proposal to set up new bodies to take up non-monetary tasks of policy formulation or execution. Existing bodies, notably the Council of Ministers, are seen as adequate for that task. The need for coordination between budgetary and monetary policies could be served through consultation procedures between the ESCB and the Council of Ministers, including a right for the President of the Council of Ministers and the President of the EC Commission to participate in the meetings of the ESCB Council without a right to vote and vice versa for the Chairam of the ESCB Board.

Reference to the international consequences of moving towards economic and monetary union are unfortunately rather sketchy. They state, that EMU would give the Community more influence in international discussions of economic policy in the same way as has already occurred in trade policy. The Chairman of the ESCB will together with the representative of the Council of Ministers represent the participants in international meetings and in the longer-run. The formation of the EMU could imply that participants merge their participation in the IMF.

<u>The approach in stages.</u>

The section in the Report, which attracted the most controversy when the ECOFIN Council first discussed it in May in S'Agaro, Spain, was para. 39 which states:

> "..The Committee agreed that the creation of an economic and monetary union must be viewed as a single process. Although this process it set out in stages which guide the progressive movement to the final objective, the decision to enter upon the first stage should be a decision to embark on the entire process" (italics in original).

Since, in my view, the momemtum intended with this formulation has been preserved in the conclusions of the Madrid Economic Council - which agreed that an intergovernmental conference to lay down the Treaty revisions required to move to the subsequent stages would meet "once the first stage has begun" on July 1st, 1990 - it may be worthwhile to recall why the Delors Committee made this linkage.

Three stages are outlined which may most briefly be summarized as (1) closer coordination on a voluntary basis, (2) a soft monetary union with the central bank, but no locking of parities, and (3) the final phase of "hard" union, as outlined above.

For the first stage which was adopted without reservations in Madrid two changes in the monetary area relative to the present practice in the EMS are recommended (1) an effort to include all EC currencies in the course of stage one should be made, (2) a higher profile for the committee of central bank governors should be adopted. The committee would from time to time express opinions on economic policy in the individual member states; such recommendations would be made by a majority vote, but they would not be binding from participants. The Committee is to report annually to the European Parliament and European Council. The Committee will work on the basis of a more structured sub-committee system and drawing on a secretariat with some analytical capacity.

This outline of the first stage sounds perfectly unobjectionable and caused little discussion among the Finance Ministers or at the Madrid European Council. It reflects a natural preference to let voluntary cooperation carry the load as far as at all possible. The EMS has proved over its

first decade that it has been capable of developing pragmatically, most recently with the so-called Basle-Nyborg Agreement in 1987 on intramarginal intervention and coordination of monetary policy. The system might develop a bit further without more wide-ranging changes than those proposed for the first stage. Why not then leave the system at that without proposing the formal linkage to the second and third stage?

Apart from the fact that such an attitude would not correspond to the ideas that inspired the Hanover resolution in 1988 and the mandate of the Delors Committee there are two reasons for regarding a more indefinite extension of stage one as inadequate to conditions in the 1990s and beyond:

The first is that the challenges to monetary policy coordination must be expected to grow significantly as capital restrictions are removed completely in those countries that still retain them and as membership in the EMS is extended beyond the present aid to Spain and the United Kingdom during the first phase. I return to these challenges in my comments on the UK participation in the EMS.

Second, the scope for moving coordination forward towards a genuine ex ante form of cooperation is extremely limited, and the first non-institutional stage does not modify these limits.

The Delors Committee conducted a small questionnaire study in the EC central banks to clarify the scope for moving ahead in coordination without Treaty changes. Crudely summarized the smaller participants did not see major problems in going further in the direction of submitting their monetary policy decisions to ex ante coordination within the Committee of Governors. But several of the larger countries did not see a possibility of moving in this direction without significant changes in national legislation and in the Treaty basis for European monetary cooperation. The reason for this was either that monetary authority is today divided between the central bank and the political authorities, or that the central bank itself has a decision-making structure which makes it impossible for it to delegate, through its president or others, competen-

ce, even to recommend, to a European body. The former of these two situations corresponds, I believe, rather well to the situation in France and the United Kingdom and the latter to that in the Federal Republic of Germany. In these circumstances it would be reckless to assume that improvisation in coordination despite the good will of participating members of the Governors´ Committee, could avoid the tensions that have marked the EMS experience from time to time in the past and which would become more likely with a wider membership, including the United Kingdom. Some upgrading of monetary competence from the present national level to the Community level is required to achieve any qualitative improvement and this in turn can only come about through a Treaty revision which attributes such competence. Hence the linkage of the first stage and the convening of an intergovernmental conference. This endorsement of procedure and momentum, though not of a precise outcome - the "automaticity" denounced by the UK government - is reassuring to those who, like myself, have seen the first stage essentially as a period for deciding upon change rather than as a change in itself.

The Report recommends that the first stage should begin at the latest on July 1st, 1990. The Report further recommends that preparatory work be started immediately for an intergovernmental conference to negotiate a new Treaty. The Madrid Europen Council followed both these recommendations, though it did choose the latest date for starting the first phase and hence the earliest date at which an intergovernmental conference can be called. Neither the Report nor the conclusions of the Madrid Council set any time limit to the conclusion of the conference and thereby to stage one.

A conclusion of a Treaty is necessary to move into stage two since the ESCB does come into function at the beginning of stage two and begins to have limited powers of decision-making. It is a weakness in the Report that stage two is not described in greater detail, because it poses significant intellectual and practical problems to see how monetary competence can be gradually transferred from national central banks to the ESCB. This task will now

largely fall on the preparations to be made in the Ministries of Finance and the central banks in the year which will pass until the intergovernmental conference is called. Several members of the Delors Committee proposed the assignment of particular instruments to the ESCB in stage two and outlined how foreign exchange interventions in third currencies and a system of compulsory reserve requirements applied to national money creation could give the ESCB a grip on both total money creation and relative adjustment problems among the participants. These ideas certainly do not provide a full blueprint for monetary management in stage two; the central bank governors were clearly reluctant to commit themselves to more precise methods of operation. After all monetary techniques continue to be in rapid evolution, and few central bankers would five years ago have predicted the methods of operation they are using today. Stage two is, however, a necessary transition period to the final stage of locked exchange rates, because it is hard to envisage that one could move straight to the locking of parities without some experimentation with joint monetary decision-making. Stage two is also to be used for a gradual narrowing of margins of fluctuations within the EMS from the present ± 2 1/4 per cent.

In the non-monetary area the second stage will evaluate the degree of goods market integration achieved during the 1992-programme and the effects of the structural and regional policies which have developed until the early 1990s. In addition the Council of Ministers will begin through majority decisions to set up guidelines for budgetary policies in the medium term. Recommendations from the Council will be more precise than today, but not yet binding for member states.

The Report finally discusses two issues of some interest.

Would one or several Treaty revisions be desirable? In principle one could envisage separate revisions of the Rome Treaty as the second and third stage are implemented and possibly for the introduction of a single currency as well or one could aim to incorporate all future Treaty changes in this area into one, while leaving to the European

Council the authority to move by unanemous decision from one stage to the next. The Report takes no clear stands between these two possibilities though my owm interpretation is that it implicitly prescribes the second, the comprehensive Treaty revision, primarily because revisions are complicated and drawn-out procedures, which cannot be repeated at fairly short intervals. In any case the Report states that at a minimum there ought to be agreement on the final aim of economic and monetary union while more flexibility can be permitted as to when and on what precise terms some member states join the arrangements of a particular stage. If some EC member states do not participate fully in a particular stage the degree of influence of those countries on the administration of that stage must obviously depend on the degree of participation.

On a second topic the Report has no doubt been a disappointment to broad groups in European industry and banking. The Report rejects the so-called parallel currency approach to European monetary integration which has been proposed regularly in recent years by bankers and industrialists and by the Committee for Monetary Union in Europe chaired by the two EMS fathers, former President Valery Giscard d´Estaing of France and Federal Chancellor Helmut Schmidt. Many of these proposals have centered on the idea that well before the permanent fixing of parities a European central banking institution should begin to issue a parallel currency, the ECU, no longer defined as a basket (average) of community currencies, but as a new monetary standard to which participating currencies would define their central rate. The parallel currency would compete with national currencies as a means of payment, a unit of account and a store of value, as, indeed, is the case already today in some respects for the present ECU (and for other national currencies within each country). The Delors Report is reluctant to adopt this strategy for two reasons. Firstly, because an additional source of money creation without a precise linkage to economic activity could jeopardize price stability and, secondly, because the addition of a new currency could further complicate the already difficult task of coordinating national monetary

policies. In short, the Committee saw little that one could do in addition with a thirteenth currency that could not already be done with the existing twelve.

The Report did, however, give a more indirect and fundamentally important support to the present ECU. It emphasized the benefits of a single currency and it said that the ECU has the potential to become the future common currency. When parities have been locked at the entry to the third stage it is in principle of no importance which unit is used as a common unit; it is analogous to the question whether one should express amounts in pounds or in shillings. In practice, it has a very considerable importance for markets to know that at an advanced stage of integration there will be a unit defined in continuity with the present ECU as the most likely candidate for the common currency.

Given this important long-run encouragement, and the positive remarks made in the Report about removal of all restrictions to the spreading of the ECU in private markets and the use of it as a monetary instrument in the second stage of the ESCB, there may still be good prospects for continued growth in the use of the ECU in both official and private spheres. Yet it is obvious that the Delors Report falls well short of the more radical suggestions made by a number of other reports in recent years.

Have we come closer to economic and monetary union?

A few weeks ago, shortly after the publication of the Delors Report, I was asked to give a talk under a similar heading in the Danish Economic Society. Some weeks before Madrid I answered the main question in the affirmative. Following the Madrid European Council I would like to enlarge on the reasons why I still have a positive answer to the main question. I based my conclusion mainly on the basis of political considerations that lie at the fringe of an economist´s normal preoccupations and expertise. I do not believe the question is answerable in terms of standard economic theory about the costs and benefits of fixed ex-

change rates and the extension of an optimal currency area. Economic theory can help a lot to clarify the criteria by which we judge economic and monetary integration. If one were to ask today: is the present European Community an optimal currency area, the answer would have to be no, and the Delors Report has frankly drawn attention to some of the requirements that have to be met in order to make it so. These requirements are primarily the removal of remaining restrictions on goods markets integration and on financial integration, structural and regional policies of approximately the scope designed for the early 1990s, and some degree of budgetary policy coordination. By underlining these additional requirements the Delors Report has admitted that one cannot rely simply on the locking of parities.

Without claiming that the Delors Report is the only
in the second part of my talk.
basis or even the main basis for discussing the content of economic and monetary union I would state as my firm conviction that a majority of member states are prepared to accept something like the version outlined in the Report. This is the case despite the demanding prescriptions for non-monetary policies which remove any hope that there are easy routes. I find comments on a minimalist shape of economic and monetary union with a gold-standard-like mechanism, no explicit powers for a central banking system and no transfer of authority over fiscal policy to the Community level out of step with realities in the Community. References to the gold-standard period, which largely ended in 1914, are hardly relevant today with the present role of national governments and their finances for judging the feasibility of monetary union. Possibilities of conflict and divergence exist today that were unlikely in the much-praised experience of the gold standard in its final decades. It is unlikely that these conflicts can be settled without an explicit central authority in the monetary area and some means of influencing fiscal policy decisions. Let me look at the attitudes to these issues in the five largest Community countries.

The decisive country is without question the Federal Republic of Germany. In 1978 as Chancellor Helmut Schmidt proposed the EMS and its further evolution after two years into a European Monetary Fund many circles in Germany expressed the fear that the institution which above any other has marked political stabilization in the post-war German history - the Bundesbank - would be undermined in its operations by wide-ranging ties to other and less stable currencies. This had happened in relation to the dollar prior to 1973 and to some extent in relation to other European currencies under the so-called "snake" arrangements. Gradually over the first ten years in the EMS German politicians and the German public have become more confident in the nature of European coordination. Price stability was not dramatically undermined and monetary policy was able to continue to be oriented largely on domestic objectives. Indeed, the problem is that the present EMS may have become so attractive in its way of functioning from a German perspective that it is difficult to persuade Germany to reform the system.

My main argument is that the Delors Report despite its defects has given a framework which is likely to be acceptable to German opinion, including the majority in the Bundestag which the Bundesbank counts on as support for its autonomy and monetary policy, and which has on at least one occasion in recent years been mobilized to block the adoption of legislation which threathened autonomy without setting any clear principles in its place.

Two elements in the Delors Report are important to German opinion. Price stability is clearly defined as a major objective of monetary policy and the criticism from France and Italy, which originally prompted the set up of the Delors committee, is not raised in the Report itself. It is explicitly recognized that the objective of price stability is to be seen in continuation of and in substitution for the present EMS with the Bundesbank as a nominal anchor. Second, the Report in its description of a central banking system contains a wide-ranging assurance of autonomy. These two points are important and possibly sufficient to convince German opinion to engage in something which

can only in German terms be described as a long-run currency reform with major institutional innovations.

There is little doubt that the German government as a whole is somewhat more favourable to economic and monetary union than the Bundesbank. This impression has been confirmed by the discussion up to and during the Madrid Economic Council. The German government sees a close economic and monetary cooperation with other European countries as an integrated part of its European policy where the importance of interests in other policy areas at times justify less emphasis on monetary and budgetary perfectionism. Lord Jenkins put the German dilemma well in December, 1977 when he said that Germany has the choice of submitting to global pressures for adjusting its domestic policy or to embrace European integration wholeheartedly. The attractiveness of economic and monetary union including some fiscal powers to community institutions is that Germany becomes further removed from the frontline of discussions with the United States and Japan on adjustments of its domestic policies. Such discussions can legitimately be regarded as internalized in an economic and monetary union.

France is basically positive in its reactions to the Delors Report. If anything, there is disapppointment that the Report did not move more radically ahead and choose a brutal way to economic and monetary union. To France the thought of giving up sovereignty in economic policy is closer to being accepted than one might expect in a large country. Since 1983 the external constraints on macroeconomic policy have repeatedly been stressed by governments of different colours. If one regards the modest French current account deficit and the fact the public sector deficit is smaller in relative terms than that of Germany, this attitude may seem surprising. There is a growing confidence in France that one can in the long run stay close to the German inflation rate. What the French governments who led France into the EMS were unable to do at the time Jacques Delors and his successors as Finance Ministers have largely implemented. There must, of course, be doubts whether parallellism in inflation will in itself be sufficient to make a permanently fixed exchange rate to the DM sustainable,

and there are signs of weakening of competitiveness in some branches of industry. Yet it is characteristic in contrast to the discussion in the United Kingdom and in my own country, for example, that much less emphasis is put on exchange-rate adjustments than on structural instruments in order to rectify this weakness in the French economy. It is a widespread attitude among French economists and politicians that France has today made most of the sacrifices of a fixed exchange-rate policy without yet reaping fully the benefits, primarily in the form of having the same real interest rate as the low inflation country of Germany. EMU would protect France more efficiently against the need to raise interest rates defensively relative to Germany and assure a smoother financing of temporary balance of payments deficits.

Italian views have many points in common with the French. Membership of the EMS has been used as a disciplining element vis-à-vis domestic prices and wages and fiscal policy, though in all respects with less success than in France. Discipline had been harder to establish, partly because of the wider scope for fluctuations for the lira, partly because the EMS has at no time put wide-ranging conditions to Italy in connection with the agreement to devaluations of the lira. Such a linkage of the EMS membership to the revision of economic policy was one important feature of the French 1983 devaluation. Italy is left with the serious problem that the government budget deficit has refused to drop below 10-11 per cent of GNP, and Italy is no doubt the major example of why a ceiling on budget deficits may be required as an element in EMU. The loss of the possibility of financing part of that deficit through money creation or through surprise inflation will in itself exercise a stronger pressure on decision-making in the Italian Parliament. Several Italian politicians in fact welcome more explicit pressure from the EC partners, including guidelines for fiscal policy. There is not the opposition to the fiscal policy aspect of the Delors Report that one might expect.

Spain has recently joined the EMS, a step well justified by the confidence generated over the past 3-4 years of EC membership. Spain has seen a surprisingly rapid integration of its goods markets and, even more dramatically, of its capital markets. Considerable net flows into Spain have occurred, which suggest that private financial markets can solve several of the disequilibrium problems which a rapid integration process gives rise to. There is in Spain considerable doubt whether the present exchange rate vis-à-vis the EMS currencies is the one that will prove definitely sustainable, but the doubt relates to the transition with some turbulence up to and beyond 1992, rather than to a long-term doubt as to the feasibility of fixed exchange rates vis-à-vis the present EMS currencies.

This brings me to the issue of British attitudes which continue to show a hard resistance both to participation in the present EMS and to active moves towards EMU. It may be useful to keep these two sources of opposition separate.

The major part of the discussion over the past ten years in Britain has clarified that fixed but adjustable exchange rates may be difficult to reconcile with a high degree of capital mobility which marks London as the main financial centre in Europe. Anticipated realignments in the EMS give rise to major flows from the weaker to the stronger currencies. But what may be more destabilizing in the long run is the reflow that takes place after a realignment during the long period when there is considerable confidence that there will be no further change in parities for some time. Inflation remains higher in the weak currency country and the inflows may create difficulties for a properly anti-inflationary policy and may serve to perpetuate inflation differentials. That experience may be illustrated by the inflows observed into Italy and France after realignments, or at times when the credibility of fixed exchange rates was strengthening as has been the case for example in 1988. At such times the authorities of the weak-currency country are faced with the unpleasant option to either accept a fall in their domestic interest rates or resist it and accept a large inflow. Capital controls on inflows has been a method of resolving this dilemma in the

past - and was practiced by Italy in late 1988 - but this option is now being eliminated as capital controls are to disappear in 1990.

British critics on the present EMS, such as the chapter in Sir Alan Walters´ book on Britain´s Economic Renaissance written largely in 1984, exaggerate, from my point of view, both the short-run instability features of the system and its post-realignment distortionary effects on relative monetary policies. Instability has been curtailed by limiting the size of realignments so as to preserve a high degree of continuity in market exchange rates before and after realignments, or by undertaking, on a couple of occasions, unexpected realignments. Speculators have had far more difficulties than in the final years of Bretton Woods and their gains have been insignificant. The flexible management which has evolved since the Basle-Nyborg Agreement of 1987 with wider use of the fluctuation bands has helped in this respect. As regards the longer-term distortionary effects of perverse flows into inflationary and high-interest-rate currencies, such effects have dwindled, as interest rate differentials have narrowed. The interest rate premium over DM assets now roughly corresponds to the excess inflation over Germany in Belgium, Denmark, France and Italy and this appears to be close to what is required to sustain portfolio equilibrium. Most EMS member states have found it gradually easier, not more difficult to manage their external flows, though obviously at the cost of monetary autonomy.

I realize that it may have has become more difficult to win acceptance for this view. Since the experience of "shadowing" the DM between March 1987 and March 1988, the accepted wisdom is that this policy forced the UK authorities to maintain interest rates below what the domestic situation, with a gradual overheating of the economy, required. The sharp subsequent appreciation, as short-term interest rates were raised to cool off the economy, seemed to bear out that analysis.

There are at least two reasons why the 1987-88 episode should not be interpreted as a general indictment of participation in the EMS. The first is that there is no substi-

tute for the explicit exchange-rate target implied by full membership in the system. Both the disciplining impact on domestic demand and the discouragement of speculative inflows work very differently in the latter case. The second is that even if a country has brought itself into a situation of divergently strong expansion where increases in relative interest rates and appreciation appear unavoidable as a short run check on inflation, there are other instruments that could be used to the same effect, for example the degree to which borrowers can claim deductibility of interest expenses in their tax returns. In general, financial integration should push national authorities to think more in terms of instruments that have moderst international repercussions.

Whether the conflict between domestic and external objectives could have been resolved by other instruments or not - or, indeed, whether the conflict should have been allowed to develop so far during the 1987-88 boom - is, of course, now a moot point. But to Britain's EC partners the abandonment of the shadowing experiment and the once more increasingly domestic orientation of UK monetary policy which it signified was a further cause for reflection on the terms on which sterling's participation in European monetary arrangements might become feasible.

Sterling's inclusion in the EMS (I apologize for using this terminology rather than the Exchange Rate Mechanism, preferred in Britain to underline that there are some, less important, aspects of the EMS in which there is UK participation) has been on the agenda since the initial negotiations of 1978. Most of the time participation has been advocated by Britain's partners and rejected or postponed by the UK authorities. In retrospect, entry from the start during the early years of petrocurrency overvaluation and the stabilization effort of the Medium Term Financial Strategy would no doubt have been upsetting, possibly fatal to an EMS which was in any case highly fragile. As overvaluation was corrected, there appeared to outsiders to have been several opportunities for sterling to join on a more sustainable basis, but the time was not considered ripe. The deep depreciation of sterling in 1986 - probably a more

important cause of the present inflation divergence than the shadowing experiment in itself -provoked some resentment among policy-makers in other European countries, as the UK authorities appeared to opt out of a common strategy of jointly lowering inflation and absorbing part of the necessary adjustment to a reduction in the US external deficit. The instability of the sterling/ECU-rate over the most recent period, though significant, has been less dramatic. In straight economic terms Britain's European partners may today feel more detached towards the issue of sterling's fluctuations than at any time since the start of the EMS; they have proved less upsetting to the cohesion between the other European currencies than could have been anticipated. But the perception that sterling's participation in an otherwise unchanged EMS could be upsetting to the results that have been gradually achieved within the System is very much alive.

These fears which may be more pronounced in countries with so-called weaker currencies than in the Federal Republic and the Netherlands, traditionally the stongest supporters of UK participation in the EMS, though they find expression there as well. After all, there is a long tradition in the UK of referring monetary policy decisions to the highest political level, and of limited autonomy for the central bank. These elements and recent experience of heavy reliance on monetary policy for domestic stabilization offer a recipe for conflict in the present framework, including an extended first stage.

My main point is that this line of reasoning suggests that, from the viewpoint of several present EMS members, full monetary unification with the UK is preferable to a prolonged first stage with extended membership, but no institutional changes. It provides an argument, additional to the traditional efficiency gains and the consolidation of the single market and the financial integration already largely achieved, for EMU.

It seems to me that there could also be important gains from a British perspective in opting for full monetary unification and an ESCB rather than an EMS. The inherent instability of the combination of a European financial area

of at least 12 currencies with discretely adjustable central rates between them would disappear. The UK government would be saved the embarrassmebnt, which it perceives more strongly than others, of submitting to a consensus on realignments, the one decision that is today taken jointly in the EMS.

The prime consideration which could make irrevocably fixed exchange rates vis-à-vis the EMS-currencies feasible and attractive is that British inflation could be kept broadly in line with that likely to be achievable in an EMU. It is understandable that recollections of the half century from 1926 onwards during which much of the UK experience was marked by efforts to contain external deficits and defend sterling in an environment where the currency was suspected of overvaluation, should have left a reluctance to be locked permanently into a fixed-rate relationship with currencies that have a good stability record. Possibly all that can be meaningfully said is that (1) both the experience of several other countries where the inflation outlook was at least as bleak a decade ago, but which are now performing better than the UK, and (2) the major reforms made in the UK to make the economy more competitive and labour markets less inertial in their approach to wage settlements make it overly pessimistic to extrapolate mechanically the past experience of negotiated wages, wage drift and price-setting.

Behind the apparent defeatism in many British circles with respect to inflation lies another deeper concern. Will not participation in an EMU submerge all major elements of British econonmic policy-making to some bland European pattern, effacing those elements of more radical innovation which the present government sees as distinguishing Britain favourably from her EEMS partners? Conversely, if an alternative government were to come into power at the next election, or the one after that, would it not feel unacceptably constrained by adhesion to an EMU in implementing its preferred policies? These questions are raised with more force in Britain than in the other large EC states because there remains more disagreement here on macroeconomic policies. In the other four large EC-countries and in most of the

smaller ones, typically marked by coalition governments, one would be hard put to outline what the policies of an alternative government would be like in macroeconomic terms. There, too, the notions that governments left of centre go for expansion, budget deficits and intervention with a readiness to assume more inflationary risks, while their competitors at the centre- right have very different preferences with respect to these macroeconomic variables and instruments, have tended to disappear with the experience of changes of government. In Britain it lingers on, and is even carefully cultivated, but it needs to be thought through in a more explicit way. An EMU does underwrite the shifts in policies as national governments change, provided of course that they are not too brutal and that they accept some common rules and constraints on the participants. This line of thinking may not be expplicitly expressed in other countries, but without it they would not be prepared to embark on the road to EMU.

It is unfortunate if the rather strong language of the Delors Report on rules for budgetary policy has created the impression in Britain that EMU is an all-out attack on sovereignty over the total range of economic policies. That is certainly not the intention with respect to the details of tax and expenditure policies, where some competition between member states will continue to be feasible and desirable, as is the case within at least some large existing federations. There is plenty of scope for most of the debates in your House of Common and in the House of Lords on matters than currently form the core of the policy debate. But nor should there be any illusion that one could manage over decadeds a union solely with a unified monetary policy, though such a policy could do much of the work. I believe such a policy needs to be supplemented by some joint authority to adjust the sum of member states' budgetary policies and debt creation.

References to an alternative minimalist version of the union based only on irrevocable fixing of exchange rates in a gold-standard like system or currency competition, dear to British, German and other liberals, by making all national currencies legal tender throughout the EC, strike