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7

INTEGRATION THROUGH MONETARY UNION - A SCEPTICAL VIEW

by Wolfgang Kasper and Michael Stahl

Weltwirtschaft Kiel 5.10.70. Bag 3376

CONTENTS:

- After several years of unrest in the international monetary scene, the governments of the EEC countries agreed in December 1969 at The Hague to place monetary union in Europe on the agenda. Behind this agreement, however, resides a wide range of differences of opinion, which are partly expressed in the host of plans for European monetary integration that have been published in recent months.
- One essential divergency of opinion is, whether one should first peg intra-Community exchange rates or whether one should first try to harmonize policies and wait till stable exchange rates come about almost by themselves.
- A premature fixing of exchange rates would lead to
  - unwanted waves of imported inflation in the more stable countries and to imported deflation and unemployment in the less stable countries,
  - regional problems in those parts of the EEC that have had a tradition of wage push, and the danger of undue industrial concentration in those parts that have a tradition of relatively high labour discipline, and
  - the necessity for sizeable intra-EEC fiscal transfers in favour of cost-push regions to counterbalance the negative effects of high wage costs. These transfers might easily overstress the European solidarity, that is the readiness to pay, of the more stable national regions.
- These problems appear to be bigger if one thinks of an enlarged EEC.
- Contrary to the costs and risks of premature exchange rate fixing, the benefits are, it seems, frequently overestimated: As long as the free flow of goods and capital is guaranteed (and not impaired in defense of outdated fixed parities, as has often been the case in the past) most of the beneficial economic integration effects are secured.
- To avoid a setback in integration - similar to the recent setback due to the premature fixing of common agricultural prices - it therefore seems advisable not to force together divergent underlying trends, but rather to implement elastic devices for a harmonious growing-together of the various European economies.

INSTITUT FÜR WELTWIRTSCHAFT KIEL · SEPTEMBER 1970

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INTEGRATION THROUGH MONETARY UNION - A SCEPTICAL VIEW*

The Hague and the Consequences

1. On the European summit meeting at The Hague in December 1969, it was declared that the EEC should undertake a new effort to embark on closer cooperation in monetary matters and on more effective harmonization of economic policies. This passage in The Hague communiqué seems to stem from the general feeling that the process of European integration had come to a near-deadlock and that, indeed, international tensions in the monetary field had harmfully affected the EEC.

   The experience that large divergencies in national price levels could arise and upset intra-EEC trade and that hectic and disruptive corrections in member countries' exchange rates were still inevitable, forms the background for the political declarations of December 1969. It was felt that a closely integrated economic union would, in the long run, suffer from such huge balance-of-payments disequilibria as had arisen after the West German recession of 1966/67, which had been engineered to stabilize the internal price level, and after the inflationary outburst in France following the social uprise of May and June 1968.

   The long retarded correction of these price-level discrepancies in two stepwise parity changes in autumn 1969 led to a change in the Franc/D-Mark parity of more than 20 p. c. This final correction had cost much of the EEC Commission's prestige, since the Commission had been openly opposed to exchange-rate corrections, even after it had been quite clear that there was no other way out. And such huge and sudden shifts in parities must indeed do harm to intra-EEC trade relations.

2. So, it seemed only logical to avoid a repetition of the unfavourable experiences of 1969 along this line by pressing for a monetary union to be brought about as soon as possible. The proposition of a monetary union in the EEC became quickly popular, but the exact meaning of what precisely is to be understood by it, seems not so clear. Europe's political leaders appear to mean by "monetary union" alternatively or combined in one vague mixtum compositum the following concepts:
   - the pooling of foreign exchange reserves (and liabilities),
   - the fixity of intra-Community exchange rates forever,
   - the acceptance of a uniform EEC-wide currency unit,
   - a common central bank or central bank system under one common leadership, and/or
   - a uniform all-embracing economic policy for the Community as a whole.

   What exactly is meant differs from government to government - if the official statements of the last months are conclusive enough. It seems, however, useful not to hide divergencies under the general term of "monetray union", so that it becomes quite

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* A sympodium under the title "Integration through Monetary Union?" was recently held at the Kiel Institute (participants: Dr. Otmar Emminger, Frankfurt; Prof. Herbert Giersch, Kiel; Dr. Wilhelm Hankel, Bonn; Dr. Stephen Marris, Paris; Dr. Ugo Mosca, Brussels; Prof. Peter Oppenheimer, Oxford; Prof. Otto Pfleiderer, Stuttgart; Prof. Robert Triffin, Yale; and Prof. Hans Willgerodt, Cologne). This paper does, however, not necessarily reflect the opinions of the participants, but only those of the authors.

clear from the very outset what the exact economic content of European monetary union is to mean.

3. The Hague communiqué gave rise to new discussions about monetary integration and added to the host of plans for monetary union in Europe[1]. Although these plans differ in details and in the procedure how to arrive at the final stage of monetary union, they have all in common that they envisage to bring about the final stage of complete monetary union until the end of the 1970s.

4. This appears to be very optimistic in the light of past experience with European integration: Since 1958 there has been a continued effort to bring about a customs union, but
   - in 1970 there are still customs officers at the internal EEC-borders holding up and controlling the traveller;
   - a German cannot buy privately a French car without going through a frightful bureaucratic mill of red tape;
   - a traveller leaving Italy cannot take more than $ 150 in Lire out of the country;
   - France has repeatedly demonstrated that she is prepared to introduce import quotas and export subsidies (as, e. g., in the summer of 1968) against her partners in the EEC as well as against outsiders;
   - goverments still intervene when other countries' firms take over another nation's industries (e. g., the French government's open intervention when Fiat tried to gain influence in Citroën).

   All efforts to harmonize economic policies effectively have so far been frustrated. There is, e. g., no sign that rates of inflation move at an even keel in the EEC as they do in the various regions of one country (graph 1). And experience with common agricultural policies has demonstrated that the attempt to bring about effective integration by constructing an institutional and exactly codified framework and by fixing common prices first means putting the cart before the horse.

Monetary Union Defined

5. What a great task the politicians have promised to undertake at The Hague in what short a time, becomes apparent when one takes into account the full implications of monetary union and of the economic and political pre-conditions for it.

   To start this line of argument, we define monetary union as an area

   (a) within which intra-regional exchange rates are unalterably fixed, and

   (b) for which a complete guarantee is given that there will be no limitations to intra-regional convertibility.

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[1] A list of these plans is compiled in the Appendix.

In this definition, which appears to be widely accepted in the economic profession, it is not necessarily implied

- that currency units of the same denomination circulate throughout (which is the difference to a single currency),
- that foreign-exchange reserves are pooled, and
- that a common central bank or other common agencies of economic policy exist (compare para 2 above).

6. Whereas the element of fixed interregional parities is generally accepted as essential for the existence of a true monetary union, the second element - that there must be no convertibility risk - seems to be less engrained in the wider public's mind. As opposed to present conditions in Europe, where we have had fixed exchange rates for reasonably long periods of time, the free convertibility element is still frequently missing. As long as the risk of limitations to free convertibility between the various currency units exists, considerable conversion charges, when one changes one's money from one currency to the other, will also exist. Because of this and since limitations to convertibility have often only heralded sizeable parity adjustments with the consequence of sizeable profits or losses, it matters, in which of the various units wealth is stored and debts are measured.

7. Experience in the past years of monetary unease has shown once again that the aims of fixity of exchange rates and free, unimpaired convertibility are frequently incompatible with each other: To maintain an exchange rate that was fixed a long time ago, various countries limited the existing degree of convertibility of their currencies. And it seems that these limitations - or even the risk of their introduction - are more important hindrances to an undistorted flow of commodities, payments, and investment in Europe than the possibility of small, and foreseeable, parity changes[1]. So, it has frequently been the fixity of parities that stood in the way of closer integration. It is not the fixity that facilitates integration, but the predictability of exchange rates.

Monetary Union - the Pre-Conditions

8. What then, it must be asked, are the pre-conditions for maintaining fixed parities and free convertibility between the various sub-areas of a monetary union?

   These pre-conditions are basically the same as those for balance-of-payments equilibria between various countries under unaltered exchange rates, namely that cost and price trends in those countries must be in line with productivity developments.

   This means: confidence into free convertibility under fixed intra-EEC exchange rates can only be maintained over a reasonable period of time,

   - if factor costs, unit costs of production, and price levels in the various EEC countries move fairly parallel because productivity develops by the same rate everywhere, or

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[1] Compare: Giersch, H.: Entrepreneurial Risk under Flexible Exchange Rates. In: Halm, G.N. (ed.): Approaches to Greater Flexibility of Exchange Rates - The Bürgenstock Papers. Princeton 1970. p. 145.

- if more-than-average factor cost rises in one country are compensated by more-than-average productivity rises (so that unit costs of production, and price levels, move parallel), or
- if a more-than-average cost rise in one country is compensated by an autonomous inflow of capital.

Since the latter case is only imaginable for rather short periods of time (long-run cost pressure will deter capital rather than attract it), we come to the conclusion that the parallel movement of unit costs of production and of price levels in the various EEC countries must be guaranteed, before the Common Market can be converted into a monetary union.

9. These pre-conditions were not given in the past. Graph 1 shows rather wide divergencies in price-level movements in various European countries, with West Germany on the more stable side and France and Britain[1] on the inflationary side.

The graph shows also the targets set tentatively by the EEC Commission for the first half of the planned transition period to monetary union[2]. These projections appear at first sight well in line with the aim of harmonizing price-level movements; and the data were indeed presented in close contact with the plans for progress towards monetary integration. However, the document, which presents them, stresses that these data are only for orientation with no binding consequences whatsoever. This is in line with the Barre Plan which does not foresee binding rules for economic policy before the third step, which is to start between 1975 and 1977. Since past experience shows that factors - such as different historical experience of the population, different trade union organizations, or different pricing attitudes - that bring about international discrepancies in price-level developments are strong and hard to change, it seems, however, doubtful whether actual developments between 1971 and 1975 will be in line with the orientation data or, as in the past, widely divergent.

10. A closer look at the Commission's data reveals further doubts in the prospects of an early harmonization of national economic policies: For the two exponents, West Germany on the stable side and France on the inflationary side, the figures given are 2-2,5 p.c. and 2,5 p.c. respectively from 1971 on. This requires two comments:

- The data stipulated for the Federal Republic are definitely not in line with the repeated policy declarations of the West German government[3]. Government has again and again defined price stability, which to pursue it is bound by the Stability and Growth Law, by a price rise of not more than 1 p.c. annually. The independent Bundesbank seems to apply a similarly clear-cut definition of price-level stability. So, the EEC prescription, if measured by the internally binding concept of price-level stability in Germany must clearly be called inflationary.

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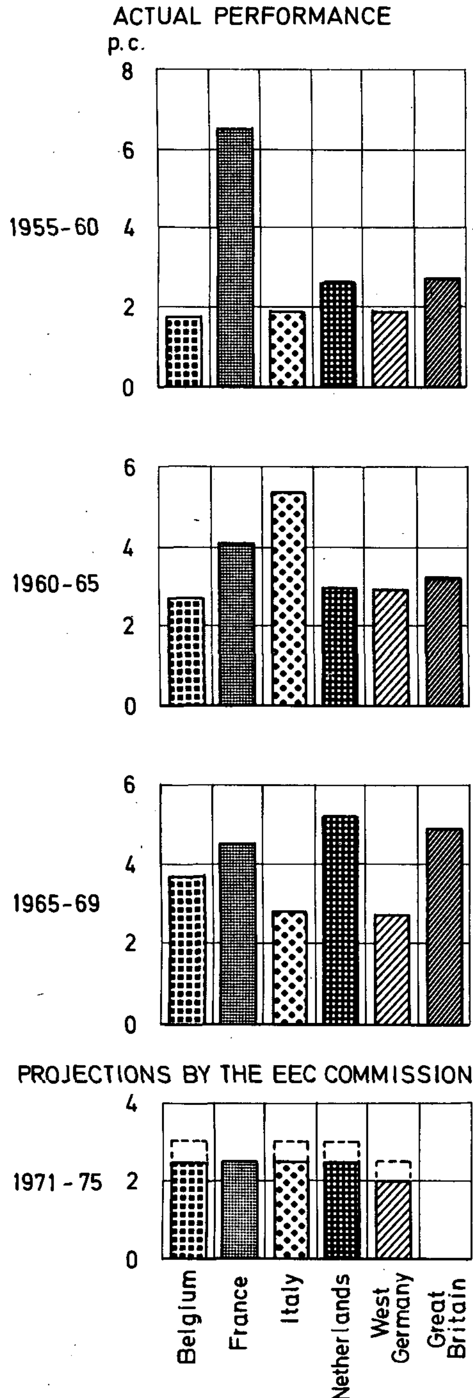
[1] Britain is included in the argument, since it seems to be the intention of the EEC Commission to oblige the new partners in a wider EEC also to adhere to cross-rate fixity. The problems discussed here become bigger for a wider Community if one takes past cost and productivity performance as a basis of judgement.

[2] EEC COMMISSION: Memorandum to the Council about Medium-term Orientation (1971-75) of Economic Policy in the Community. Brussels (Dec. 15th) 1969.

[3] See for example: Bundesregierung: Jahreswirtschaftsbericht 1969. Appendix I.



- The number for France (2.5 p.c., which is slightly more than the German figure) is clearly out of line with anything that was achieved in the past (graph 1). It is also below the mark that French officials have, in the past, held sufficient for price-level stability. This holds the more true, as the uprise in early summer of 1968 has demonstrated the power of those interest groups that are in favour of quickly rising wages (and hence prices), and since the practice of implementing automatic price-slide formulae seems to be spreading in France.

11. Even if the EEC projections came true, it seems, however, that a certain price differential between Germany and France would develop. Already less than a year after the DM/Franc realignment, which had brought German and French price levels roughly in line with each other, price levels have begun to get out of step again: the current rate of consumer price rises in the spring of 1970 was 6.1 p.c. for France and 3.1 for West Germany[1]. The resulting slight gap is likely to widen in 1971 (the basis for the EEC projections), since Germany has adopted a stabilization programme with tax increases and tight money, whereas France seems at present rather inclined to expand (on August 28th 1970, the discount rate was lowered), and since the EEC arrangement for the deferred adoption of agricultural prices in France is likely to bring a new push of price rises. And from this uneven basis onwards, the Commission projects even a slightly more

[1] OECD: Economic Outlook. Paris (July) 1970. p. 4.

inflationary development for France than for West Germany.

The conclusion is that the D-Mark will again be undervalued vis-a-vis the franc, and that - in spite of official declarations for harmonization - the old stresses under the fixed-rate regime are likely to reappear in the Common Market.

12. If there is lttle reason for sincere hopes of policy harmonization in the next five years: What would then be a more ideal set of policy conditions that would bring about progress in monetary harmonization?

For cost and price levels to develop in fair uniformity, it seems necessary to have similar trade union movements, and similar entrepreneurial attitudes towards pricing. It stands no doubt that entrepreneurs and labour unions in the various European countries differ widely in their attitudes towards price stability and in their responsibility for overall policy objectives (the problem does not become smaller, if one includes Britain and the other applicants for EEC membership). This point need only be highlighted by a comparison of strike statistics in the various countries:

Table 1

Working Days Lost because of Labour Disputes
- annual average 1957 to 1967, per 1000 workers -

Country	Days lost
France	321
Italy	1104
United Kingdom	300
West Germany	33

Source: Kasper, W.: Zur Frage größerer Wechselkursflexibilität. Tübingen 1970. p. 143.

Towards a Common Central Bank

13. To outweigh these existing divergencies in the pricing of labour and commodities, the policy framework will have to be uniform all over the EEC, and harmonizing policy pressures will have to be stronger than they would have to be with more similar cost and price attitudes. To ensure a uniform impact of economic policy on all member countries of the monetary union, it seems therefore essential to establish a common central bank, i. e. to take away from the single countries the sovereignty to set their own rate of interest or to expand the quantity of money on their own. So, although a common central bank was not considered an essential element of a monetary union as we defined it above (para 5), it seems an indispensable prerequisite for practical monetary union within Europe.

Common central bank policies must already be put into practice before the exchange rates between the EEC countries are definitely fixed. To paraphrase it: The clockworks must be tuned to guarantee long-run synchronization: it does not suffice, simply to set the watch-handles to the same hour. Otherwise, there is the danger of a

loss of prestige by those who fixed the par value - as had been, e. g., the case after the 1969 realignment - and of a major setback in integration as a whole. Without an effective harmonization of central bank policies (and this would mean more than mere, unobliging committee meetings of bank officials in Brussels), the danger of continued conflicts in diagnosis and therapy between national central banks would be permanent. The influence of a particular policy move by one national central bank would quickly spread over the whole area of the monetary union, much quicker as it does already today, in spite of convertibility limitations. And experience during the 1960s has taught us that integration under fixed exchange rates cuts down on the sovereignty of national central banks in conducting policies of their own.

14. Most of the plans for monetary union are, however, not very explicit on the point of effectively integrating policy- making:

- The Werner Plan seems widely to rely on consultations and institutional harmonization of central bank instruments. Only in the last phase, it stipulates that central banks deposit parts of their assets with a common fund.

- The Plan of the Belgian Ministry of Finance is a little more explicit on pre-conditions for monetary and credit policy: Till 1977, important decisions in credit policy should only be made after consultations within the common committee of central bank governors, but final decision-taking is still to rest with national bodies. Furthermore, it is not defined what "important decisions" means.

- The Schiller Plan puts more weight than the others on harmonization of bank policy, but here also the decision-taking by Community-wide majority vote is only envisaged for the very last phase of monetary union (from 1978 on).

- The Barre Plan only talks of "harmonization" and "orientation" for the first phases of integration; and only after 1976 or 1978, it is planned to dismantle the decentralized decision-taking procedure in the national central banks.

So, a common and uniform pressure of monetary policy on all entrepreneurs and labour unions, on all investors and consumers alike is only envisaged to come at the end of the process of monetary integration, rather than at its beginning. The resultant divergencies that must be foreseen to arise in the meantime, foreshadow either a repetition of the well-known practice of denying parity changes for a long time and then suddenly adjust the exchange rate nevertheless or the danger of convertibility limitations - which both have serious disintegrating effects.

Whether sovereignty in the very important field of credit policy will be given up even within six to ten years, seems again open to doubt in the face of the fact that the EEC countries so far have not even found themselves prepared to adopt the rule of majority decision in minor fields of policy, as had originally been foreseen by the founding fathers[1] .

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[1] Article 148 of the Rome Treaty had stipulated that the Council of Ministers would as a rule decide by majority vote. De facto, however, European policy-making is still by unanimous consent largely on the grounds of the 1966 Luxembourg agreement which made the provision of Article 148 practically senseless. Each country has still the right to block policy decisions and to immobilize the EEC. One cannot help but be reminded of this contrast between early, idealistic declarations and later practice of sticking to petty national influence, when one reads the declarations at The Hague.

A Common Standard of Orientation

15. A common central bank policy would be greatly facilitated if it could orient itself by some common standard of policy aims, namely of the money value. This seems the more necessary as one would have to expect widely divergent pressures from the various "national regions" exacted on the new European Central Bank Board. The only feasible way of evading such pressures and the only means to unite a body of various nationals would be to prescribe this common Board a more or less binding rule for action. This would have the advantage that

    - the Board could hint at the rule when under public pressure,
    - alternative opinions within the Board would have to converge around a well-defined standard, and
    - the Board would be forced to act under particular circumstances and would thus not be immobilized by the deadlock of different opinions and interests, as has been frequently the case in international bodies. Such a mutual immobilization of national interests seems particulary big, if the actions that are called for are in favour of stability and therefore unpopular with influential circles.

    The standard could be cast in various forms: It could, e.g., be put down that the Board should decide on contractive or expansionary monetary action,

    - if the movement of consumer prices was out of line with a prescribed norm,
    - if wage increases surpassed a fixed norm, or
    - if the quantity of money did not expand with a predetermined rate.

    Such a common standard of orientation would not only help the Central Bank Board, it would also contribute to synchronize expectations in the various European countries and would by this directly facilitate the task of stabilizing demand developments and the money value.

    The fixing of such a standard would, of course, be difficult, but it could be considered as a test for the true will to integrate Europe. The acceptance of a definitive standard would also tell the population of the various countries what a European currency will mean to them in terms of possible inflation and/or unemployment.

How much Common Fiscal Policy?

16. Similar problems for a union-wide stability and growth policy may arise, if national fiscal policies remain almost completely uncoordinated. However, if a wellfunctioning central bank system sets the global, macro-economic data, the need to harmonize fiscal policies would not be so far-reaching. It would probably suffice to coordinate the size of the national budgets and set a general framework for them, so that they do not upset the policies of the central bank with regard to price-level stability, employment, and growth. But within this framework, national authorities would still have ample scope to exert their influence as to how the budget is to be structured.

    In this context, all the delicate problems of fiscal coordination that are well-known from experience within national federal states would manifest themselves, but as long as the national governments and parliaments would stick to the centrally set

global framework for their expenditures and revenues, this would not affect the function of monetary union.

A Cost-Benefit Analysis of an Early Monetary Union

17. The institutional and legal framework that would ideally comply with smooth working of a monetary union would require a common central bank system and some sort of co-ordinating arrangement for overall fiscal policies of the economic and monetary union as a whole. The substantial concessions of national sovereignty that would be required to achieve this, do, however, not seem possible in the near future; not even the EEC Commission's own drafts for monetary union envisage such concessions.

    It must then be asked: what are the economic costs and benefits of the alternative strategy of forming a monetary union, i.e. of narrowing down the intra-EEC bands for market exchange-rate fluctuations or of definitely pegging intra-EEC par values, *before* policies and policy-making are effectively harmonized. This seems to be the strategy that is envisaged by most officials in the EEC countries and in the Commission[1].

The Costs

18. The possible costs of such a strategy have already been touched on the preceding pages. They may be grouped in the following five categories:

    - The cost that with closer integration more frequent and stronger waves of imported inflation will occur in the up to now more stable member countries, and the cost that imported deflation and unemployment will become more clearly felt in the less stable countries.
    - The cost of faster overall inflation in the EEC as a whole due to the fact that stability-prone attitudes in the more stable countries are frustrated and finally given up.
    - The cost of regional problems in those parts of the European Community that have had a tradition of wage push; and the danger of an unwanted agglomeration of economic activities in those parts where labour has been relatively disciplined.
    - The cost of sizeable financial transfers from the prosperous (stability-prone) regions to the (wage push) problem regions in the EEC, which might entail resistance by the paying partners.
    - And, because of this, the danger of a setback in integration policy; an attitude of hostility towards the objective of integration both in the member countries' public and policy-making circles may arise in these circumstances, once the costs of integration become felt.

    All these potential costs can be illustrated from past experience.

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[1] This attitude was clearly brought to the fore in the EEC Commissions's efforts before the 1970 meeting of the IMF in Copenhagen to oblige member governments that they would not agree to arrangements of limited flexibility between each other.

19. Imported inflation, for instance in West Germany, has again and again upset a population which is very sensitive to price-level rises because of the fact that the generation which now runs the country lost much of their fortunes in two inflations (in 1922-24 and in 1945-48). The German population is by experience convinced that inflation as such is a social cost.

    With closer integration, it can be expected that the possibilities of a national stability policy will become even smaller than they have already become. Once the convertibility limitations that still exist among the member countries are removed the scope for national monetary policy will shrink to almost nil. Shall the German Central Bank in these circumstances simply declare that it has to give up the aim of price-level stability?

    It seems hard to imagine that political leaders will be able to convince the man in the street in Germany to accept a European currency, if they cannot at the same time point out that this new currency will be at least as stable in its value as the D-Mark. And it would not seem very convincing that the European currency was more stable, if there was not the guarantee of binding rules that would oblige those member countries, which look back on a past with relatively high inflation rates, to stick to stability as defined in Germany (this is a further reason for an orientation standard - see para 15).

    The reverse type of integration cost will be observed in the less stable countries. Public opinion will be hostile to those foreign competitors that exert - from the outside - deflationary pressure and that supposedly cause unemployment (one need only be reminded of British complaints about unfair foreign price competition). Only that - within a monetary and economic union - such deflationary pressures would make themselves felt much more immediately and strongly.

20. In the longer run it is plausible to expect that the world-wide trend to more inflation would also affect the up-to-now more stable European countries. Repeated disappointments and deceptions in the form of experiences of imported inflation in an ever more closely integrating world will make for an adaptation of trade union and entrepreneurial attitudes towards faster wage and price rises. And, once no country is prepared to hold down the price-level developments in the Community by sacrificing consumption or investment, there will be an acceleration in the total rate of inflation in the EEC. Similar developments - i.e. a growing reluctance to sacrifice consumption, investment, or employment for the sake of stability - could already be observed in the western world as a whole all through the 1960s.

21. Regional inequalities are wide in the EEC. The premature fixing of intra-EEC exchange rates - i.e. also the fixing of the relative costs of production - would tend to widen these differences or at least would make it harder than it is now for the more backward regions to compete for investments by low labour costs. This is the problem of the south of Italy, where long standing traditions and the distance from markets cannot be made good by a policy of lowering the costs of production for outsiders and potential investors by devaluing the "South Italian Lira". This is also the problem of Northern Ireland or of Brittany. Had these regions a device to lower their wage costs for buyers in the industrial centres of Europe, they could attract more capital and industries and needed not be long-run problem regions from which labour is migrating away into the congested industrial centres.

22. Various EEC structural programmes foresee intra-European structural aids and transfers. This policy is motivated by the want to equalize living conditions all over Europe and is intended to compensate for unfavourable locational factors. However, these efforts can easily be more than outbalanced by the market effects within an economic union that run contrary to them. If, e. g., Northern Ireland were included in future EEC programmes of regional restructuration, these aids might well be fruitless, if local wage cost of production in Northern Ireland was too high as compared to competitors in the monetary union that were closer to markets, e. g., North-Rhine-Westphalia. The possibility of lowering North Irish wage cost vis-a-vis their German competitors by devaluations would be excluded, the economic drag would be much more heavily felt than it is already now, since the jobs in Northern Ireland would not only have to compete on equal terms with those in England but also with those on the Continent.

    Monetary union would furthermore enforce tendencies to equalize wage levels all through Europe, since the cross comparison of nominal wages would become more easy than it is now.

23. The combination of traditional economic backwardness and of relatively high production costs will make necessary sizeable transfers from the richer to the poorer parts of Europe. The flow of transfer capital will be substantial and will have to be maintained for very long periods of time. It will be considerably higher than those intra-regional transfers that are carried through in big European countries right now, since structural differences are bigger and since pricing and cost attitudes vary more widely between nations than within one.

    It must be asked whether transfers of this size and duration will find public and parliamentary support in the paying regions. European solidarity, and not the traditional bonds of national solidarity, would have to back the financing of regional policies. Will the voter in the Ruhr understand that he has to forego an additional autobahn in favour of structural investments in the mezzogiorno or in Scotland, especially if he sees this in combination with local strikes there or supposedly ill-managed public institutions? Resulting stresses on integration efforts are easy to imagine.

The Benefits

24. The benefits of monetary union are, it seems, frequently rated very high, but they are rarely quantified or even specified.

    Apart from the psychological effect that a monetary union can form a very strong bond and strengthens the feeling of togetherness, the economic benefits lie in the following fields:

    - Computations and transactions are made easier, if exchange-rate variations can be excluded. This would particularly hold true if the par value were set at 1 : 1. The exchange risk would disappear. This would facilitate trade.
    - Banking charges for transactions within the economic and monetary union would be minor to what they are, if the economic union is not at the same time a monetary union.
    - Convertibility limitations would be ruled out.

25. The latter appears to be the most important economic benefit. Limitations to free convertibility, or even the risk of their imposition, can easily hinder the free flow of capital, goods and entrepreneurial activity. If an investor cannot be completely sure that he can change back his yields at any moment from an investment in another region of the economic union, he may well hesitate or be only induced to invest abroad by an abnormally high profit. Under this aspect, the repeated infringements of the rule of free convertibility in the last years[1] weigh very heavily as obstacles to fuller integration (paras 6 and 7 above). Even if these obstacles were removed right away within Europe, it would take a long while until full confidence in convertibility guarantees would return.

26. However, past experience shows that limitations to free convertibility were introduced in defence of fixed parities, which demonstrates that the important benefit of free convertibility is often sacrificed for fixed rates, i.e. for the other economic benefits and for supposedly political reasons.

    The net saving of costs of easier computation and transactions and of banking charges by sticking to fixed parities that are in a disequilibrium does not seem substantial, since convertibility limitations give rise to heavy extra costs, e.g. to sizeable costs for hedging prospective receipts against the risk of parity changes or new limitations to convertibility. But even if a fixed parity does not entail convertibility limitations, it seems doubtful whether the additional cost of converting values from one currency denomination into another weigh very heavily, since traders are specialized in calculation anyway and since the risk of exchange-rate changes can be hedged

    - by selling or buying prospective receipts or payments in the forward market,
    - by taking up a credit in a foreign currency equal in amount to a future receipt (or, on the reverse, by giving a foreign-currency credit equal to a future payment), or
    - by stating contracts in one's own currency.

    All these possibilities of risk evasion will cost a price, but the price will not be very high, as long as there is no great exchange-rate disequilibrium or risk of convertibility limitations. As long as these conditions hold, banking charges in international transactions will hardly be much above those in national transactions, as competition between banks will hold the price of bank services down. High conversion cost and difficult calculations are - to repeat ourselves - not the consequence of different currencies as such, but of disequilibria between them and resulting limitations to convertibility.

27. So, if the economic benefits of monetary union are not to be rated very high, what about the possible political benefits? If it is the will of the European peoples to cooperate and to form wider markets with equal investment opportunities and a wide choice for consumers, this will also be possible with several independent currencies. It is ridiculous to maintain - as it is sometimes done[2] - that the alternative of monetary union is a re-nationalization in Europe.

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[1] For example, West Germany introduced a "coupon tax" on yields of certain types of portfolio investments by foreigners; France reintroduced heavy controls of her international payments on May 31st 1968 after the revolts; Italy is far from anything like free convertibility of the lira.

[2] Mosconi, A.: Comments on Mr. Kasper's Paper: Requiem for European Integration. In: Halm, G.N. (Ed.): op. cit. p. 388.

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On the other hand, we see the risk of political tensions in Europe, if exchange rates are pre-maturely and artificially fixed, i.e., if monetary union is introduced before the basic pre-conditions are warranted. The same tensions as exist between regions in countries, where there are considerable economic inequalities (as, e.g., in France between Brittany and the centre, or as in Great Britain between Scotland and the South of England) can be expected in Europe, only

- that these tensions are not tempered by strong bonds of national solidarity and
- that these differences are much larger than within one single country.

These tensions may well transform themselves in centrifugal political forces, that bring an end to monetary union, just as the failure of those many historical experiences with monetary unions that were not held together by the same central bank policy. The tensions in the Latin Monetary Union founded in 1865 and its final breaking-up in 1926 illustrate this clearly[1], although economic integration between the members was a lot looser than it is now, so that disequilibria could be maintained longer than would be nowadays possible. The quick dissolution of de facto monetary union between metropolitan France and her former territories (franc zone), once political and central bank influence was decentralized, is another case that might be quoted here. And it seems worth mentioning that the unification of Germany in the 19th century, which is considered by many as a model case for European unification only led to monetary union at a very late stage.

Conclusion: An Alternative Strategy

28. All this must not necessarily sound destructive, on the contrary it should be considered as a plea for an alternative strategy of economic and monetary integration: Since it will probably take at least a generation to alter the deep-rooted attitudes of entrepreneurs and trade unions that make for different long-term cost and price trends ("natural rates of inflation"), an elastic device is needed to facilitate the growing-together of national markets with equal competitive opportunities throughout and with a wider choice for buyers: This device could be the introduction of limited flexibility between the member currencies:

    - This would have the advantage of greater national economic sovereignty in the transition period without doing harm to other countries and without the necessity of meddling unduly in other countries' affairs.
    - Limited flexibility would further help to avoid balance-of-payments disequilibria and resultant interventions against free convertibility which would facilitate functional integration.
    - Intra-EEC rates would probably not vary widely (by more than 3 to 5 p.c. annually between the most stability-minded to the least stability-minded European nation). These variations would be foreseeable and can therefore not be considered a heavy burden on intra-Community trade and payments.
    - Common agricultural policy that is based on prices fixed in US-dollars could, in the computer age, also be handled under limited flexibility: intervention prices could be

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[1] Krämer, H.R.: Experience with Historical Monetary Unions. Kieler Diskussionsbeiträge 6. Kiel (June 1970) p. 1.

converted either by the current cash rate, or by a parity that is the lagged average of market exchange rates which could be guaranteed for a crop year[1].

29. Such an elastic device would leave due time for the harmonization of policies, but it could be tailored so as to exert a certain pressure towards more parallel policies. As Stephen Marris has recently pointed out, the introduction of limited flexibility in the EEC together with the exclusion of large parity changes of the conventional kind could well work as a device to permanently educating European policy-makers to harmonize national legal frame-works and basic attitudes and get them to accept the full consequences of monetary union[2]. It could be imagined to start with the permission of an upward or downward crawling peg by a maximum annual rate of 3 per cent. Once it is well proven - let's say, over ten years - that policies in Europe are harmonized enough to let this system work smoothly, the crawl rate could be reduced to 2 per cent, and in a third step to a maximum of plus or minus 1 per cent annually. Once it is proven that this works without sizeable balance-of-payments disequilibria and under full convertibility, the final step of monetary union could be done.

30. This procedure is more pragmatic and less spectacular. It seems politically less risky, as it is based on sound economics. And it would make sure that the clocks in Europe are synchronized, not because the handles are artificially bound together, but because the clock-works are well tuned.

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[1] Josling, T.: Exchange Rate Flexibility and the Common Agricultural Policy of the EEC. In: Weltwirtschaftliches Archiv. (March) 1970. p. 57.

[2] Marris, S.: The Bürgenstock communiqué: A Critical Examination of the Case for Limited Flexibility of Exchange Rates. Princeton 1970. p. 28.

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