AN APPEAL FOR A REALISTIC EUROPEAN MONETARY UNIFICATION POLICY :

The choice : a single or a parallel currency

by Francis Woehrling *)

After many years of progress since 1958, the movement towards an Economic and Monetary Union, an element of a larger European Union, has stalled and is giving way to an intensive search for new approaches.

The Manifesto for Monetary Union and Stability, published in the London Economist on November 1, 1975 as the "All Saints' Day Manifesto", mostly of monetarist inspiration, holds the failure to be due to the lack of "political will". Accordingly it advocates more "efforts" to reach a Monetary Union in which a single currency is used and a single monetary policy, backed by budgetary transfers, is implemented.

Other economists, who are of more eclectic inspiration, and whom we shall refer to here as the advocates of a "New Monetary Unification Policy" (the "New Policy"), believe that lack of economic imagination, as well as political will, lie at the root of our present difficulties. They argue in favor of a more subtle unification policy devised to support, by calculated exchange rate adjustments, economic integration through long transitional stages, during which the very divergent national economic systems will be homogenized by market forces as the economies open up to each other. They therefore conclude that the single European currency, stable or not, is undesirable and costly as long as the economies diverge but that a parallel currency is needed to satisfy the needs of intra-European trade and commerce. According to them, the politicians' instincts were basically correct in refusing to subject very diversified European economies to a centralized economic management - even if this uniformity were imposed, as in the Manifesto, by the best currency in the world.

The proponents of the "New Policy" believe that the integration policy pursued in the past broke down mainly because the instruments developed for governments to cope with the problems raised by the European integration

*) The author, an economist in the Monetary Affairs Directorate of the Commission of the European Communities, writes in his personal capacity. His views do not necessarily reflect those of the Commission or its staff. The Commission's policy is stated, inter alia, in its "Report on European Union" (sections 40 to 42).

process were insufficient. The governments therefore rightly refused an intolerable burden. But, if economists were to devise means to alleviate this burden - mainly by solving the additional problems that arise from the state of semi-integration that presently characterizes Europe - enough "political will" would be forthcoming to implement a reform that would be beneficial to all. The "New Policy" is based on such instruments viz : (1) a common currency, the Europa, to be substituted for the Euro-dollar and thus to do away with the disturbances it causes; (2) a controlled exchange rate flexibility to support economic integration (a speedy transition to fixed exchange rates is advocated, de jure, by the Werner plan and, via the single currency, by the Manifesto); (3) more independence of fiscal policies to combat unemployment, supported if necessary by borrowings from the European capital market (the "Europa" market). Having regained control over the separate facets of their semi-integrated economies, the European countries would then be able to pursue a more stability-orientated monetary policy.

The Manifesto, on the contrary, argues that exchange rate flexibility and monetary and fiscal policies are, "in the long run", inefficient and should be abandoned : the long run is very short, the Phillips curve does not exist, demand management is a delusion. Exchange rate changes therefore contribute nothing to the adjustment of divergent economic structures; they merely prevent diverging monetary policies from disturbing integrated economic life. Consequently, a very strong parallel currency is needed to eliminate the national currencies and to deprive the central banks of their powers. Underlying this reasoning, there is a political position : the politicians' interference with demand management is harmful. The "New Policy" believes national governments have been overwhelmed by the already sizeable integration of European economies and must be helped to perform still useful tasks.

The Manifesto's reasoning, if correct, would destroy the bases of the "New Policy" and the instruments with which it seeks to render the European integration process less costly : for the latter, the Europa is an instrument aimed at promoting orderly financial conditions during the economic integration process by stabilizing the currency composition of the portfolios of European firms by offering an attractive substitute for Euro-currencies;

.../...

for the Manifesto, it is a device for firmly establishing a strict rule, a new feature of an otherwise conventional monetary policy aimed at stabilizing a price index. The "New Policy" aims at a balanced, and therefore less costly, integration process, the Manifesto at a traditional price stability policy in disregard of economic integration.

As a result, if the Manifesto's arguments were to hold, we are driven back to the "all or nothing" proposition of a "gradual" (but rapid) transition to a Monetary Union, inflation-proofed but supported by taxes and transfers, and to the "political will" necessary to impose these.

Thus the Manifesto brings the European monetary discussion back to the starting point - and farther for its proposals are even less realistic than those of the Werner plan : its transition process is faster and its targets more demanding. No doubt, its transition process is more elegant and smoother than that tentatively sketched by the Werner plan, but the technique of converting national currencies is secondary. The real issue is the imposition of a single currency on economies that remain diversified, thus admittedly necessitating budgetary transfers. These must be more massive the more stable the single currency.

Before clamouring for more "political will" and then giving up hope, one might do well to examine whether the Manifesto is correct in assuming that the European economic structures are so flexible and fluid that exchange rate changes are useless. The Manifesto has been careful enough to attack exchange rate unification by fiat (something which has been all but officially abandoned) and to avoid discussing the usefulness of moderate exchange rate changes for supporting the integration process as put forward by the "New Policy".

The "New Policy" also requires political will : the will to implement the necessary reforms leading to an improvement of some of the powers of national governments as well as to a centralization of a large part of their monetary policies and to the imposition of changes on the Euro-markets. But not a will to accept the sudden death of national monetary policies and the abandonment of all demand management.

*

*　　*

II. The "New Policy"

1. The innovations since the Werner plan

The Werner plan is a complex document describing the many social, economic and political facets of a monetary and economic union in its transitional and final stages. In the more technical field of monetary union, the plan advocated - at a time of already considerable exchange rate stability - further progress towards an exchange rate union which it conceived mainly as a tool for speeding up the harmonization of demand/management policies, thus making the issue of a single currency possible. Supporting structural policies (aimed at harmonizing the diverging European economies), based on considerable budgetary transfers, were clearly seen as a prerequisite of such a Union. The Manifesto sees no means other than structural policies based on transfers for adjusting economies. Its integration policy therefore does not differ substantially from that of the Werner plan. This leads to the conclusion that "political will" is needed to achieve such large transfers of wealth and sovereignty.

The New Policy, on the other hand, puts forward three principles:

- Exchange rate flexibility is needed for some time to support the real integration of divergent economies;
- A parallel currency is needed to deal with the financial consequences of the economic integration of the markets;
- European integration has already deprived national governments of their real power in monetary matters; there is little sovereignty left to be transfered to the federal level.

The New Policy set out to strengthen national policies as well as to "coordinate" them at the Community level.

2. The analysis of the New Policy

A. Exchange rate flexibility was shown to be a useful tool for reducing the divergence between European economies and an indispensable adjunct to the structural policies. Consequently, the rapid transition towards a single currency and/or the narrowing of exchange flexibility was rejected as suboptimal even if "a political will" to impose these existed. Such a policy would merely subject the weaker members of the union to cumulative underdevelopment or increasing dependence on transfers. Exchange rate flexibility was to remain moderate because the proponents of the New Policy were well aware that excessive depreciation would throw the depreciating countries into an inflationary spiral. The higher the degree of openness, the less this instrument was to be used; openness develops with integration.

B. A parallel currency was advocated (the term "Europa" was then coined) as the instrument necessary to infuse a measure of monetary order into possibly long transitional stages.

. First, it was shown that any economic integration would lead to "monetary difficulties". Adopting modern monetary (portfolio)theory to the situation where very open national economies, each using its own currency, coexist, the New Policy showed that efficient and rational behaviour would inevitably lead firms, because of the very conditions imposed on them by doing business in Europe, to behave as follows:

(i) They would use various financial instruments denominated in several currencies and continuously alter the composition of their holdings as interest rates and expectations changed; this leads to capital flows that disrupt economic life and constrain monetary policies;

(ii) They would preferably include the most widely-traded financial assets denominated in the most important currencies in their holdings. Thus European economic integration explained to an important extent the growth of the Euro-dollar market and, later, the markets in other Euro-currencies.

One major drawback of using the dollar in Europe, as liquidity for European business, is that its supply conditions are mainly determined by US monetary policy. This is perhaps the major burden placed on the European Governments' policies. A first priority is to alleviate the already sizeable burden originating in the use of multiple or "parallel" currencies.

The New Policy thus concluded that such "monetary disorders" (i.e. the "unavoidable" changes in the composition of financial holdings) made any co-operation exceedingly difficult; governments should not be expected to devote themselves to such a task; yet, at the same time, it also concluded that the inevitable development of such parallel currencies in integrated areas makes the coordination of such monetary policies imperative (because independent action is inefficient).

. Second, it was concluded that the time had come to do away with the monetary arrangements, characteristic of the early stages of integration, necessitating the use of the dollar, and other national currencies, for conducting business in Europe. Accordingly, a large scale redenomination of European assets and liabilities, denominated in dollars and other Euro-currencies, was advocated to replace, overnight, as it were, the Euro-dollar and other Euro-currencies by a large and attractive Europa zone ; the European Fund for Monetary Cooperation would be reformed. No other institutional changes would have to be made in the present highly liberal set up of the Euro-markets. Financial institutions and supervisory agencies would continue to act as before. The change-over to the Europa could, for example be engineered by a temporary (e.g. 6 months) prohibition of dollar holdings in Europe by European residents. Non-residents would continue to have the right to hold Euro-dollars in Europe. The authorities would commit themselves to maintain a "strong" Europa during the years following the change. (1)

Thus, the New Policy also requires "political will": the will to impose changes on a powerful and tradition-bound private sector; the will, for some countries, to accept temporarily the amount of controls necessary for carrying through the redenomination; the will to accept the policies needed to bring about a strong Europa; but this is a will of a different kind from that of the Manifesto. It is not a will to impose fundamental changes in national policies and to fight inflation by speedily discarding national currencies but a "will" to implement the reforms called for by the very nature of the integration process; a will to act perhaps against the short-sightedness of the Euro-financial community (whose long term welfare and independence these reforms ensure) and against the general lack of imagination which has characterized action or the failure to act in this field.

.../...

(1) The conversion of Euro-dollars into Europas may appear to many as an undue and politically unacceptable interference with the markets. This objection would be fully correct if the amount of "European" Euro-currencies were negligible. If this assumption does not hold the choice will increasingly be between exchange controls which interfere with the markets but do not solve the problem, and the conversion operation which in comparison appears as a liberal solution. Furthermore, if the need for a common European Currency is sizeable, the markets are, to a great extent, indifferent as to which currency they use, provided this currency will be a good one. The value of the Europa is ensured by the explicit commitment of the authorities described below (p. 9 *); its liquidity by the conversion operation itself.

. Third, the New Policy sought to achieve three targets :

1. "Monetary disorders" would be reduced because their "raison d'être" would be eliminated. A satisfactory currency for intra-European and international trade would meet the operators' need for a common, liquid, and moderately stable currency. The scope for speculation would also be reduced but few economists will argue that this represents a considerable social loss. As far as the weaker currencies are concerned, once the need for restructuring private financial holdings has been satisfied, exchange and capital controls are likely to be more efficient since they would no longer conflict totally with the irrepressible force of markets in need of a common currency. In particular, if the dollar should weaken again, international business would find another acceptable currency besides the DM. DM appreciations, aimed at reducing capital inflows into the German economy, but detrimental to its partners' price stability, could be avoided.

2. After the conversion of euro-currencies into Europas, the authorities will obviously have gained more control over the European liquidity base than they can ever hope to have with the Euro-dollar. The deposits of the Euro-banks in New York now are naturally largely determined by US policy. The conversion will strengthen control by the authorities on both sides of the North Atlantic over their economies and improve the working of the entire International Monetary System. One must not forget that, as highly authoritative voices have claimed, monetary policy in the United States also now requires protection against the ebbsand flows of Euro-money.

3. The authorities will have set up a Europa that captures the features of the Euro-currency market. The Europa will not circulate among the European population at large; there will not be excessive inducements to denominate wage contracts in Europas. The continued use of exchange rate flexibility as an instrument of economic adjustment will not be jeopardized (as is the case with the Manifesto which aims at displacing the European currencies rather than the dollar ; the latter's high liquidity compensates for its comparatively lesser attractiveness in terms of price stability).

C. The idea of a "transfer of monetary sovereignty", commonly associated with European monetary unification, was criticized by showing that the actual degree of openness of the markets and the use of financial assets denominated in non-national currencies had already taken away much of the substance of

.../...

national power. Important exchange rate depreciations and domestic monetary policies strongly divergent from the general trend, only lead to inflation. A limitation of these powers to what the money and exchange rate instruments can still reasonably achieve is no limitation of economic sovereignty. Therefore the New Policy argued that if governments were to implement institutional changes, explicitly taking into account the actual degree of integration, they could actually recuperate a moderate amount of their lost power, mainly by reducing "monetary instability" and dependence on the dollar.

3. The New Policy's proposals for a reform of the institutional set-up of the transitional stages are based on the belief that, if the governments are given adequate means to cope with their legitimate national problems, mainly their employment problems, there will be enough "political will" to accept this new institutional set-up. It advocates therefore two types of measures :

(a) The strengthening of the national governments in certain areas because the solution of real economic problems requires this measure, and because it is politically unwise to ask them to commit themselves to abandon all powers, as is implicit in the Manifesto. According to the New Policy, the national governments should be strengthened (especially in comparison with the Manifesto proposals) by

- the introduction of a moderate exchange rate flexibility (that results in a greater degree of freedom of their monetary policies) and
- a larger degree of independence of their fiscal policies which would be supported inter alia by governments borrowings on the European capital market (the Europa market);
- reducing the burdens imposed on them by the monetary disorders implied by the (hitherto unavoidable) use of Euro-currencies through the issue of a Europa (in particular, capital controls could be more efficient) and by giving them instead a voice in the management of the Europa.

(b) Implementation of a European monetary policy. The New Policy underlines that - given the increase in their real power - the member governments should be prepared to recognize the fact of their actual national monetary dependence and to discuss the means of implementing European

.../...

monetary independence. The new European monetary policy would consist of determining, on the basis of various considerations, the rate of growth of the Europa and would result in a Europa-dollar exchange rate. It would be implemented by a reformed European Fund for Monetary Cooperation which would decide on the maximum permissible annual percentage changes in the central rates of the member states. National monetary and exchange rate policies would be used to implement, within each nation, monetary and economic policies at variance with the Europa policy. National governments would retain, with respect to the Europa policy, about the same effective power as they presently have; they would, in addition, gain a voice in managing the Europa; at present they have no say in dollar policy. The Europa monetary policy would have to strike a balance between stability and growth. The policy would be more stability-orientated than the present system for at least two reasons : the Europa system would replace the inflationary Euro-dollar system; the authorities would have to commit themselves to a moderate appreciation of the Europa-dollar rate and to no sizeable depreciation of the Europa-DM rate during the initial phases.

One of the major benefits of conducting an explicitly European monetary policy would consist in bringing into the open the fact that, the larger the amount of intra-European transfers, the more monetary policy could be stability-orientated. The Eüropean Council could discuss this genuine political issue in more rational terms than is possible today.

.../...

III. The Europa and the Manifesto

While the Europa advocated by the New Policy grew out of the above-sketched analysis of the integration process as a means to reorganize this process, the Europa of the Manifesto results from the confluence of two strands of economic thought : an older one, consisting mainly of the critique of the Wernerian technique of exchange rate unification by fiat; and a newer one, representing the monetarist view with respect to demand management in general.

a) The first strand is liberal but not necessarily monetarist; it objects to the cartel-like aspect of the Werner plan (exchange rate unification by fiat) and to the New Policy proposals for introducing the Europa by administrative incentives and orders. This liberal approach wishes to promote competition among European currencies (viz. co-circulation of all currencies in all European nations). The indexing of the Europa is merely seen as the means of rendering it attractive, despite its initial lack of liquidity, and thus of assisting its penetration into the domains of national currencies. At the beginning the progress of the indexed Europa could be slow because it lacks liquidity; but as soon as its liquidity develops the national currencies would be wiped out, except for the dollar and for some time the DM. At this stage of the development of the idea of an index-linked Europa, three objections were raised : first, during the initial stages, this currency may well not take hold (because of its lack of liquidity, because of exchange controls, or because depositors in Europa would earn negative interest rates, especially if competitivity equalizes the effective yield of the Europa to that of comparable but more liquid assets). Second, once the currency became successful, it would destroy the weaker European currencies first (entailing the distinct possibility of protective exchange controls and hence of the decline of convertibility). Finally, once the "index-linked single European currency" had replaced all other currencies, the intra-European exchange rate mechanism would become inoperative. This system would thus have brought about the suboptimal single currency. It was thought that this was a high price to pay for ultra liberal "ideals" that could not accept even a measured amount of government intervention in the money markets at a time when a mixed economy and government interventions prevailed in all other sectors.

.../...

b) The second, the monetarist strand, made a virtue out of this defect. National currencies must be eliminated because exchange rate changes contribute nothing to the adjustment of divergent economic structures; they merely prevent diverging monetary policies from wreaking havoc on an otherwise harmonious business world. National currencies must be eliminated because central bankers and politicians must be deprived of all power to conduct economic policy. The long discourse in the Manifesto on the presumed non-existence of the Phillips curve is aimed at establishing that exchange rate changes and indeed monetary and fiscal policies have no effect in the "long run" (the key-word of the Manifesto). For the Manifesto, indeed, the "long run" is very "short"; there is no need of, and no possibility for, an anti-cyclical policy; fiscal, monetary and exchange rate effects are washed out "in the long run", i.e. so rapidly that they are not worth being undertaken. Only structural policies have effects. All this is subsumed in the Manifesto's tirade against the Phillips curve.

For the New Policy, such an approach is utterly biased and unfounded: there are other rigidities besides those in the labor market; the Phillips Curve, at best, captures only one part of reality. Besides, even in the narrow field of Phillips curve analysis, the Manifesto's contentions are far from reflecting the scientific consensus. Calculated exchange rate changes have beneficial effects for the export sector; their effects are different from those of domestic inflation and it would be legitimate to reduce exchange rate policy to the imposing of an undifferentiated inflation tax, as the Manifesto does, only if economies are very open. Above all, the short run (in which exchange rate and demand management are efficient) is quite long. There are therefore "in the short run" other measures to support the European integration process beside government transfers.

As a result of its monetaristic slant, the Manifesto ends up by supporting the essential features of the old Werner plan : a single currency, monetary and budgetary harmonization, leading to a full-fledged centralization of economic management. To this, the requirement of a 100 % price stability is added. This implies, of course, high intra-European transfers and hence continued dependence of some regions on subsidies from others, as administered by a large central government. Successful adjustment of economies through exchange rate changes produce an increase in the domestic saving rate of the depreciating country.

The Manifesto rightly concludes that "political will" is needed to impose the new centralized European state against legitimate national interests, a monetarist stability policy against the will of large groups of voters (the Unions) and a suboptimal integration policy.

*

* *

The proposals presented here as the "New Policy" combine the views of several authors, mainly J.M. Fleming's criticisms of exchange rate unification; the contributions of G. Magnifico and the proposals of the author of the present text, F. Woehrling.